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Eco Analysis
Russia

Bank of Russia to become more 'decisive' with policy easing

The Central Bank of Russia (CBR) has quickly softened its monetary guidance, which came as a surprise to us and the market, though inflation recently broke below our forecast of 4.1% yoy and the official range of 4.0-4.5% for 2019. Last Friday the CBR Governor Elvira Nabiullina mentioned room for a "decisive" move, which we view as a bold signal that a 50bp cut (to 6.50%) is possible at this month's meeting (25 October), combined with possible off-schedule downgrade of inflation projections.

Inflation falling below the forecast was probably not the only reason for this change in the CBR's view. We think the regulator's perception of economic challenges has changed so that it is now in favour of more active policy moves inside the neutral rate (6.0-7.0%) and likely below. In light of this, easing could gain momentum in 1H20, when we expect CPI growth to flirt with 3.0% yoy, but it will likely lead to more volatility in inflation, rates and FX dynamics.

How to interpret the recent signal from Nabiullina on a 'decisive' rate cut?

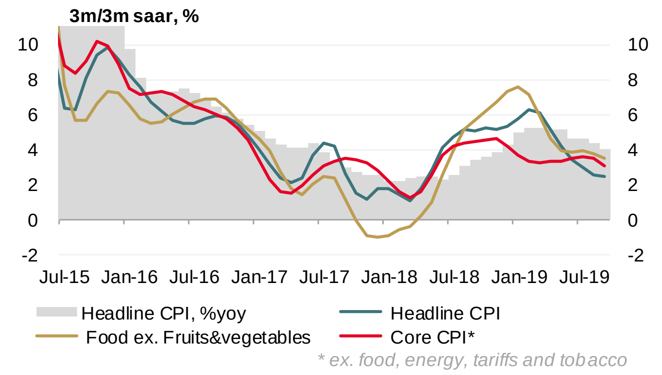
While the initial monetary policy guidance conveyed in September ("to consider the necessity of further key rate reduction at one of the upcoming meetings") was neutral, or at best sent a dovish signal for the December meeting, the past couple of weeks turned things upside down. One reason for this could be the greater attention being paid to policy framework by President Vladimir Putin, who noted on 25 September some "spinning of macroeconomic indicators" by the CBR. Later, on 10 October, Nabiullina surprised with a hint to make off-schedule downgrade to inflation projections. All this helped the economic consensus drift consistently towards a 'moderate' policy rate cut of 25bp on 25 October. However, Nabiullina's last-minute interview with the CNBC news agency indicated an even more "decisive" move at the next CBR meeting.

The CBR has not been explicitly managing market expectations for some time (since late 2017), so a clear signal for "decisiveness" likely indicates a soft commitment to a 50bp rate cut. With the monetary stance staying virtually neutral inside the defined range of 6.0-7.0% for the key rate, such a quick shift to 6.50%, combined with dovish guidance, would inevitably lead to a debate about the consequences for medium-term monetary policy and the terminal rate level.

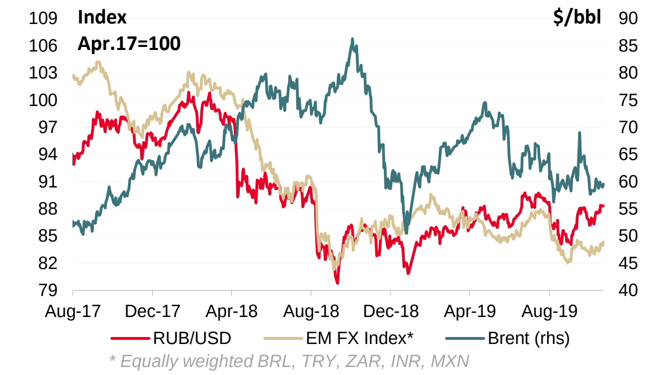
How critical was the change in inflation in 3Q19?

Disinflation in Russia has deviated from the usual seasonal pattern, gaining strong momentum in mid-October. According to weekly inflation reports, the CPI growth rate slowed to 3.8% yoy on the week to 14 October, well below our previous forecast and the lower bound of the CBR target range (4.0-4.5%). These figures are not directly comparable without detailed monthly data, but this nosedive could hardly be mitigated by broader statistics in the next couple of months. Moreover, it seems that inflationary risks have not only settled down in 3Q19 (e.g. owing to successful government regulation of the gasoline market), they also turned around owing to a good harvest season, depressed consumer demand and limited pass-through of producer inflation to consumer prices.

Inflation has geared down strongly



External backdrop did not respond to CNY and oil volatility



Source: Rosstat, Bloomberg, SG Cross Asset Research/Economics

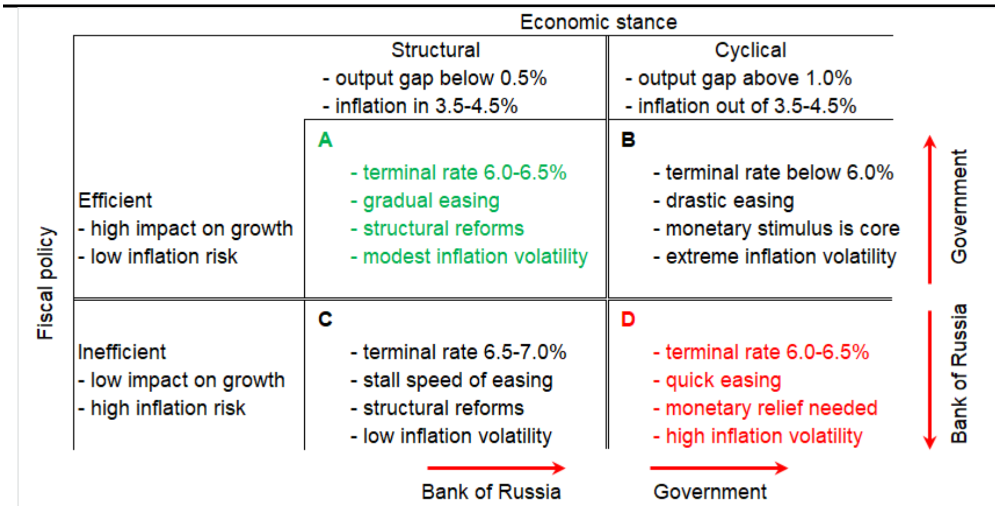
Finally, the ruble demonstrated unusual resilience to external shocks. The CNY-driven turmoil on the EM FX market has not evolved into a vicious circle since August, so competitive local real yields coupled with global easing sentiment continued to fuel portfolio inflows into sovereign bonds and drove attention to valuations of other domestic assets. Other than that, a stronger RUB/CNY real effective exchange rate (+4.4% yoy) could have also contained pass-through risks for domestic inflation related to costs of imports from Asia. As such, we believe the significance of exogenous drivers of inflation has declined for end-2019 and 2020.

What could make the CBR change its mind about guidance and the key rate?

Our quick answer to this question is that a more decisive CBR implies a strengthened expectation of cyclical deceleration. Consider economic policy along the two axes: 1) whether cyclical or structural forces keep driving the ongoing disinflation; and 2) whether fiscal policy will be able to boost economic growth in the medium term and affect its long-term potential. A backward-looking analysis is insufficient, as we have a short history of inflation targeting, and this period was associated with heterogeneous shocks. However, a forward-looking analysis must also be adjusted for the government's loaded economic agenda, and we need to filter out the expected medium- and long-term impact of fiscal policy.

Below, we present our view on economic states that could fit the Russian economic environment at the moment. These states are subjective, both for us and for each economic regulator; however, they are not known and could be incorrectly specified. In particular, each regulator may identify a separate state because of prior beliefs or policy goals, which may lead to a suboptimal policy mix.

The CBR likely shifted from structural (C state) to cyclical (D state) issues



Source: SG Cross Asset Research/Economics

We think the government considers the fiscal programme highly efficient (A and B states) in terms of its high impact on growth in economic potential at a low cost for inflation. So, the preferred terminal key rate could be well below the middle of the neutral range (6.5%), and it could be adjusted fast enough. However, the CBR has sounded constructive with respect to fiscal policy initiatives (C and D states), as it is wary of being inconsistent in policy and the potential inflation risks. These points can be confirmed either by assessing the execution of National Projects (inability to follow the budget spending schedule, which could condense spending into a shorter timeframe) or government plans to invest excess cash from the National Wealth Fund (NWF) domestically since 2020. In terms of policy, the CBR likely preferred gradual monetary accommodation either within the neutral rate range (6.0-7.0%) or below.

Divided by columns, the economy might have fallen into structural stagnation (A and C states) with inflation equilibrium in the range of 3.5-4.5%, or it might have been stressed by cyclical shocks (B and D states), with a (likely short-term) plunge in inflation below 3.5%. Ignoring debates about modern monetary theory, structural stagnation in developing countries can hardly be cured with accommodative monetary policy (i.e. the key rate should hover around 6.5-7.0%). On the contrary, a cyclical shock could be softened by a rapid and temporary cut in the key rate to 6.0% or below. So far, in terms of monetary policy, the incorrect specification of structural stagnation could lead to excess loosening of credit conditions and losing of control over inflation expectations, exchange rate volatility and economic sentiment.

With all that said, we believe the government is looking at economic stimulus via the cyclical factors (B state), simply because of the high reputation cost of the slow implementation of institutional reforms and risks of a delayed acceleration in economic potential. On the contrary, the CBR was initially inclined to strengthen its reputation of inflation crusader (C state) but might have seen cyclical forces dominating recently (D state), which tactically enabled it to accelerate monetary easing.

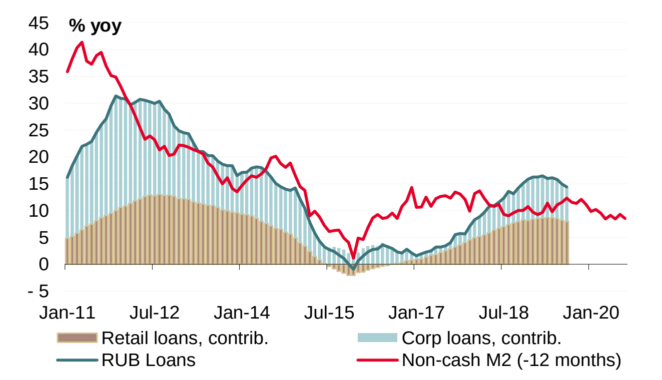
What makes us consider economic slowdown structural rather than cyclical?

The recent economic performance certainly looks bleak compared with initial expectations and the short-term government outlook for GDP growth of above 3.0% in 2021-24. We estimate the probability of a cyclical slowdown at just 20-30%:

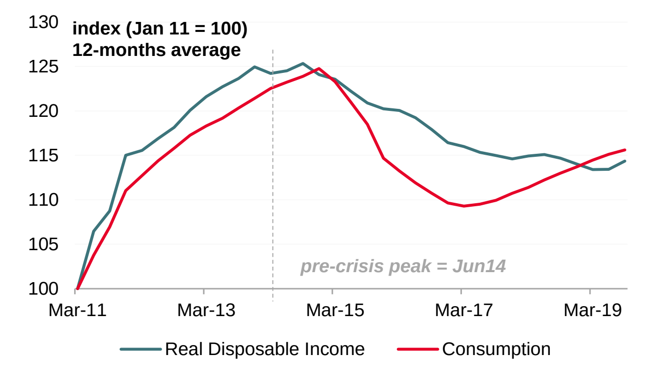
- GDP grew 0.7% yoy in 1H19 amid the slow recovery in private consumption from the VAT rate hike and an idle investment cycle (only inventories performed well). Moreover, household consumption growth continued to slow in 3Q19, coming in at 0.9% yoy, amid slower retail sales growth of 0.8% yoy and weaker inflation momentum.

- The credit cycle (RUB corporate and retail loans decelerated to a respective 10.1% yoy and 21.3% yoy on 1 September) also started gearing down following temporary key rate hikes in 2H18 and tightening credit conditions since 1H19 owing to increased credit risks. Combined with stagnation in non-cash M2 growth (+8.5% yoy on 1 September) over the past several quarters, further compression of the credit cycle should be expected for the rest of 2019 and 2020.

Slower M2 growth indicated lower potential for credit expansion



Real disposable income still at multi-year lows



Source: CEIC, Bank of Russia, SG Cross Asset Research/Economics

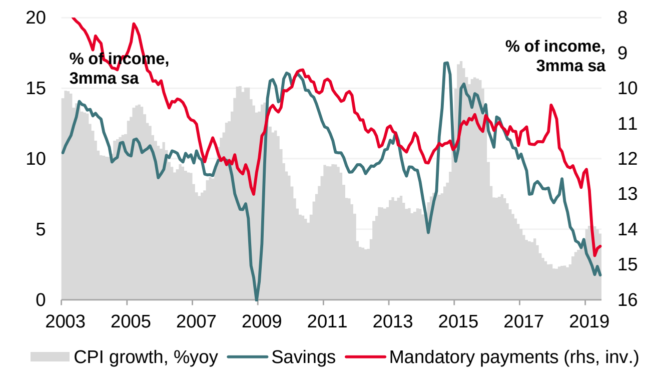
We assign a 70-80% probability to a structural slowdown, with a mix of reduced potential for private, public and external demand growth, and a potentially bumpy restart of the investment cycle.

- One cannot ignore the long-lasting stagnation in real disposable income (+0.2% yoy ytd in 3Q19), which shows there is a shortage of self-sustained drivers of domestic consumption. This point is echoed by the record-low savings ratio and peak mandatory payments from the regular income, which could reduce household consumption potential for many years to come.

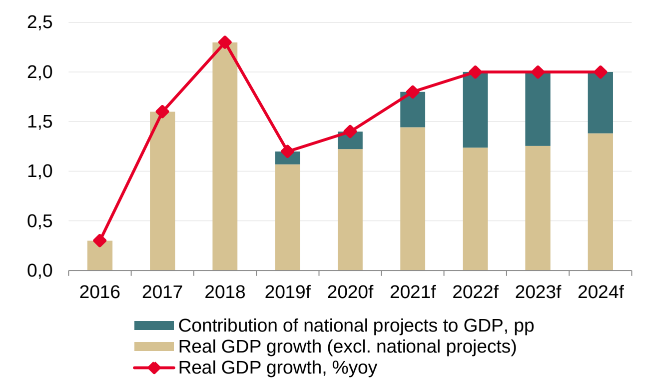
- The government is set to slightly relax the fiscal stance in 2020 and 2021 (by 0.3% of GDP each year), but it will generally remain tight and restrictive for public consumption (successive fiscal surpluses of 0.8%, 0.5% and 0.2% of GDP over 2020-22). Meanwhile, the abrupt switch from a demand-driven to investment-driven model of growth (built in National Projects) may have a delayed impact on economic potential owing to major spending being back-end loaded, earmarked for 2022-24, as well as limited incentive for private capital to participate.

- Structural restrictions may also tighten on the external side if energy markets start pricing oversupply of combustive fuel. This does not imply a quick deterioration in the external backdrop due to an escalating trade war or policy mistakes in developed economies, but rather that rising structural limits for natural growth in EM countries (especially in Asia) will become evident.

Savings rate and mandatory payments are at extreme levels



National Projects likely to fill gaps, but not to spur expansion



Source: Bloomberg, SG Cross Asset Research/Economics

What are the potential consequences of a rapid change in CBR stance?

We can imagine a bolder series of key rate cuts until mid-2020, with a target of 6.0% or slightly below amid inevitable disinflation to c.3.0% in 1Q20 and a sluggish recovery through end-2020. However, subsequent acceleration in monetary inflation would require a quick tightening back to 6.5% no later than 1H21.

Given the dominance of structural factors, we assume the looming easing cycle will become excessive. Namely, a shift in the CBR's view to the D state from the C state (when A and C could be considered the only reality) would inevitably enhance intra-cyclical volatility in inflation and interest rates. Because of this volatility, the value of forecasting the terminal rate could decrease dramatically.

Higher ruble volatility is another potential consequence of CBR decisiveness. The currency should appreciate to USD/RUB 63.0-63.5 in 1Q20 thanks to the improved outlook for capital outflows ($20bn in 2020e vs $35bn in 2019e), even against an expected decrease in the current account surplus ($67bn in 2020e vs $75bn in 2019e) and persistent FX purchases by the MinFin ($52bn in 2020e vs in $55bn in 2019e). However, this could be smoothed out excessive OFZ supply in 2020-22 and uncertainty on how funds from the NWF will be invested (in RUB or USD, and how it is converted). These factors will likely put the ruble back on a depreciating trend towards USD/RUB 65.5 through end-2020 and beyond.

Updated projections

end of period	4Q19	1Q20	2Q20	3Q20	4Q20	2020	2021
Inflation, %	3.6	3.0	3.2	3.6	3.6	3.6	4.5
Key rate, %	6.25	6.00	5.75	5.75	5.75	5.75	6.25
USD/RUB	63.5	63.0	64.0	64.5	66.5	66.5	66.5

Source: SG Cross Asset Research/Economics

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