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CBR's huge rate hike unlikely to restore financial stability

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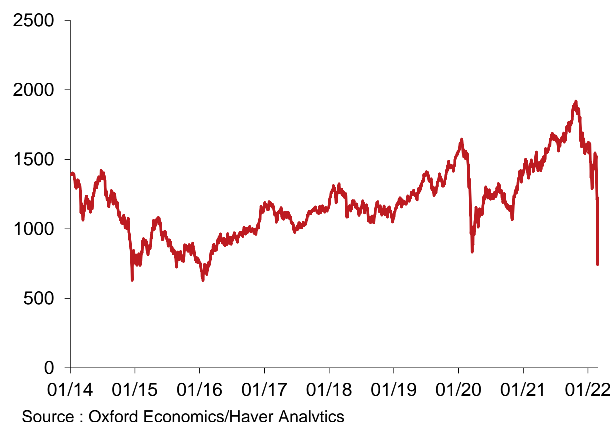
- **Following Russia's invasion of Ukraine, the US and EU announced harsh new sanctions, including banning some Russian banks from SWIFT and freezing the assets of Russia's central bank.**
- **The weekend announcements have caused panic in Russia's domestic market and prompted the CBR to hike the policy rate to 20% from 9.5% on Monday morning. The authorities have also imposed capital controls, including prescribing that exporters sell 80% of their foreign currency gains from exports.**
- **Cutting Russia's banks from SWIFT and freezing the CBR's assets are crushing policies. Given that Russia is a large economy deeply integrated into global markets and the financial system, unforeseen consequences may follow.**
- **On Friday, S&P cut Russia's sovereign rating to BB+ from BBB- and put it on negative outlook. Moody's, which currently rates Russia's debt at Baa3, has put Russia on review for a possible downgrade. We would not be surprised to see Russia's ratings cut deeper into "junk" territory given the severity of sanctions.**
- **A glimmer of hope has emerged with arrival of a Ukrainian delegation in Belarus for peace talks with Russia. But it is too early to expect positive results.**

Over the weekend, the US and EU agreed further severe sanctions against Russia, some of which had not been mooted before and therefore had not been included even in our "full-scale invasion" scenario. The consequences of the invasion, including scenes of mass exodus from Ukraine and human suffering in besieged Kyiv and Kharkiv have prompted EU leaders to put aside divisions and unanimously approve tough policies, including cutting some Russian banks off SWIFT and sanctioning Russia's central bank.

Figure 1: Russia's stock market plunges



The Russian stock market crashed initially when Russia invaded Ukraine. Following the announcement of new sanctions targeting the CBR and SWIFT access, pressure on Russian assets has become extreme, forcing the CBR to hike the policy rate by an unprecedented 1050bps.

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Disinvestment plans are being constrained by capital controls and a lack of buyers

In addition to these developments, sovereign funds and global corporations are considering divesting their Russian assets. The most notable announcement came from BP, which intends to dispose of its 19.5% stake in Russia's oil giant Rosneft. Similarly, Norway's sovereign wealth fund has said it will sell its Russia holdings of around $3bn.

Before the weekend, signs emerged that the war in Ukraine was causing panic among Russian households and businesses. Russians queued at bank branches and cash machines were emptied as people tried to exchange their roubles for foreign currencies. There were local reports of people buying white goods to turn their cheapening roubles into something with tangible value.

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Any rate rise by the CBR won't offset the current extreme risks associated with holding RUB assets

This morning, the CBR announced a steep 1050bp increase in its policy rate, to 20%. In addition, it ordered all exporters to sell 80% of their export proceeds at the open market. At the same time, the CBR banned local brokers from selling securities held by non-residents. The central bank also sought to support the local banking system: it announced a package of macroprudential measures to soften the impact of the new sanctions by the West and the RUB devaluation on banks' balance sheets. It will also allow domestic banks to use reserves earmarked for unsecured consumer loans and mortgages, which is equivalent to an injection of RUB733bn into the banking system. The CBR also announced exemptions for banks facing sanctions from requirements applied to open FX positions. In a separate announcement, the CBR suspended stock trading at today's session.

Despite a more favourable path for oil, the pressures on CBR dwarf those in December 2014

The CBR can draw on its previous experience of responding to FX crises during adverse geopolitical shocks. In December 2014, following the annexation of Crimea and subsequent sanctions, the CBR hiked its policy rate by a combined 750bps to 17% at its regular and extraordinary meetings. The CBR was severely criticised for this dramatic move, and some of its key officials were demoted following this decision. The CBR already cut its policy rate by 200bps to 15% in January, and more cuts followed at subsequent meetings. This time, however, it's unlikely that rate hikes can offset the perceived risks of holding RUB assets even for Russian citizens.

There are limits to the usefulness of lessons from the late 2014 crisis. Apart from the first waves of Western sanctions, Russia's economy and markets were then also affected by a sharp drop in oil prices. The FX market stabilised in late December 2014 – January 2015, in part due to the decision to place government representatives on the boards of leading exporters to ensure that the latter were selling FX proceeds in the FX market rather than hoarding them. This was equivalent to "backdoor" capital controls; it ensured demand for roubles in the FX market and helped reverse the RUB weakening trend.

After today's measures were announced, the first FX sales were reported on the local market, suggesting that the above measures were working, at least to some extent. We think that in the coming days exporters' FX sales could help relieve some of the pressure on the RUB market, which is to a large extent due to a lack of liquidity. There is a caveat: some exporters, for example those in metals and mining sectors, are likely to encounter difficulties receiving payments owing to the ban on SWIFT. Although for now, energy-related transactions are exempt from the SWIFT ban, even hydrocarbon exporters are likely to experience delays and non-payments due to the changes in the assessment of Russia-related risks and tightening of compliance procedures.

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On the rates side, we think the CBR has done all it can to support the rouble. From now on, the path of the rouble FX rate will likely be mostly determined by the liquidity situation in the Russian market.

We think Russian debt repayments will probably remain manageable, though sanctions on the CBR could make life very difficult, especially if potentially friendly counterparties fear US retaliation

Another important issue is how Russia will refinance its external debt. At $62bn, hard-currency sovereign debt is relatively low. As of H1 2021, principal hard-currency sovereign debt payments due in 2022 amounted to only $2.6bn. Banks owe $14.5bn in principal on external debt repayments this year, and companies in other sectors, $42bn (the latter amount includes $15.8bn due in Q1, which has likely already been refinanced). Even assuming Russia has completely lost access to global capital markets, we still think that repayments are manageable. Still, the announced sanctions could precipitate technical defaults as they have disrupted the channels for making and reporting payments.

At first glance, Russia's gross FX reserves (including gold), which were valued at $630bn as of the end of January, provide an ample cushion against shocks. When Russia previously found itself in a similar situation, CBR's FX reserves were deployed to plug the gap in external refinancing. But now, according to sanctions announced over the weekend, the CBR's assets abroad will be frozen, including those held at banks in the US and Europe. While the data on where the CBR keeps its FX holdings is patchy, various estimates suggest up to $300bn worth of its assets could be tied-up at foreign banks as the result of the latest sanctions.

That said, the CBR could still utilise its gold holdings valued at $133bn at the end of January. We assume that all gold bullion owned by CBR is held in its vaults. In theory, the CBR could swap gold for US dollars or US treasuries with other central banks that have ample holdings of US-denominated assets. It remains to be seen, however, whether other central banks (for example, the People's Bank of China) would be prepared to offer help to the CBR given the threat of retaliatory measures by the US.

Also, using the strength of Russia's fiscal position, the authorities could announce a scheme for rouble-denominated deposits to compensate deposit holders for losses related to local currency depreciation, similar to the one recently deployed in Turkey. We think such a measure would help tackle two problems simultaneously: it would provide an incentive for a return of the cash recently withdrawn from banks into the banking system; and it would decrease the pressure on the rouble from conversions of rouble household savings into FX. This move would come at a cost, however, as it entails the government writing a financially valuable option to Russian citizens, which could have a huge fiscal cost if it failed to prevent a further RUB slide.

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