June 5, 2020

How soft will the Bank of Russia's monetary policy be in 2020?

Russian economy: stimulus measures

- **The Bank of Russia has considered and will continue to consider the possibility of reducing the key rate by 1 percentage point.** Elvira Nabiullina, Governor of the Bank of Russia, announced this for at least the third time on May 22, 2020. Back in April, the vast majority of analysts did not consider such a significant easing as a baseline scenario, as evidenced by both consensus forecasts and market indicators. The main question is this: will the signal about room for monetary policy easing mean a significant reduction in the key rate in the coming months?

- **Even reducing the key rate by 1 percentage point would not allow the Bank of Russia to match the degree of monetary policy softness demonstrated by the central banks of most developing countries** that also adhere to an inflation-targeting regime. Russia's key rate at 5.5% is still close to the so-called neutral rate, which in a recession can be considered evidence of a relatively tight interest rate policy. Based on the real external parity model, ACRA estimates the neutral rate for Russia at 5.5–6% in 2020, which is lower than the Bank of Russia's public target of 6–7%.

- **The tightness of monetary policy is based on the previous assessment of pro-inflationary risks arising from the introduction of restrictions, financial stability risks,** and the timing of the onset of the coronavirus epidemic in Russia. An analysis of the Bank of Russia's public statements and documents shows that in the second half of 2020, under most realistic scenarios, the key rate should be lower than the neutral, but above 4%.

- **Choosing the key rate's minimum value within 4–5.5% will depend on how significant a threat to inflation expectations the Bank of Russia considers lifting self-isolation restrictions in mid-summer to be** compared to the threat of weak demand. A 1-percentage point reduction in the key rate, taking into account repeated signals about this from the Bank of Russia, could be considered a baseline scenario for the middle of the year given all the information available as of May 22, 2020. However, since the Bank of Russia's last statement on the possibility of reducing the rate by 1 percentage point in the baseline scenario, relatively positive preliminary data on economic activity and unemployment in April–May were published. This could mean both a slower pace of monetary policy easing in the summer and a reassessment of the overall amount of reduction necessary in the key rate for the year as a whole.

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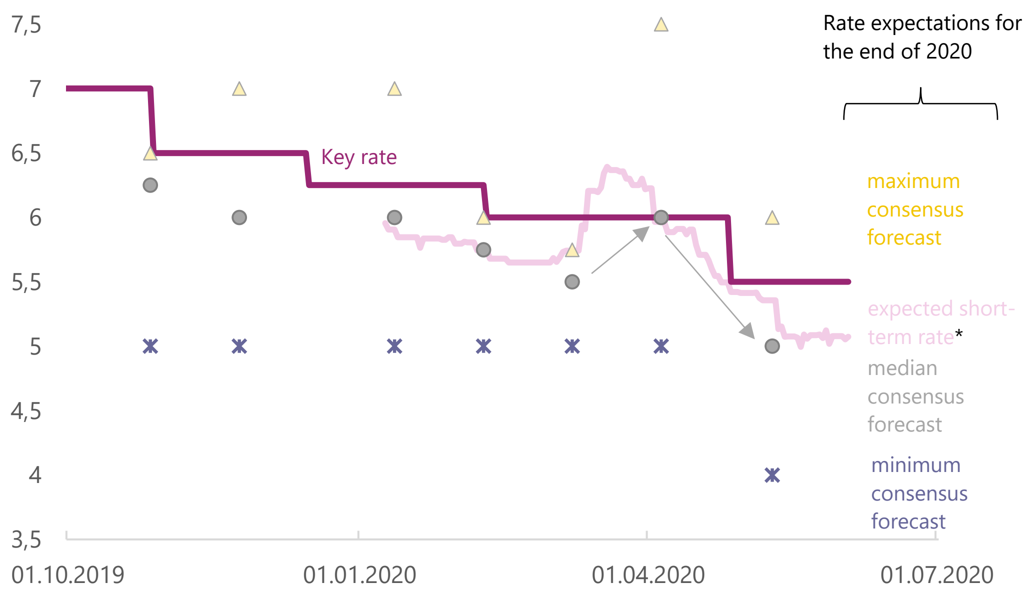
The Bank of Russia is forming expectations to further ease its monetary policy in 2020

See the release on the press conference from May 8, 2020.

The Bank of Russia has considered and will continue to consider the possibility of reducing the key rate by 1 percentage point, as announced by its Governor Elvira Nabiullina on May 22, 2020. Similar statements have already been made at press conferences on April 24 and May 8, which increases the likelihood of this scenario being implemented. It is worth noting that back in April, most analysts did not consider such a significant easing (up to 4.5%) as a baseline scenario. Moreover, in the initial phase of the crisis, expectations were rather revised towards an increase in the key rate, as evidenced by both market indicators and the consensus forecasts of economists (*Fig. 1*). In particular, according to a FocusEconomics survey from April 5, 2020, none of the representatives of investment banks, rating agencies, or expert organizations (21 respondents) publicly expected a reduction in the key rate to less than 5% by the end of 2020 in the baseline scenario, and on average expectations were close to 6%. However, on May 10, after lowering the rate by 0.5 percentage points and the re-emergence of information about the decision options discussed by the Board of Directors of the Bank of Russia, expectations were revised down by an average of almost 0.5 percentage points.

Figure 1. Market expectations on the short-term rate (key and RUONIA) were substantially revised in the beginning of May

** The short-term rate expected at the end of 2020 is calculated based on futures prices at the RUONIA rate due in December 2020–January 2021. In 2017–2020, the RUONIA rate deviated from the key rate by approximately +/-0.3 percentage points.*



Sources: FocusEconomics, Moscow Exchange, Bank of Russia, ACRA

Will the Bank of Russia really lower the key rate by 1 percentage point in the next few months? Taking into account all currently available information available, ACRA believes that it is reasonable to expect a decrease in the near future, but by a smaller amount. At the end of the year, theoretically, a more significant decrease is possible. ACRA's conclusion is based on the answers to the following two questions:

1. Does the current key rate constitute a tight monetary policy?
2. Are factors such as inflationary risks, the risk of financial instability, and a stimulating fiscal policy currently holding the Bank of Russia back from participating in the global rate-cutting trend?

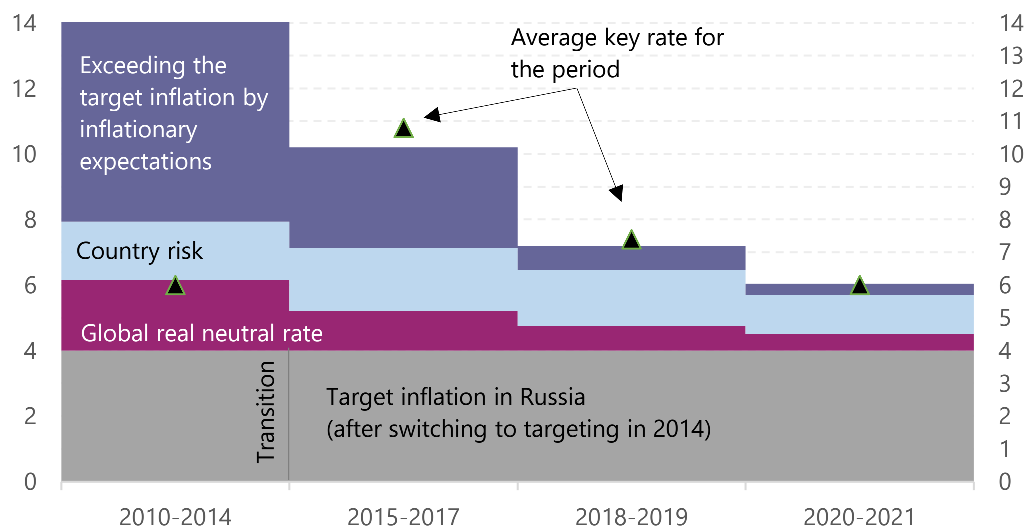
Approaches to determining the softness of current monetary policies

One of the reference points for monetary policy is the neutral interest rate. This is a central bank's rate on transactions with commercial banks, which would neither stimulate nor restrict the economy or lending. In an equilibrium (i.e., with full employment and no financial stress), short-term market rates would be comparable to a neutral rate. The amount of deviation of the monetary policy rate (the key rate in Russia) from the neutral rate is a measure of a monetary policy's tightness or softness.

The neutral rate as an indicator is unobservable directly, but it can be estimated using more or less complex models. Throughout 2017–2020, the Bank of Russia's own benchmark for equilibrium short rates has declined: the stated range has changed from 2.5–3% to 2–3% in real terms, and now the wording "closer to the lower limit of the range" is being used to clarify the latter. The Bank of Russia's economic research also included an estimate of a range with an even lower average value of 1.0–3.2%[1]. According to the Bank of Russia's public statements, both two years ago[2] and now[3], one of its models uses internal rates that are in real parity with the rates of the external world as equilibrium rates. In this model, the real neutral rate is equal to the global real neutral rate adjusted for country risk, and the nominal neutral rate is obtained by adding inflation expectations to the real neutral rate (*Fig. 2*).

For more information about the logic of real interest parity and the long-term factors of a neutral rate, see the "CBR's key rate may go below 6%" section in ACRA's study "[Six investment drivers in Russia](#)" from April 4, 2018.

Figure 2. Estimation of the neutral level of the nominal interest rate in Russia based on the real interest parity model[4]



Sources: Bank of Russia, Reuters, FocusEconomics, ACRA

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[1] D. Kresptsev, A. Porshakov, S. Seleznev and A. Sinyakov. (2016). The Equilibrium Interest Rate: A Measurement for Russia. Economic Research Working Paper, Central Bank of Russia.

[2] See the press conference following the meeting of the Board of Directors of the Bank of Russia from March 23, 2018: http://old.cbr.ru/press/st/2018-03-23/.

[3] See Monetary Policy Guidelines (hereinafter, MPG), page 21.

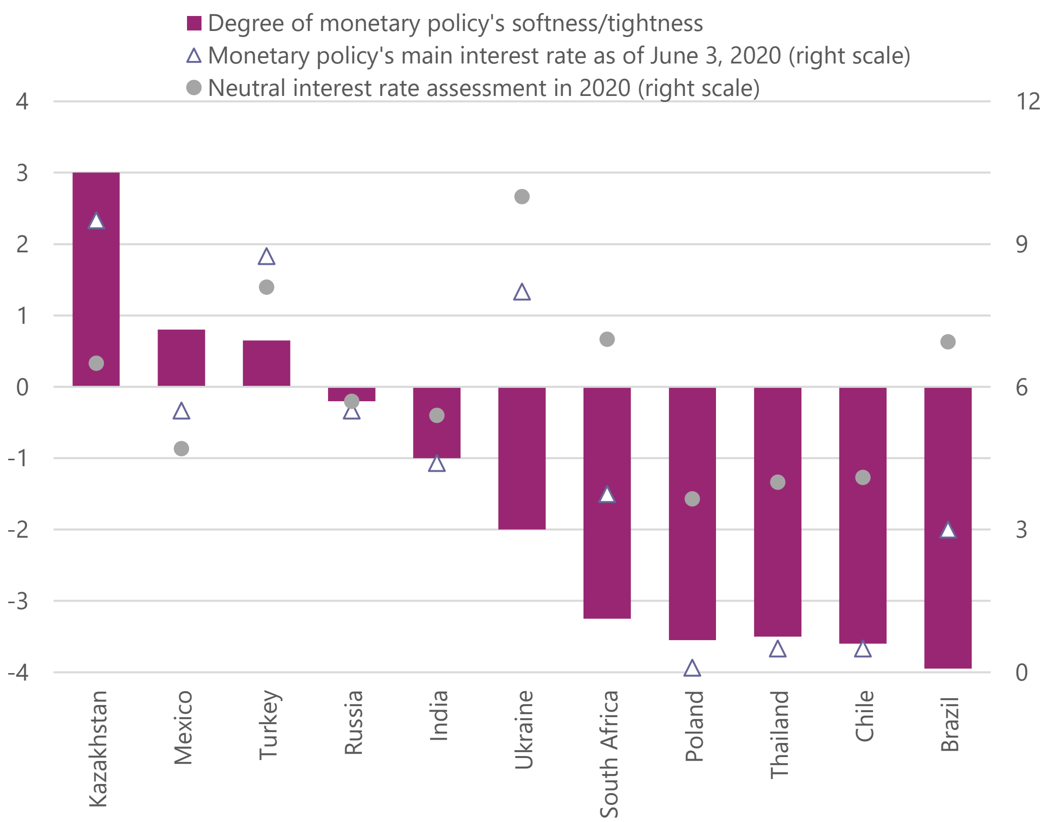
[4] For the chart, the history of the global neutral rate refers to the long-term expectations of members of the US Federal Reserve Board of Directors regarding federal fund rates that are relevant for the corresponding year. This approach is more relevant when analyzing monetary policy than using r-star estimates, since the latter often characterize short-term equilibrium. The equilibrium country risk assessment was obtained by averaging long-term CDS 5Y over the past four years without recessions and financial crises. Expected inflation is calculated as the weighted average of professional forecasters' expectations (FocusEconomics consensus forecast: 85% weight) for the next year and the population (inFOM survey: 15% weight). The average key rate for the current period is calculated from the beginning of 2020 through June 5, 2020. For 2010–2014, instead of the key rate, Figure 2 shows the rate for one-day repo operations with the Bank of Russia.

For this graph, the neutral level of interest rates in other countries is estimated based on a real interest parity model similar to Russia (Fig. 2). However, for simplicity, in this graph inflation expectations for all countries are the central bank's target level for inflation (if the target level is represented by a range, its midpoint is used).

This model allows for significant uncertainty in the values of factors and is probably not the main one in making decisions about the dynamics of the key rate, although it is used as a communicative tool. In any case, it makes it possible to roughly assess the dynamics of the key rate and conduct cross-country comparisons. The real neutral rate mentioned by the Bank of Russia at 2–3% currently seems to be the sum of 1–1.5% of the global rate and 1–1.5% of the equilibrium country risk. However, global neutral rates over the past two years have been revalued downward to 0.5%[5], which may have already partly influenced the revaluation of the range and led to the above-mentioned wording (closer to the lower limit of the range) being used to clarify. ACRA expects the Bank of Russia to further revise its public benchmark for the real neutral rate downward to 1.5–2% before 2022. Currently, the nominal neutral rate, in addition to the target inflation, probably also includes a small but positive component due to the population's inflation expectations that are consistently above the target level. A revision of this component may also lead to a reduction in the key rate in the long term.

If the model reflects reality, the key rate at 5.5% (as of May 25, 2020) is still close to both the current neutral level (5.5–6% based on the real parity model) and the Bank of Russia's public benchmark at 6–7%. Therefore, even reducing the key rate by 1 percentage point would not allow the Bank of Russia to match the degree of monetary policy softness demonstrated by the central banks of most developing countries that also adhere to an inflation-targeting regime (*Fig. 3*).

Figure 3. The difference between the monetary policy rate and the neutral interest rate as of June 3, 2020



Sources: Central banks of the above countries, ACRA

[5] See, for example, 2.5% in 2020 – the median long-term forecast of the US Federal Reserve Board of Directors at its meeting on December 11, 2019. Accordingly, in real terms: ~0.5%.

The reasons for the significant difference in the degree of softness or tightness in the monetary policies of the above developing countries lie in a significantly different set and balance of factors taken into account by the central banks when determining the level of the key rate. In particular, the differences are due to the heterogeneity of fiscal policies and the different levels of stability in banking systems. Now, it seems that the beginning of the coronavirus epidemic in each individual country happening at different times is playing a particularly important role.

Factors taken into account by the Bank of Russia when determining the degree of tightness of monetary policy

The history of key rate decisions made by the Board of Directors of the Bank of Russia is short and limited to a period of relatively tight monetary policy. Therefore, it is difficult to establish rules according to which the Bank of Russia would react to changing economic conditions that could be applied to all possible changes in conditions. ACRA currently focuses on the Bank of Russia's public statements and its documents that contain a description of factors that are taken into account, the assessment of such factors, as well as conditional "promises" regarding decisions. Table 1 lists relevant statements from the current MPG, which are regarded as the "promises" mentioned above. ACRA used the statements made at two recent weekly press conferences (hereinafter, PC 8.05 and PC 22.05) and the press conference on the meeting of the Board of Directors (PC 22.04) as the Bank of Russia's current assessment of relevant factors; preference is given to the statements made at the most recent press conference.

Table 1. Main factors in key rate decisions and rate forecasting factors

Factor	(A) "Promises" of the Bank of Russia	(B) Bank of Russia's current assessment of the factor
1. Output gap (GDP)	• Accommodative monetary policy is resorted to when an economy grows below potential (i.e. the output gap is negative) <…>. In order to <…> eliminate the negative output gap, the key rate should be set below the neutral level. (MPG, page 8)	• Over the last three weeks, incoming payments (excluding extraction of commodities, production of petroleum products, and government activities) have consistently been around 4–5% lower than their "usual" level. This is a significant improvement compared to the 18% decline that we recorded in the first four non-working weeks. <…> the normalization of settlements in the economy this month is clear. (PC 22.05)
2. Inflation	• If this is the case, inflation tends to deviate persistently downward from the target or there are risks that such deviations may emerge. In order to bring the inflation rate back to the target, <…> the key rate should be set below the neutral level. (MPG, page 8)	• Annual inflation is likely to grow as the very low monthly values recorded in summer and fall last year are removed from the calculation base. Nevertheless, it can be said that the impact of temporary pro-inflationary factors was less significant than we set out in the April forecast. The Bank of Russia has room to carry out further easing of monetary policy should disinflationary trends prevail in the future. (PC 22.05)
3. Inflationary expectations	• At the same time, factors, which are short-term in nature, may have a longer impact if they affect inflation expectations. <…> such a situation may call for monetary policy measures. (MPG, page 9)	• The inflationary expectations of the general public and businesses have increased, however, this change will be short-term in conditions of reduced demand. (PC 22.04)
4. Financial stability	• <…> the Bank of Russia uses monetary policy and the key rate as its core mechanism to maintain the inflation rate close to the target, while the financial sector stability is secured through other policy measures. (MPG, page 13) • A situation where systemic risks ultimately materialize generally requires a closer coordination in the implementation of monetary policy and financial stability policy. In such cases, making key rate decisions the Bank of Russia can take into account the need to both stabilize financial markets and maintain the sustainability of the financial sector as a whole. (MPG, page 14)	• When making the key rate decision, the Bank of Russia also took into account the task of maintaining financial stability, especially in the conditions of the changing situation in international commodity and financial markets. (PC 22.04) • The market situation indicates a certain decline in financial stability risk. Foreign participants' interest in our stocks and bonds is recovering. FX market volatility indicators have fallen from elevated levels and are now approaching the boundary of "normality". And OFZ yields have fallen to historic lows. (PC 22.05)
5. Fiscal policy	• Maintaining a balanced fiscal policy is an indispensable condition that ensures absence of inflationary pressure along the fiscal channel. In contrast, imbalanced fiscal flows	• As for fiscal policy, we now have more clarity regarding the third package. <…> support measures are sufficient in duration — many of them will run until the end of the year, and even until the start of next year <…>. On the contrary, we

	and a considerable build-up of budget expenditure may have inflation consequences. (MPG, page 10)	see growth in expenditures to support the economy <…>. I’ll say it again: we see potential for a softening of monetary policy. (PC 22.05)
6. Duration of factors, speed of impact of the key rate on economic activity, and timing of decisions	• The Bank of Russia revises the key rate if current trends point to a persistent deviation from the target on the forecast horizon or if long-term factors are in place which are highly likely to lead to such a persistent deviation. (MPG, page 9) • <…> the key rate pass-through to demand and price dynamics takes from three to six quarters. (MPG, page 9)	• We need to wait for a considerable lifting of limitations that are constraining both production and consumption in order to make a comprehensive assessment of the current level of inflationary pressure. (PC 22.05) • In our opinion, the schedule for decision-making at the meetings of the Board of Directors, which is announced a year in advance, is one of the elements that makes our policy predictable. Obviously, unplanned meetings may happen, but they are only justified in the event of sharp changes in the economy and the financial market <…> (PC 22.05)
7. Signal	• A key rate decision <…> is generally accompanied with a signal of possible monetary policy moves which may be made if the economic development and inflation dynamics are close to the Bank of Russia’s baseline forecast. (MPG, page 8)	• <…> at the last meeting of the Board of Directors we looked at the possibility of lowering the rate by 100 basis points. If the situation continues to develop as it is now, then the option of a 100 bps cut will definitely be considered, in addition to other options. (PC 08.05) • The possibility of a 1-percentage point cut to the key rate in June is on the table. Although the possibility of it happening is still less than 100%. (PC 22.05) • The Board of Directors doesn’t see any need for resorting to negative real rates in the baseline scenario in the foreseeable future. (PC 22.05)

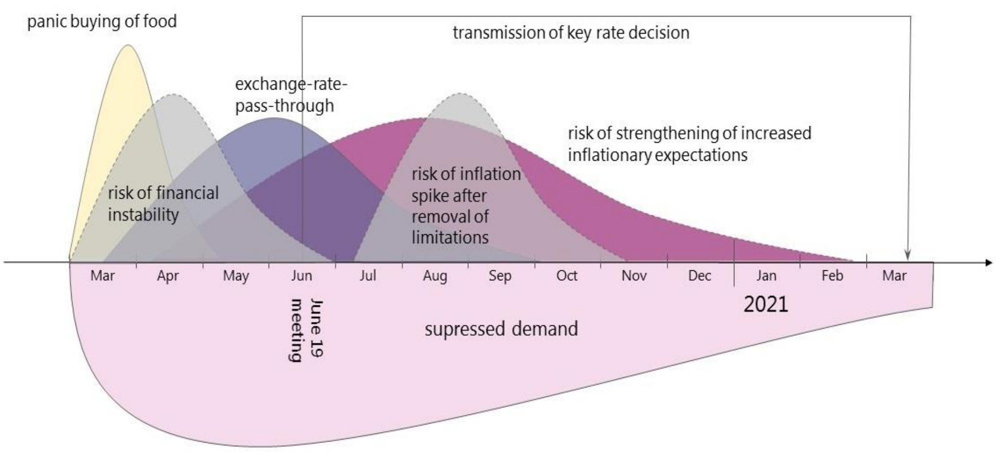
Sources: Bank of Russia, ACRA

Cells from Table 1 that are used to justify the corresponding statement are indicated in parenthesis.

On the basis of this collection of statements, ACRA has come to the conclusion that the key rate will be lower than neutral (1A+1B) in the second half of 2020; if the Bank of Russia’s public guidance regarding the neutral rate is used, then technically this is already the case. Furthermore, the Bank of Russia’s baseline scenario limits the lower boundary of the key rate to 4% (7B). The possibility of lowering the key rate below 5.5% and the corresponding signal (7B) arose due to two factors. The first is the reassessment of financial stability risks (4B). The second is that on the horizon of the key rate’s impact on economic activity (6A), the Bank of Russia sees more risks from suppressed demand (2B) than from inertia of higher inflation in the event of a potential inflation spike following a lifting of the self-isolation regime (6B+3B). This logic is described schematically in Figure 4.

The part of the diagram above the axis displays the main factors preventing the Bank of Russia from lowering the key rate. The lower part displays the factors that stimulate lowering the key rate.

Figure 4. Diagram of the period of validity of factors for changing the key rate



Source: ACRA

Taking into account repeated signals about this from the Bank of Russia, a 1-percentage point reduction in the key rate could have been considered to be the baseline scenario for the middle of the year given all the information available as of May 22, 2020 (the date when the Bank of Russia made its most recent public statements about monetary policy). The trajectory of decline would be more or less pronounced, although it was likely that the main decisions would be made in June and July, and for the rest of the year changes to the key rate would be less significant in the absence of any force majeure events.

See the following documents: "Information on Russia's Socioeconomic Situation" (for January–April 2020) from May 26, 2020 and "Monitoring of Sectoral Financial Flows" (seventh issue) from June 4, 2020.

However, after May 22 relatively positive preliminary data on economic activity in April was published. In particular, seasonally adjusted unemployment grew by only 5.6%, and the overall GDP decline in April was less than 15% year-on-year. Data for May on sectoral financial flows was also released, which indicates that despite the continuation of many quarantine measures, the end of May was only 10% lower than the norm. Compared to the -20% indicator recorded in April, this looks like a significant recovery. This information may serve as a reason for the Bank of Russia to positively reassess demand at the start of 2021, and also to revise downward the volume of monetary stimulus required (compared to its previously announced guidelines).

See ACRA's macroeconomic forecast "Questions and lessons from the 2020 economic crisis" from April 22, 2020.

Taking the above into account, ACRA is maintaining the long-term key rate expectations expressed in its baseline macroeconomic forecast: 5.5% in 2022 and a lowering to 5–5.25% by 2024. However, it is very likely that in 2020 key rate decisions will be driven by the need to provide stimulus to a larger extent than we previously expected. In particular, the June meeting of the Bank of Russia will probably result in a rate cut of 0.25–0.75 percentage points, and the rate established as a result of these summer cut (or cuts, should more follow) will be left unchanged until at least Q2 2021. Data on consumer demand after the lifting of quarantine measures, the possibility of re-imposing these measures, and unemployment figures for May–June will be of vital importance to the Central Bank at its summer key rate meetings.

In ACRA's opinion, growth of the key rate must be retained in the pessimistic macroeconomic forecast given the risks of financial stability, which logically arise from the negative prerequisites of this scenario.

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