

Macro Keys

Russia: More in reserves?

Economics

Global

Introduction

With trade-weighted RUB up 8.3% in the first four months of the year and inflation declining close to the 4% target earlier than expected, the possibility of the CBR buying FX to top up reserves has once again come up to investors' attention earlier this month. The CBR officials quickly pointed out that anchoring inflation at 4% takes precedence over reserves accumulation – which we take as a signal that a resumption of FX purchases is unlikely to be imminent. We summarise what the CBR and government have done to increase FX reserves in the recent past, why the CBR may want to top up reserves, and what to watch for signs that "Program 500" might be re-started.

To begin with, Russia already scores well on usual metrics of FX reserves adequacy, especially for a country with a floating exchange rate. As of 1 Jan 2017, Russia had reserves covering about 17 months' of imports or 2.8 times the external debt service over the next 12 months (see Chart 1 overleaf).

The CBR aims for \$500bn in reserves, motivated by the painful experience of recent crises, where it had to withstand a large and swift pick up in capital outflows – generated not only by the need of the banks and corporates to cover external debt repayments in the a situation of a "sudden stop" in capital inflows, but also by a dollarisation of the domestic deposit base. Net private capital outflows totalled \$185bn in Q3'08-Q1-09 (CBR reserves went down by \$215bn from July'08) and \$128bn in Q4'14-Q2'15 (CBR reserves were down by \$98bn). To the best of our knowledge, the policymakers never fully explained why \$500bn exactly is the "magic number" but CBR officials' comments back in June 2015 suggested this would have allowed the CBR to have adequate reserves coverage even in event of prolonged stress situations with 2-3 years of capital flight. Initially the CBR planned to get to \$500bn over a 3-5 years horizon but dropped a specific timeline in later communication.

The CBR bought \$10.1bn in 2.5 months from 13 May 2015, following a swift recovery in the RUB after the end-2014 sell-off (see Chart 3). The CBR stated that its FX operations were not aiming to support a certain exchange rate level; purchases of \$100-200mn a day were evenly spread throughout the trading days. However, a renewed RUB weakness as oil prices fell prompted the CBR to suspend purchases in the end of July, putting the so-called "Program 500" on ice. The \$10bn the CBR bought added just over 3% to reserves but actually exceeded \$5.6bn current account surplus net of private capital outflows for May-July 2015, thus contributing to the RUB depreciation over the period, in our view.

The FX purchases Finance Ministry and the CBR started from February this year are quite different. The CBR is buying FX on Finance Ministry's behalf and in amounts set by the Finance Ministry's formula and would have to sell if oil prices drop (see our note [here](#) for details of the scheme). While the FX bought adds to the CBR's FX reserves, the underlying motivation was largely fiscal, in our view: to tie up prospective above-plan oil revenues before they were claimed for additional spending by other stakeholders in government and to smooth RUB fluctuations in response to oil prices.

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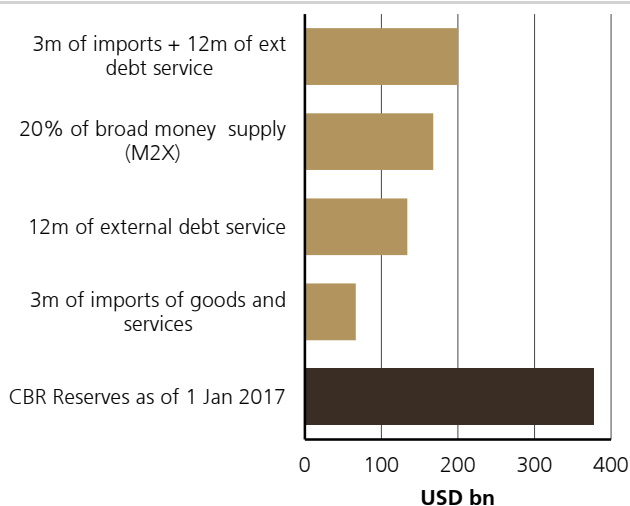
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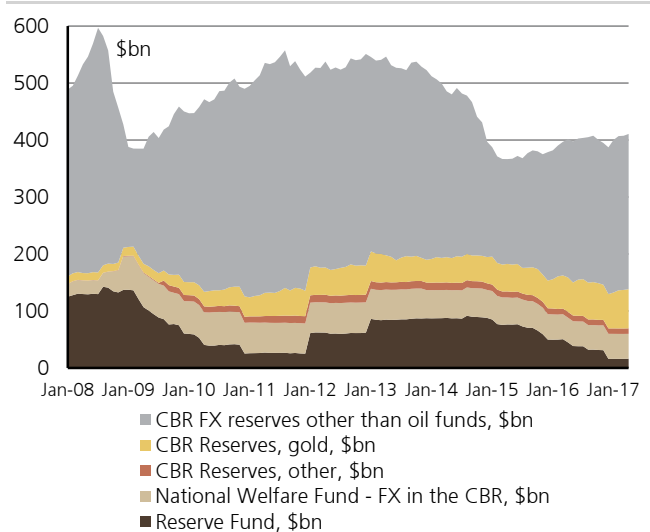
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Figure 1: Russia's reserves adequacy already high



Source: CBR

Figure 2: Structure of CBR's reserves

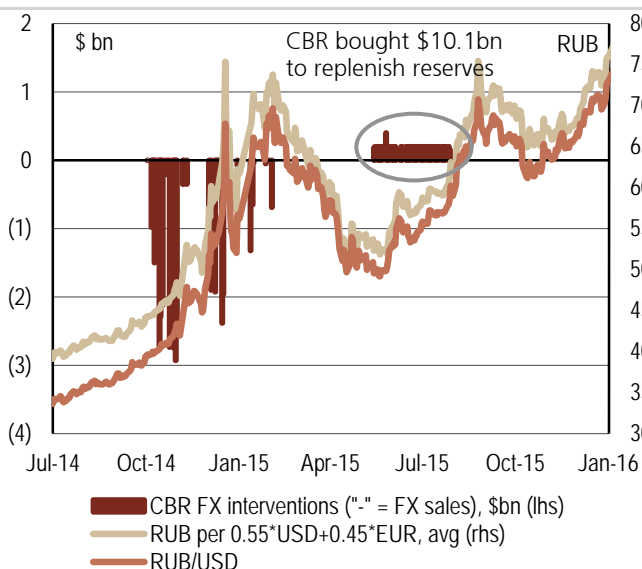


Source: CBR, UBS

Under the circumstances the latter meant trying to get a weaker RUB at a given level of oil prices, boosting RUB-denominated oil revenue. Unlike the CBR in 2015, the Finance Ministry was quite vocal about its view on the RUB: Minister Siluanov in March opined in March that the RUB was 10-12% overvalued.

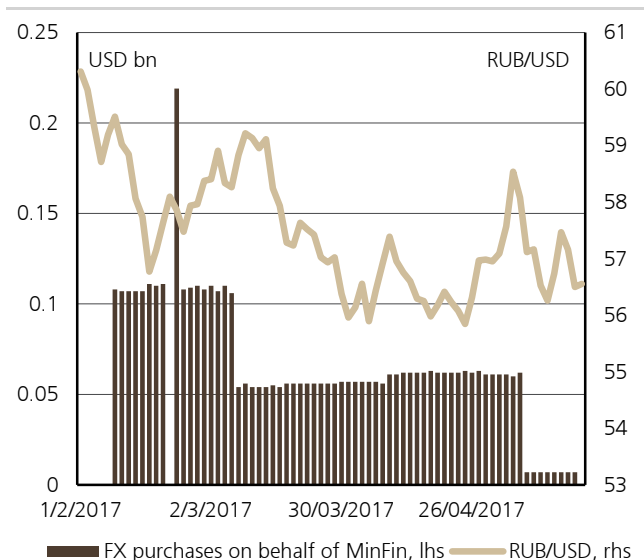
A stronger than expected RUB and lower than planned oil tax receipts meant that so far the purchases are coming well below our initial estimate of \$15-\$23bn. The Finance Ministry bought \$4.1bn since February, with the daily sums coming down from c. \$100mn in Feb to \$7mn in May, too small for the currency buoyed by strong current account surplus (\$25.7bn in Jan-Apr vs \$21bn in net private capital outflow), foreign inflows into the OFZ market and high real rates. The amendments to 2017 Federal budget include an accumulation of RUB 616bn on "other treasury accounts", assuming Urals oil at \$45.6bn, implying less than \$6bn in FX purchases for the rest of the year.

Figure 3: CBR FX interventions in 2015



Source: CBR, Haver, UBS

Figure 4: Finance Ministry FX purchases in 2017



Source: CBR, Haver, UBS

In our view, so far the CBR has kept the MinFin's operations and government's attempts to talk the RUB down at an arms' length, turning to a more hawkish tone in February after the FX purchases started and cutting rates only after it became evident that the RUB remained well-supported. The goal of reserve accumulation was not abandoned but the CBR signalled that anchoring inflation at 4% took priority. In addition, the CBR reserves have actually been growing anyway as banks returned FX liquidity borrowed during the crisis via the FX repo facility.

In early May the CBR Governor Nabiullina said that increasing reserves was still viewed as necessary, but the CBR will buy FX into reserves only after the 4% inflation target is achieved, the situation at the FX market is stable and CBR's actions "won't affect the exchange rate". A few days later, the head of Monetary department Dmitriev was even more specific, saying that plans to rebuild reserves to \$500bn "were a question of the future" and that it was not a question of buying reserves when RUB was strong and stopping when the RUB was weak, rather that "certain conditions needed to be in place" for interventions to resume.

The CBR is understandably vague on what these conditions are, but we think it involves a) some conviction that inflation and inflation expectations are anchored at 4% (rather than CPI touching 4% for a couple of months) and b) a comfortably high current account inflow (net of private capital outflows), enabling the CBR to commit to FX purchases for longer than a couple of months. In Monetary policy guidelines for 2017-19 the possibility of reserve accumulation is mentioned in the "optimistic" scenario with oil prices rising to \$50-\$55/bbl in 2018-19, versus the base case of oil at \$40/bbl. In our view, this gives an additional reason to focus on possible revisions in the oil price assumptions in the CBR's forecast in June and September: it affects not only the interest rates path but also the likelihood of reserve accumulation. Irrespective of the outcome of the upcoming OPEC meeting, the CBR may continue to stick to its conservative long-term oil prices view at \$40/bbl - not only out of caution but also to keep a united front with the Finance Ministry which relies on similarly conservative assumptions.

Importantly, with the Finance Ministry aiming to pass Budget Code amendments later this year formally re-introducing a fiscal rule, the CBR may well forgo "active" reserve accumulation altogether, limiting itself to FX purchases sterilising oil revenues above a certain cut-off oil price set in the rule and saved into the (FX-denominated) Reserve Fund. Uncertainty over how the fiscal rule will look like – including whether the cut off will be set at \$40/bbl or higher, - is another reason, in our view, for the CBR not to rush with FX operations of its own before the parameters are set.

In terms of our strategy views, we have recommended being long OFZs funded in CAD (reducing the beta of this position to oil). While we believe RUBCAD will struggle to appreciate much further, having already risen by 10% ytd not including carry, there are few triggers for a big move lower. The risk reward of this overall position is certainly weaker than it was 6 months back as the price has moved, but the rationale for holding on to OFZs – high real rates- remains in place. We are holding on to this trade, but expect coupon, not capital gains will be the driver of returns from here.

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes

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