# On Our Minds

## Let’s talk about quantitative easing à la Russe

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**Despite massive stimulus from the CBR and the government since the pandemic broke out, the end result remains far from optimal owing to elevated long-term rates prompted by oversupply of public debt. The accommodative monetary policy instruments used so far have failed to overcome this issue.**

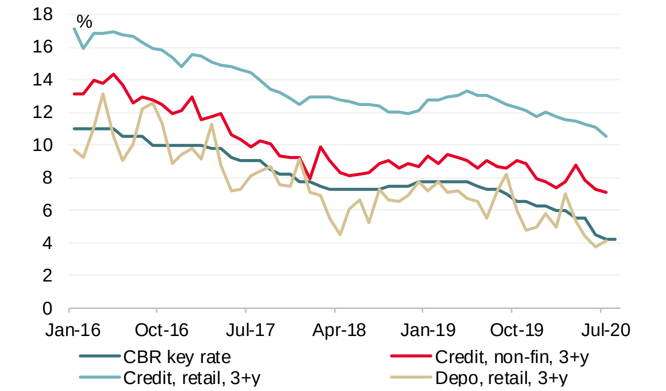
**That is why we think the CBR and MinFin need to cooperate to redistribute the debt burden from 2020-2021 to subsequent years. One solution could involve a cross-currency swap of the National Welfare Fund’s FX reserves. With a rigid framework, such a swap could help overcome the major drawbacks of alternative balance sheet programs that were launched in a number of developing economies during the course of 2Q20.**

**We think that the credibility of the CBR’s inflation targeting mandate wouldn’t be imperilled, while the net impact on the economy via lower long-term yields could be highly positive even despite keeping the key rate flat (SG: 4.25% over 4Q20-3Q21).**

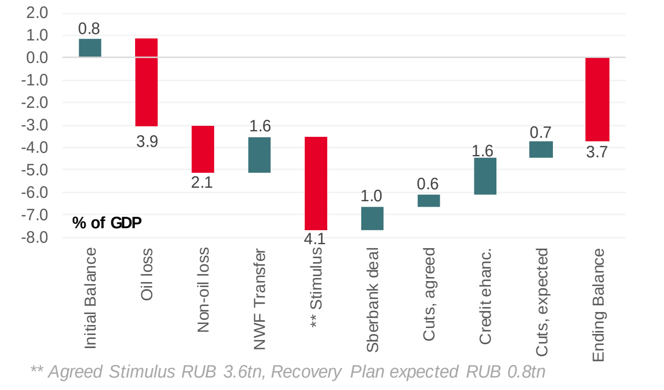
### Re-appraisal of monetary policy tools

The CBR has done a marvellous job stabilising domestic financial and macroeconomic conditions since the COVID-19 outbreak. Key measures introduced include easing of the fair value accounting of bonds purchased from 1 March until 30 September (will expire on 1 January 2021), easing of the risk weights for retail and corporate credit, provision of ruble liquidity via term REPO facilities collateralised by securities and credit to SMEs, and FX market intervention (should the Urals oil price fall below $25/bbl). The cherry on the cake was massive monetary policy easing – the key rate has been cut by 200bp year-to-date to 4.25% – combined with moderately dovish guidance and a 100bp downgrade of the neutral rate range to 5.0-6.0%.

RUB credit rates lag the key rate and depo rates




Enforced budget manoeuvre in 2020 is dramatic




Source: SG Cross Asset Research/Economics

Nonetheless, we take all those measures with a pinch of salt as long as the record low funding rates fail to transform into lower medium- and long-term interest rates, both in the corporate and retail segments.

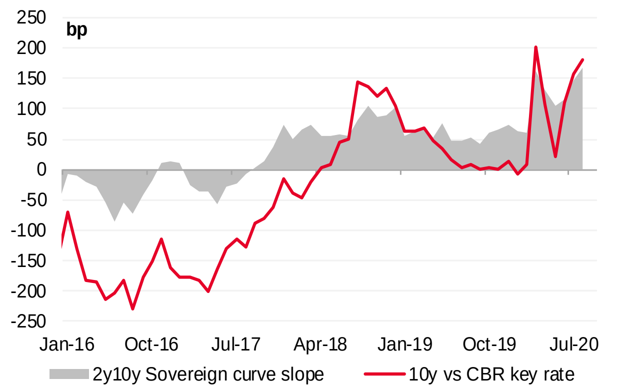
A barrier to boosting full power of monetary accommodation lies outside the central bank's scope of responsibility. All the monetary measures have to lean against fiscal imbalances pushed by the economic lockdown in 2Q20. This is not yet a 'fiscal dominance' problem, which implies government solvency issues, but the issue already has the features of a deadlock and pushes medium and long-term interest rates to the upside. While the MinFin is solely responsible for the ambitious borrowing plans drafted for 2020-2021: RUB5.0tn gross issuance in 2020 (guidance) and RUB 4.1tn in 2021, the CBR has to cope with limited transmission of the record-low key rate to the economy.

The root of the problem, as we see it, is the one-year duration of fiscal policy. Having adopted a two- or three-year plan (especially in the event of urgent plunge of regular income), the MinFin has to raise funds from debt market over the rest of financial (calendar) year. With the year-end around the corner, excessive supply of bonds may not be optimal and may reduce the appeal of public debt for local and foreign investors. Therefore, the mix of the country's high credit quality (Baa3 / BBB- / BBB; public debt target 21.3% of GDP in 2023) and accommodative monetary policy will not be reflected in the marginal pricing of public debt and cost of long-term credit resources for the economy.

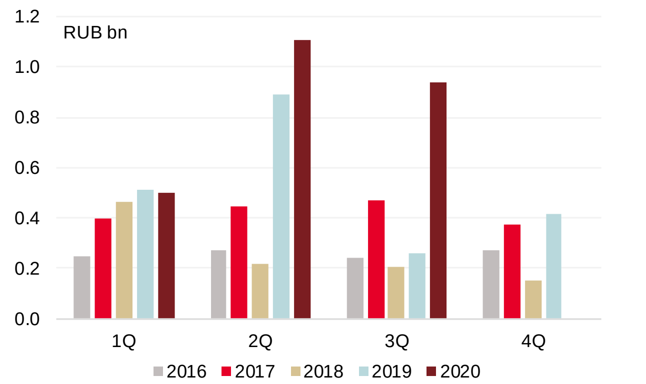
By 'optimal' debt issuance policy, we mean a balance between the tempo of public debt issuance and its price-setting framework. It has mostly qualitative characteristics and behaves as an endogenous parameter depending on market conditions. At the utmost, the constant widening of price discounts (or yield concessions) in a long series of primary auctions indicates a violation of the principles of 'optimal' borrowing policy.

However, a backward-looking analysis provides us with a wide range of estimates for optimal public debt supply subject to market conditions. That is why the fact that the MinFin has managed to issue RUB2.55tn of debt year-to-date versus annual average of RUB1.5tn of gross issuance over 2016-2019 does not imply the maintenance of a price-volume balance on the market. More than that, the residual c.RUB2.45tn due to be issued this year does not look marketable.

Public debt trading in stressful mode




OFZ issuance spree is overwhelming

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## New practices worth exploring

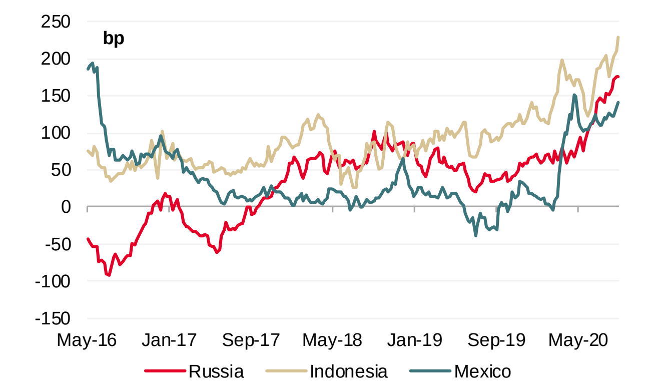
The central banks of developed economies have used a wide range of tools[1] affecting long-term rates since the 2008-2009 crisis and have reinforced them since the COVID-19 outbreak. These vary from buying back public debt and targeting long-term government yield levels to more sophisticated practices like yield curve control (e.g. yield curve twist) and buying back private debt.

Several central banks in developing economies followed this path of implementing quantitative easing practices only in March-April 2020, with very limited contributions from bond purchases programs. The Bank of International Settlements has already acknowledged in research pieces[2] the strong positive individual and average impact of such practices on domestic financial conditions.

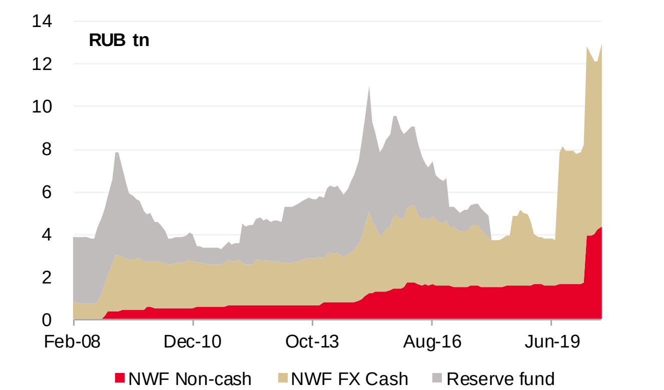
Speaking publicly in April-June, the CBR governor raised concerns over intervening the government debt market in Russia owing to the affordable impetus of the already adopted stimulus. However, we think the CBR can take a more active role amid the current market backdrop to help re-distribute to later years the MinFin's strong demand for funding in 2020-2021.

We do not however call for the CBR to launch a naïve bond purchase program to absorb debt from the secondary or primary markets. To our minds, a ground-breaking solution could be a cross-currency swap between the CBR and MinFin, with amortization of the notional over 7-10 years (or a ladder of bullet swaps with comparable maturity). An unconventional policy tool with good ability to improve domestic financial conditions such as swap could be structured more carefully and transparently than bond purchase programs.

Rise of the 2y10y yield curve slope is getting out of control




MinFin has enough resources to apply swap with CBR




Source: SG Cross Asset Research/Economics

1 BIS Working papers 570 – Unconventional monetary policies: a re-appraisal

2 BIS Bulleting 20 – 13 developing countries introduced bond purchase programs March and April with 8 of them having no clear information about the upper limit of operations.

**Prepare exit strategy before entering murky waters**

One of the key criticisms of the balance-sheet methods implemented by central banks of developing economies is related to the moral hazard issue[3] – governments of those countries are suspected of breaking fiscal discipline after the crisis and thus undermining monetary policy independence. Such criticism is well deserved in many cases because most programs lack an explicit framework (specifying debt yield targets, volume and frequency of operations, exit strategies etc.). Above all, some central banks do not have sufficiently credible policies before launching such programs, which end up imperilling their primary mandate of inflation-targeting.

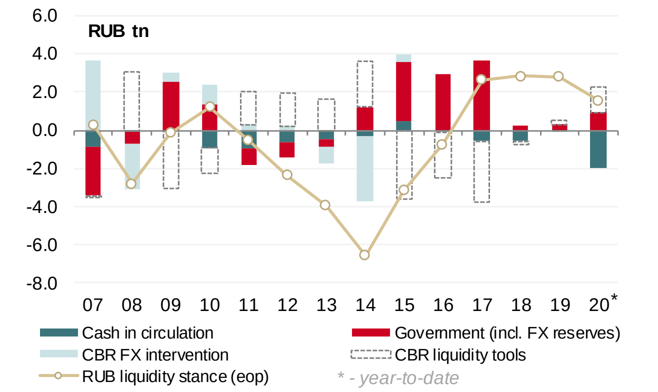
The swap mechanism we propose responds to the above criticisms in at least three ways. First, the term of the swap (or swap ladder) is fixed and defined by a special agreement between the parties involved. Second, it is a collateralised instrument. The MinFin has to transfer a part of available National Reserve Fund FX reserves to the CBR as collateral. Despite the direct sale of reserves, which is prohibited by NWF rules, the swap will be reversible and payable (e.g. fix-fix swap could help the MinFin to reduce rising exposure to interest risk). Third, fiscal discipline will be tight. The MinFin has already highlighted budget consolidation beyond 2021 as a top priority, having restricted the duration of amendments to the budget rule over 2020-2021 (amendments for 2021 have been confirmed by the minister of finance but not yet signed). We have no reason to doubt the MinFin's framework given its attitude to budget consolidation in recent years.

Extra financing needs for 2020-2021 could be swapped

| RUB tn | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|
| pre-Covid | | | | |
| Primary balance | -0.8 * | -0.7 | -0.7 | |
| Gross borrowing | 2.3 | 2.5 | 2.9 | |
| post-Covid | | | | |
| Primary balance ** | -4.0 | -1.9 | -0.2 | -0.4 |
| Gross borrowing | 5.0 | 4.1 | 2.9 | 3.5 |
| **Sum to swap *** ** | **2.0** | **1.2** | **-** | |

* ex saving to NWF
** according to MinFin projections for 2021-2023
*** expected 4Q21 gross borrowing/ increment PB deficit in 2021

Government account is leading RUB liquidity driver




Source: SG Cross Asset Research/Economics

[3] Examples of critics from analysts can be found through links:
https://www.am.pictet/en/us/global-articles/2020/monthly-market-views/emerging-markets/qe-in-emerging-markets
https://www.eulerhermes.com/en_global/news-insights/economic-insights/QE-in-emerging-markets-Playing-with-fire.html

Another criticism is easily defended – unsecured printing of the monetary base or monetization of debt. The MinFin has already used its reserves in the way that has inflated the monetary base: the last time in 2014-2016 led to a sustainable inflow of ruble liquidity and prompted the CBR to intensify its liquidity absorption operations. Since then, the mechanism of spending/accumulating the budget's FX reserves has been transferred to the secondary FX market, though the CBR strengthened its set up for managing its ruble liquidity stance. With the 'reserve swap', any inflow to ruble liquidity surplus would be limited by the term of the swap.

**Setting up additional institutional restrictions**

Transparent and rigid rules for setting up a notional of such a 'reserve swap' should be outlined and fixed in advance. We suppose that a starting point for such a calculation should be the size of the primary deficit for 2020-2021 projected in 2019. At the same time, any excess budget deficit associated with the execution of the government's countercyclical program (i.e. top-out above initially planned) should put a cap on the swap notional.

We observed two enforced and timely corrections to the budget rule adopted by the MinFin in 2020-2021. The first correction is direct compensation from the National Welfare Fund (NWF) for oil income missing due to the OPEC+ agreement. Such payback for the plunge in oil production volume was not formally specified in the 'price-based' budget rule. Nonetheless, the MinFin assumed oil market backdrop to be temporary and promised to return to initial guidelines of the rule beyond 2022.

The second correction was related to an upgrade of the budget's target primary deficit with the purpose of servicing the government's counter-cyclical program. The program was not financed by additional non-oil income (except for the CBR's profit from the transfer of Sberbank) or assets, so it relied on the deepness of the public debt market. Moreover, secondary effects arising from the substantial growth in the exposure of the MinFin's balance to interest rate risk (owing to rising issuance of floating rate notes) and the concomitant restriction on monetary policy transmission to long-term rates were not taken into account.

Limiting the notional of the 'reserve swap' by the size of the unfunded counter-cyclical program could help redistribute the MinFin's funding needs to subsequent years. By cutting its debt issuance plan for 2020-2021, the MinFin would be obliged to increase borrowing plans in subsequent years. If we say that the notional of the swap is RUB3.2tn (RUB 2.0tn expected 4Q20 gross borrowing and RUB 1.2tn increment 2021 primary balance deficit) with maturity of seven years (and amortization starting from 2022) then the reduced borrowing plan now will be equivalent to RUB 0.55tn of annual debt growth plans from 2022 to 2027.

**Strong impact on yields expected despite flattish key rate**

We think the swap would have a net positive impact on social wealth via improving of the transmission mechanism of monetary policy. In general, it may also reduce the need to encourage a downward trend in the key rate for multiple quarters (SG: 4.25% during 4Q20-3Q21), which was seen as unnecessary amid elevated volatility in the financial markets and a gradual recovery in inflation (3.6% yoy, SG: 4.3% yoy in 4Q20-1Q21). We suggest that the 'reserve swap' would have an impact on yields comparable with bond purchase programs in emerging economies in 2Q20 – a contraction of the 10y yield by c.80-100bp (SG: 5.3% / 5.2% / 5.0% / 5.2% in 4Q20 / 1Q21 / 2Q21 / 3Q21).

Otherwise, convergence with the outlined levels will take longer time due to domination of the front-loaded public debt issuance program and adjustment of market consensus to potential flattish key rate trajectory onwards. Nonetheless, we still consider those levels as 'fundamentally fair' and achievable over time against strong public finance governance and high resilience of the economy to the current crisis.

To conclude, the 'reserve swap' could enforce recent CBR steps to improve monetary guidance. In its annual review of Monetary Policy Guidance (MPG) for 2021-2023, the CBR proposed publishing the projected key rate trajectory from 2021. The form of publication has not been decided yet (we consider confidence intervals or dot plots most suitable).

We think that such a signalling instrument would have limited impact on long-term rates, mainly because there is a vast number of alternative scenarios assumed in the new reading of the MPG, with two of them implying restrictive policy in the face of global and domestic challenges. Thus, the weighted average of the suggested key rate trajectories may substantially deviate from the 'baseline' scenario. However, we are under no illusion that even the 'baseline' scenario is a binding commitment for the CBR.

Key rate / yield outlook

| %, eop | Current | 4Q20 | 1Q21 | 2Q21 | 3Q21 | 4Q21 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|---|---|---|
| Key rate | 4.25 | 4.25 | 4.25 | 4.25 | 4.25 | 4.50 | 4.50 | 4.50 | 4.50 |
| 10y yield | 6.17 | 5.30 | 5.20 | 5.00 | 5.20 | 5.30 | 5.30 | 5.50 | 5.75 |
| CPI rate | 3.6 | 4.3 | 4.3 | 4.1 | 4.0 | 3.8 | 3.8 | 4.0 | 3.9 |

Source: CBR, SG Cross Asset Research/Economics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