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Bank of Russia: Pause ahead of further cuts

OUR COMMENT

The Bank of Russia kept the benchmark interest rate at 4.25% at the September policy meeting, in line with expectations, leaving inflation forecasts for 2020 and 2021 unchanged from the previous meeting in July. The decision came in line with the median market consensus as well as our outlook published in a recent meeting preview note.

The regulator's tone has become more hawkish, when it comes to short-term expectations, signalling inflationary risks and the rouble's weakening, but the Central Bank has kept the dovish rhetoric, a sign that it's ready to move to the final stage of the current monetary easing cycle as geopolitical risks decrease. The Bank of Russia provided no details about the nature of these threats. However, it is very likely that they relate to a new package of anti-Russian sanctions, which may be introduced in the wake of Joe Biden's victory in the US presidential election, as well as in response to Russia's intervention in Belarus and Alexei Navalny's poisoning by Novichok.

It seems that the regulator considers this threat to be very serious, as all other factors don't look so crucial for further monetary easing. The Central Bank sees the recent price growth acceleration as short-term. Disinflationary factors still dominate in the medium-term. Moreover, in order to get as close to the inflation target of 4% in 2021 as possible, it is likely to be necessary not only to keep monetary stimulus in place, but also to “fine-tune” them (i.e. take steps to ease policy further). ***We therefore maintain our forecast that the regulator will return to monetary easing in 1Q21 as market volatility reduces and the 3.75% key rate will mark the bottom of the current cycle.***

MARKET REACTION

Since the Central Bank's move met expectations this time around, there was no tangible market reaction from the OFZ market to the meeting's outcome. Sovereign bond prices continued to fluctuate in a narrow range, where they have been since opening on Friday. Meanwhile, a new sign that geopolitical risks are highly likely to materialize had a negative impact on the Russian currency - the rouble began to weaken with faster pace.

THE BRIEFING HIGHLIGHTS:

- Households' inflationary expectations have increased slightly recently, driven by such factors as rapid consumer demand recovery after the lockdown and recent weakening of the rouble. But in the medium term, disinflationary risks still prevail. At the same time, reaction to a fundamental change in the market environment this year has been much weaker than it was seen previously. The regulator attributes it to a stronger anchoring of inflation expectations due to historically low inflation levels seen in recent times.

- Much of monetary policy easing path has already been covered, although the regulator still sees some room for additional rate cuts. The Central Bank says that a return to neutral policy is possible in the second half of the three-year forecast period, but it is too early to speculate about it.
- The effects of deferred domestic demand have been considerably implemented and the overall recovery of the Russian economy is likely to continue at a more moderate pace. It is essential to maintain accommodative monetary conditions next year in order to stabilise inflation close to 4% over the forecast horizon. Monetary policy parameters may also need to be fine-tuned, provided that the impact of disinflationary factors is greater than expected. The Bank of Russia expects annual inflation to be 3.7-4.2% this year, 3.5-4% in 2021 and around 4% in the future.
- Geopolitical risks increased globally (upcoming elections in the US, their impact on economy, global politics), including specific Russian risks, but investors have mostly priced them in, and if the situation deteriorates the Central Bank has the tools to maintain stability.
- The CB decided to start publishing the trajectory of the key rate, as the market has become more aware of the regulator's communication and the risks of seeing this trajectory as an obligation to implement a monetary policy have been reduced. Discussions are still in progress on the timing and specific form of this publication.
- The Central Bank does not see any additional demand for currency from the population, which is already used to floating rates. The impact on the rouble rate from selling the currency from the sale of Sberbank will be insignificant. The regulator has yet to sell ₽185 bln, plans equally-sized sales of foreign currency, until the end of the year.
- The Bank of Russia supports the policy of the Ministry of Finance and the government at large aimed at gradual budget consolidation and a return to the budget rule.

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