Economics

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Russia Macro View

Narrowing corridor, widening band

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With thanks to
Aleksandr Voropaev

- We expect the CBR will gradually narrow the corridor of its interest rates during 2011 and at the same time will widen the ruble band. We do not rule out the possibility that the central bank might increase interest rates on its deposit facilities in December, keeping other interest rates unchanged.

- We expect the CBR will increase reserve requirements at the beginning of 2011 to mitigate risks of too large capital inflow. Together with an expected tightening in other emerging markets and changes in taxation of foreign borrowings, an increase in reserve requirements could allow the CBR to hike rates by 75-100bp during 1H 2011.

- The near term risks to the long end of the curve are limited, in our view, as Min Fin is likely to cut borrowing due to higher oil prices. We believe ruble appreciation in the beginning of 2011 and expectations of moderate disinflation in the second half of the year will to some extent compensate for expected hikes in the CBR deposit rate and help to postpone an increase in borrowing costs for Minfin.

- We believe the basket could appreciate to around 34.5 rubles in 1H 2011 on the back of stronger CA surplus and capital inflow. Decreasing CA surpluses, uncertainty related to elections, higher budget spending and seasonal capital outflow in 3Q, could bring the basket back to slightly above 35 rubles in the end of 2011. We think the central bank will widen the band for the ruble basket, but will conduct discretionary interventions in the event of too sharp movements in the ruble.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Narrowing corridor, widening band

CBR to hike deposit rates soon

The central bank has started to worry about inflation and will probably consider changing rates at the Board meeting on 24 December, CBR Chairman Ignatiev said (Reuters, 8 December). According to official forecasts, inflation could accelerate to 8.4%YoY (Citi forecast 9.1%YoY) in December from 8.1% in November. Ignatiev said that the weaker ruble in recent months has affected inflation, which is in line with our view (see below). According to Ignatiev, net capital outflow reached US$9bn in November, driven by banks increasing foreign assets. At the same time Customs data showed flat or slight decrease in imports from non-CIS countries in November. This contrasts to the situation in 3Q when the ruble was weakening on the back of a sharp surge in imports and capital flight driven by corporates. Under the new circumstances we think the CBR could decide to stop capital flight by increasing attractiveness of its deposit facilities.

Why care about inflation amid modest recovery? Two things make us believe that inflation will stay in 8.5-9% range in the 1H 2011. First, we think non food prices have bottomed out and are likely to start to accelerate on falling money demand and second-round effects of external shock to the food basket[1]. Second, over a third of retail sales are imported, so the pass-through from a weak exchange rate to domestic prices is high, particularly as the CPI is being stressed by the after-effects of the summer drought. While exchange rate pass-through is usually low right after the crisis it then gets back to higher levels[2], which we estimate is close to 0.35 (10 pp depreciation of NEER leads to 3.5 pp increase in inflation rate). Meanwhile, the persistence of relatively high inflation should help to keep the ruble expensive in real terms, and could keep import demand high. This may lead to a vicious circle: if import demand stays high, the market will worry about the current account surplus, and this would fuel further expectations of ruble depreciation and hence increase inflationary pressure.

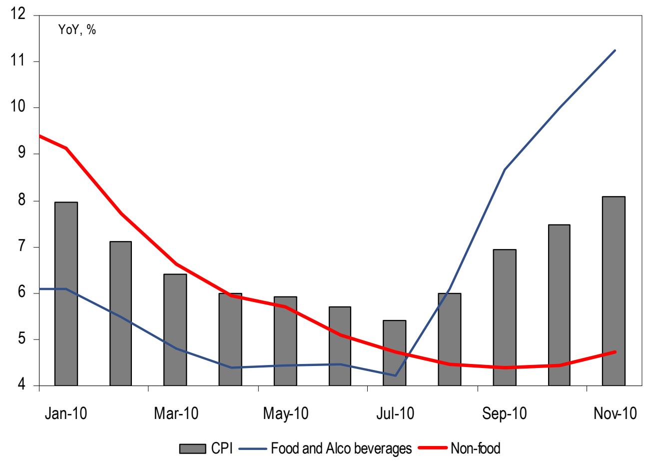
We do not rule out the CBR increasing deposit rates in December. We think a 50bp move in the deposit rate would be just enough to make the low boundary of the interest rate corridor the effective floor for money market rates. Over the last 3 months the RUONIA index (benchmark for actual interest rate on interbank overnight deposits) has been on average 50-60bp higher than the CBR's bid. Hence a 50 bp hike would just bring the CBR deposit rate to the level of market rates. However the CBR will probably choose a more cautious strategy and decide to hike rates in several steps rather than making one large move before the year end.

Refinancing rates probably unchanged in 2011. We expect liquidity of the banking sector to grow in the beginning of the year, and therefore the deposit rate should remain the effective policy rate. Further on if the CBR believes the output gap will close only in the mid of 2011 and inflation will decelerate to 6-7% by the end of next year (the target set by the Monetary Policy Guidelines) than keeping refinancing rate slightly negative in 1H 2011 should not be a problem. At the same, changes in refinancing rates are likely to have stronger effect on the cost of borrowing to both the government and the private sector. Pressure on yields is undesirable given that credit growth is still getting up to speed and the government plans to borrow about 2.5% of GDP in 2011.

[1] See Russia Macro View: Trip Notes: Growth Concerns Override Inflationary Risks (November 3, 2010).

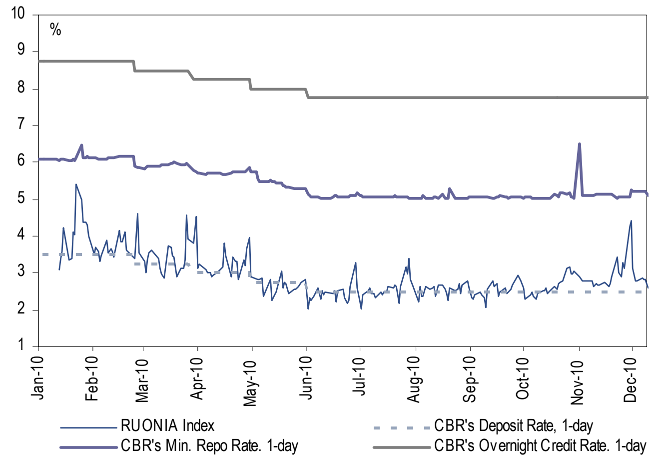
[2] Burstein A., Eichenbaum M., Rebelo S. Why Are Rates of Inflation So Low After Large Devaluations? Rochester Center for Economic Research, WP 486, 2002.

Figure 1. With non-food inflation bottoming out…



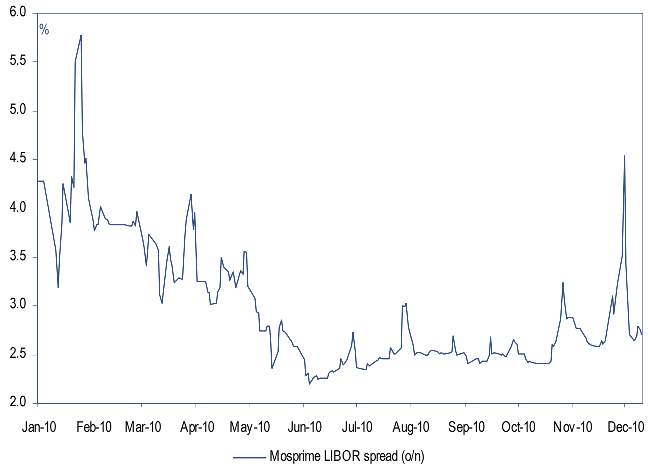
Source: Haver, Rosstat, Citi Investment Research and Analysis

Figure 2. ...CBR to likely to narrow interest rate corridor



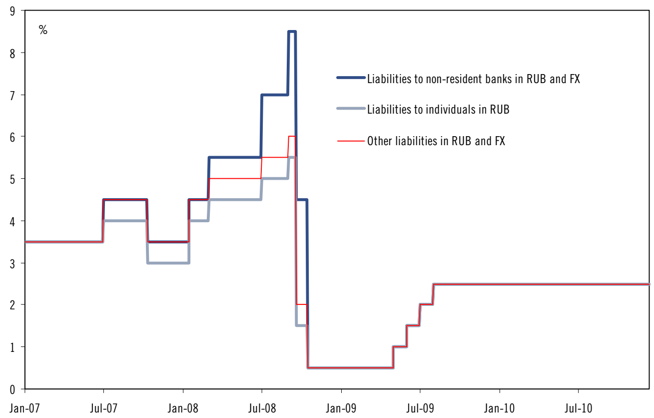
Source: Bloomberg, Citi Investment Research and Analysis

Figure 3. Mosprime vs Libor



Source: Bloomberg, Citi Investment Research and Analysis

Figure 4. Hike in reserve requirements to follow



Source: CBR, Citi Investment Research and Analysis

Reserve requirements to follow

We expect the CBR to increase reserve requirements in the beginning of 2011 to mitigate risks of too large capital inflow. At present required reserves ratio stands at 2.5% and is equal for all kinds of deposits. That was not the case in 2007-2008, when required reserves ratio on liabilities to non-resident banks and liabilities in foreign currency were 50-300 bp higher than the ratio for liabilities to individuals in rubles. We estimate the CBR will have to increase reserve requirements for non-residents by about 25 bp to compensate for the 25 bp increase in deposit rates. On the other hand, as was repeatedly mentioned by the CBR representatives (for example Ignatiev, 8 December 2010), higher reserve requirements could also be used to discourage external borrowing by Russian companies. Together with expected tightening in other emerging markets and changes in taxation of foreign borrowings, an increase in reserve requirements could allow the CBR to hike rates by 75-100 bp during 1H 2011.

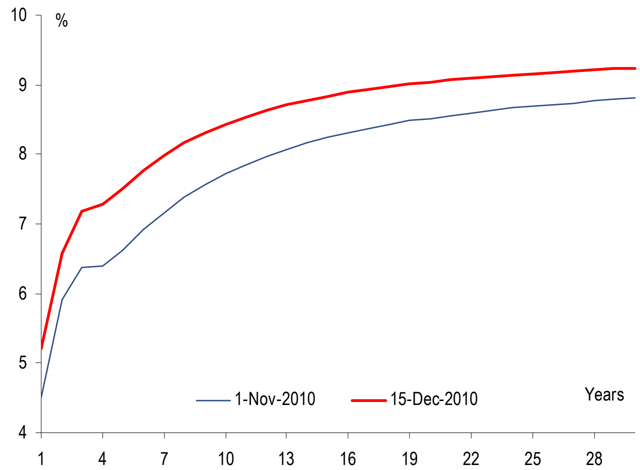
Limited risks to the long end in the near term

The near term risks to the long end of the curve are limited, in our view, as Minfin is likely to cut borrowing due to higher oil prices. Next year's budget plan envisages net domestic bond issuance of RUB1.3tr and net external borrowing of around US$4.5bn[3]. However, according to Deputy Minister of Finance, Pankin (Reuters, 8 December 2010), if the oil price remains above the budgeted $75 (Citi forecasts $85 avg Urals in 2011) Minfin is likely to cut its borrowing program, and first of all to reduce foreign currency placements. Although we do not rule out an increase in government expenditures next year given forthcoming parliament and presidential elections, the effect of higher borrowings and interest rates would not be felt until the end of the year.

Reserve fund and diversification of investor's base should also help to minimize pressure of the cost of borrowings in the course of 2011. Ruble Eurobond issuance is still on the agenda as well as 15-30 year dollar-denominated Eurobonds and a debut euro-denominated placement. We remind that the Finance Ministry plans to issue up to RUB100bn of medium or long-term ruble-denominated Eurobonds at yields below OFZ curve. In addition to that the government has about $41bn (RUB1.3tr) in the Reserve fund, of which about Rub 300 bn are expected to be used in 2011.

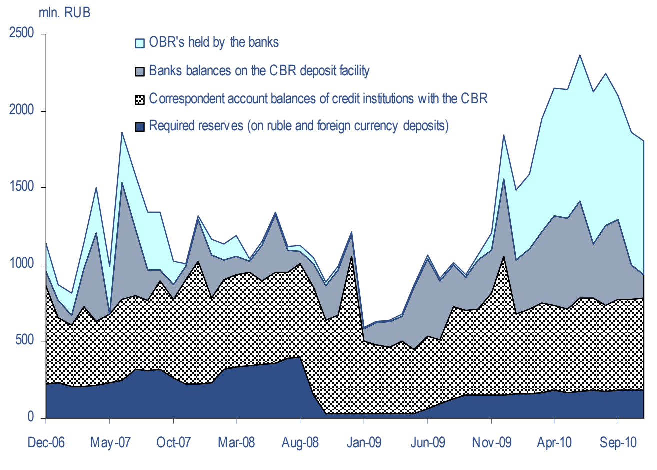
Ruble appreciation and lower inflation expectations likely to have a more significant effect on long-term yields than short term interest rates. In this regard we believe ruble appreciation will take place in the beginning of 2011 and moderate disinflation in the second half of the year will likely, to a certain extent, compensate for hikes in the CBR deposit rate. This should help to postpone any increase in borrowing costs for Minfin.

Figure 5. The risks to the long end of the curve are limited



Source: CBR, Citi Investment Research and Analysis

Figure 6. Excess liquidity is still high



Source: Haver, CBR, Citi Investment Research and Analysis

[3] Russia Macro View: Interest rates to increase, but not just yet (September 24, 2010) - https://www.citigroupgeo.com/pdf/SEM07005.pdf

Ruble in 2011: flexibility vs stability

We believe the basket could appreciate to around 34.5 rubles in 1H 2011 on the back of stronger current account surplus and capital inflow. While the central bank's Ignatiev does not expect further weakening of ruble given strong oil price, First Deputy Chairman, Ulyukaev[4], said that in December CBR had reduced the pace of interventions, which exceeded US$5bn in November. We expect the oil price to average US$85 per barrel in 2011 and believe it could stay close to US90bn in 1Q. With imports seasonally low in the beginning of the year we estimate the current account could widen to $18-20bn in 1Q. At the same time debt repayments should be around $4-5bn in Jan-May 2010 as compared to US$11bn on average in July-Dec 2010.

With CA surpluses decreasing to the end of the year, uncertainty related to elections, higher budget spending and seasonal capital outflow in 3Q should put pressure on the ruble in 2H 2011. Accession to WTO (chances are high it will happen in the end of 2011) could be positive news for the ruble and likely to stimulate FDI, but the effect of this is likely be postponed to 2012 (see Focus on Russia and WTO)[5].

Given the rules of the game within the political cycle we think the CBR will try to avoid significant ruble depreciation in the end of the next year. Parliamentary elections are set for Dec 2011 and presidential elections are expected in the beginning of 2012. In view of a potential depreciation trend in the ruble in the second half of the year we think the CBR will seek to limit ruble gains in the beginning of the year. The costs of sterilization would probably not rise enough to encourage more ruble flexibility. With deposit rates increasing and OBR yields unchanged (or even falling given that OBR's maturity decreased from 6 months to 3 months) the share of excess reserves going to CBR deposits should increase and the weighted average cost of sterilization is likely to decrease.

We think the CBR will widen the band for the ruble basket, but will conduct discretionary interventions in the event of too sharp movements in the ruble. Currently the operational band is about 33-37 rubles per bi-currency basket. Apparently, the CBR does not intervene in the middle of the band but will increase the volume of interventions once the cost of the basket moves towards one of the boundaries. The CBR uses target interventions to "neutralize stable expectations of the domestic currency market with respect to changes in the exchange rate" [6]. Periodically it also conducts discretionary interventions to '' smooth exchange rate fluctuations of the ruble, not due to the influence of fundamental economic factors". Once the total amount of discretionary interventions within the existing band exceeds US$650m boundaries of the operational band if moved by 5 kopeeks. The share of discretionary interventions (not based on specific rule) was 35-45% in October-November. According to Ignatiev, the CBR could arrive at "almost free-float" in the next two years, where the CBR follows the path of widening the corridor, and the ruble fluctuates in its central part without any interventions.

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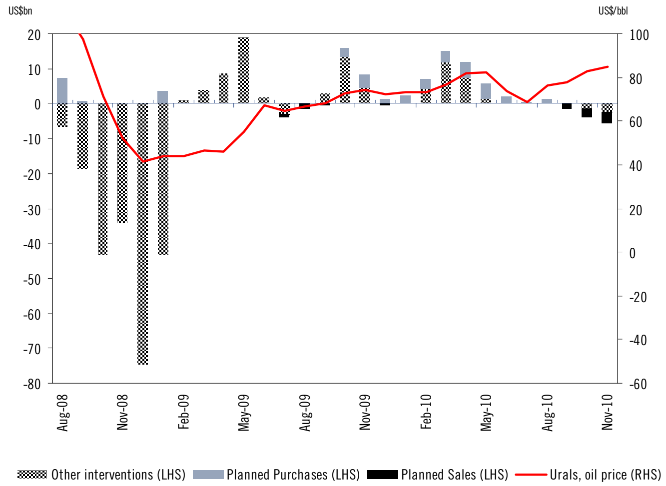
[4] Reuters, RIA Novovosti, 8 December 2010

[5] Focus on Russia: WTO accession is in sight (Dec 16, 2010)
https://www.citigroupgeo.com/pdf/SEM07736.pdf

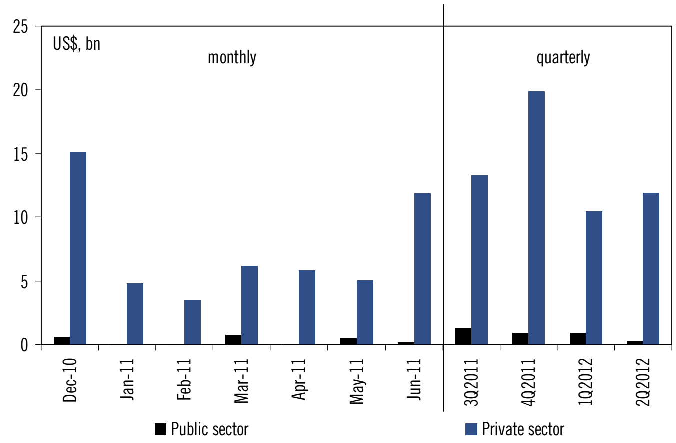
[6] According to CBR press release (June 2010) -
http://www.cbr.ru/press/Archive_get_blob.asp?doc_id=100607_1708455.htm.

Figure 7. . FX interventions above US$5bn in November



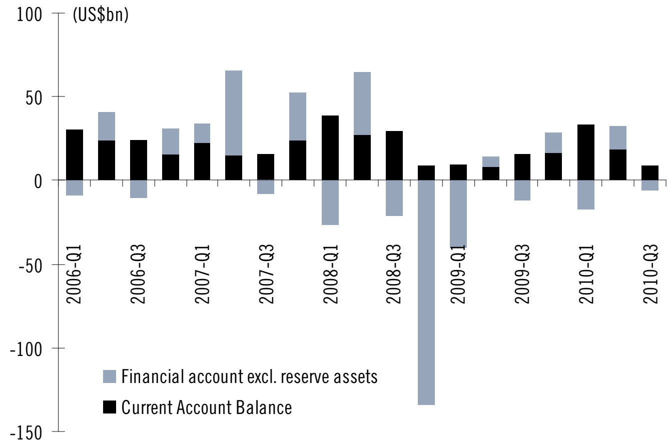
Source: Haver, CBR, Citi Investment Research and Analysis s

Figure 8. External debt amortizations (as of 1 July 2010)



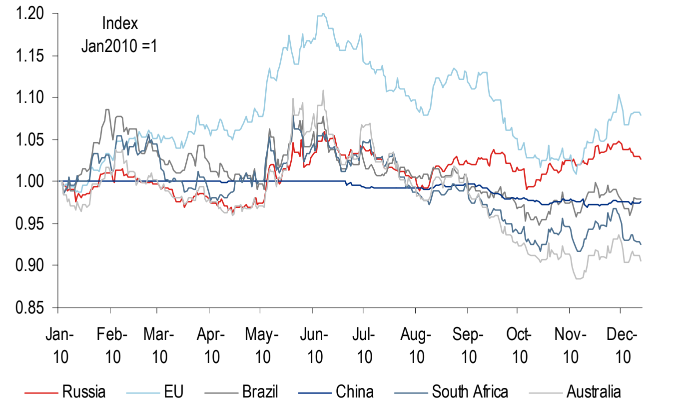
Source: CBR, Citi Investment Research and Analysis

Figure 9. BoP tends to be stronger in the 1Q-2Q



Source: CBR, Citi Investment Research and Analysis

Figure 10. Ruble underperforms other currencies so far



Source: Bloombert, Citi Investment Research and Analysis

Figure 11. Russia Economic Indicators

	2004	2005	2006	2007	2008	2009	2010F	2011F	2012F
Summary Data									
Nominal GDP, US$ bn	592	764	989	1,294	1,660	1,229	1,432	1,698	1,905
Nominal GDP, local currency bn	17,048	21,625	26,904	33,258	41,445	39,064	43,525	50,010	57,450
GDP per capita, US$	4,114	5,338	6,942	9,117	11,740	8,726	10,202	12,144	13,681
Population, m	143.9	143.2	142.5	141.9	141.4	140.9	140.3	139.8	139.3
Unemployment, % of labour force	8.2	7.6	7.2	6.1	6.4	8.3	8.0	8.0	7.5
Economic Activity									
Real GDP, % yoy	7.2	6.4	7.7	8.1	5.6	-7.9	4.1	4.0	4.0
Real investment growth % yoy	12.6	10.6	18.0	21.1	10.6	-18.2	3.9	13.5	16.0
Real consumption growth % yoy	9.2	8.8	9.2	11.6	9.1	-6.2	3.4	4.8	4.1
private consumption growth % yoy	11.6	11.2	11.2	13.8	10.6	-8.0	4.5	5.5	5.1
Real export growth, % yoy	11.8	6.5	7.3	6.3	0.6	-4.8	4.8	3.1	3.0
Real import growth, % yoy	23.3	16.6	21.3	26.6	14.9	-30.9	15.6	15.3	10.0
Prices, Money & Credit									
CPI, % yoy	11.8	10.9	9.0	11.9	13.3	8.8	8.9	7.6	6.3
CPI, % avg	10.9	12.7	9.7	9.0	14.1	11.7	6.9	8.1	7.5
Nominal wages, % yoy	24.0	25.2	25.5	26.0	27.4	9.1	11.3	8.1	6.1
Credit extension to private sector, % yoy		35.2	49.5	50.9	36.4	5.0	10.0	15.0	25.0
Policy interest rate, %, eop	13.00	12.00	11.00	10.00	13.00	8.75	7.75	7.75	7.50
1 month inter-bank rate, %, eop	-	6.39	5.71	6.09	20.20	6.32	3.80	4.00	4.20
Long-term yield, %, eop	-	6.8	6.5	6.3	8.7	8.6	7.8	7.6	7.6
RUB/US$, eop	27.8	28.8	26.4	24.6	29.4	30.2	30.5	29.5	30.5
RUB/US$, avg	28.8	28.3	27.2	25.6	24.9	31.8	30.4	29.5	30.2
RUB/EUR, eop	37.8	34.2	34.6	35.7	41.4	43.4	40.8	41.5	41.5
RUB/EUR, avg	35.9	35.2	34.1	35.0	36.4	44.2	40.1	41.0	41.5
Balance of Payments, US$ bn									
Current account	59.5	84.6	94.7	77.8	103.7	49.5	65.4	51.7	26.0
% of GDP	10.1	11.2	9.9	6.1	6.2	4.0	4.6	3.0	1.4
Trade balance	85.8	118.4	139.3	130.9	179.7	111.6	140.3	131.0	101.2
Exports	183.2	243.8	303.6	354.4	471.6	303.4	385.9	419.7	426.7
Imports	97.4	125.4	164.3	223.5	291.9	191.8	245.6	288.8	325.5
Service balance	-12.7	-13.8	-13.6	-18.9	-24.3	-20.1	-27.4	-36.3	-30.2
Income balance	-12.8	-19.0	-29.4	-30.8	-49.0	-39.6	-46.0	-43.0	-45.0
FDI, net	1.7	0.1	6.6	9.2	19.4	-8.2	15.0	20.9	27.2
International reserves	120.8	175.7	295.3	466.4	410.7	405.8	471.3	523.0	542.9
Total amortisations	38.3	57.7	76.6	55.9	91.5	117.0	90.0	60.0	50.0
Public Finances, % of GDP									
Consolidated government balance	4.3	7.5	7.4	5.4	4.1	-5.9	-4.2	-3.6	-3.0
Consolidated gov primary balance	5.5	8.4	8.0	5.8	4.5	-5.4	-3.7	-3.0	-2.3
Public debt	21.5	13.2	8.3	6.6	5.2	8.2	9.4	11.1	12.6
of which Domestic	4.4	3.9	3.8	3.8	3.4	4.7	5.6	7.9	9.8
Foreign Assets & Liabilities, US$ bn									
External debt	196.8	229.9	250.7	368.1	480.0	469.7	489.7	509.7	519.7
Public	100.8	71.1	44.7	37.4	29.5	43.4	53.4	53.4	53.4
External debt / GDP	33.2	30.1	25.3	28.4	28.9	38.2	34.2	30.0	27.3
External debt / XGS	96.6	85.5	74.9	93.5	91.8	136.1	126.9	121.4	121.8
Short-term debt	26.4	27.1	40.5	79.1	73.0	48.0	53.0	58.0	65.5
Short-term debt/International reserves, %	21.9	15.4	13.7	17.0	17.8	11.8	11.2	11.1	12.1

Quarterly Economic Indicators

	2009 Q4	2010 Q1	2010 Q2	2010 Q3F	2010 Q4F	2011 Q1F	2011 Q2F	2011 Q3F	2011 Q4F
GDP, % yoy	-2.9	3.1	5.2	2.7	5.4	3.0	4.5	4.0	4.5
CPI, % yoy	8.8	6.5	5.8	7.0	8.9	8.4	8.2	7.5	7.6
Policy interest rate, %, eop	8.75	8.25	7.75	7.75	7.75	7.75	7.75	7.75	7.75
1 month inter-bank rate, %, eop	6.66	4.37	3.50	3.26	3.80	3.50	3.75	3.80	4.00
Long-term yield, %, eop	8.99	7.18	7.04	7.33	7.78	7.48	7.35	7.40	7.60
RUB/US$	30.2	29.4	31.2	30.4	30.5	29.5	29.5	29.4	29.5
RUB/EUR	43.4	39.7	38.2	41.4	40.8	40.5	40.8	41.2	41.5

Source: Citi Investment Research and Analysis

Citi latest research on Russia and CIS

Focus on Russia — WTO accession is in sight

Focus on Ukraine — Prospects and challenges in 2011

Focus on Russia — CBR to consider rate hike on 24 December

Focus on Russia — Russia GDP stalls on agriculture and transport

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Russia Macro View: Ruble Flexibility Is In Sight

Kazakhstan Macro View: Trip notes: Tenge appreciation inevitable?

Russia Macro View: Interest rates to increase, but not just yet

Russia Macro View: Ruble – much ado about not much

Ukraine Macro View: How Much Sovereign Debt to Expect?

Russia Macro View: Year-End Inflation Likely to Exceed 9%

Focus on Russia — Consumption steady without credit.

Russia Macro View: 2010 Growth Likely Close To 5%

Russia Macro View: Higher food inflation augurs well for stronger CIS currencies

Russia Macro View: Trip Notes: Smooth sailing for Russian markets, for now

Russia Macro View: Recent Developments and Policy Challenges for 2011

Focus on Kazakhstan — Tenge unlikely to strengthen fast.

Russia Macro View: St Petersburg Economic Forum - Fiscal Policy Challenge

Focus on Ukraine — Return to growth.

Focus on Russia — Money grows too fast? Tighten fiscal policy.

Focus on Russia — How does Greece matter to Russia?

Ukraine Macro View: Trip notes March 11-12: Cautious optimism:

Russia Macro View: March 9-10 Trip Notes: Further rate cuts expected

Russia Macro View: Phoenix Miracle in 2010?

Kazakhstan Macro View: Jan 25-28 Trip Notes - Recovery Well on Track

Appendix A-1

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