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Liquidity: surplus to succeed squeeze by end summer

Options for absorbing excess liquidity

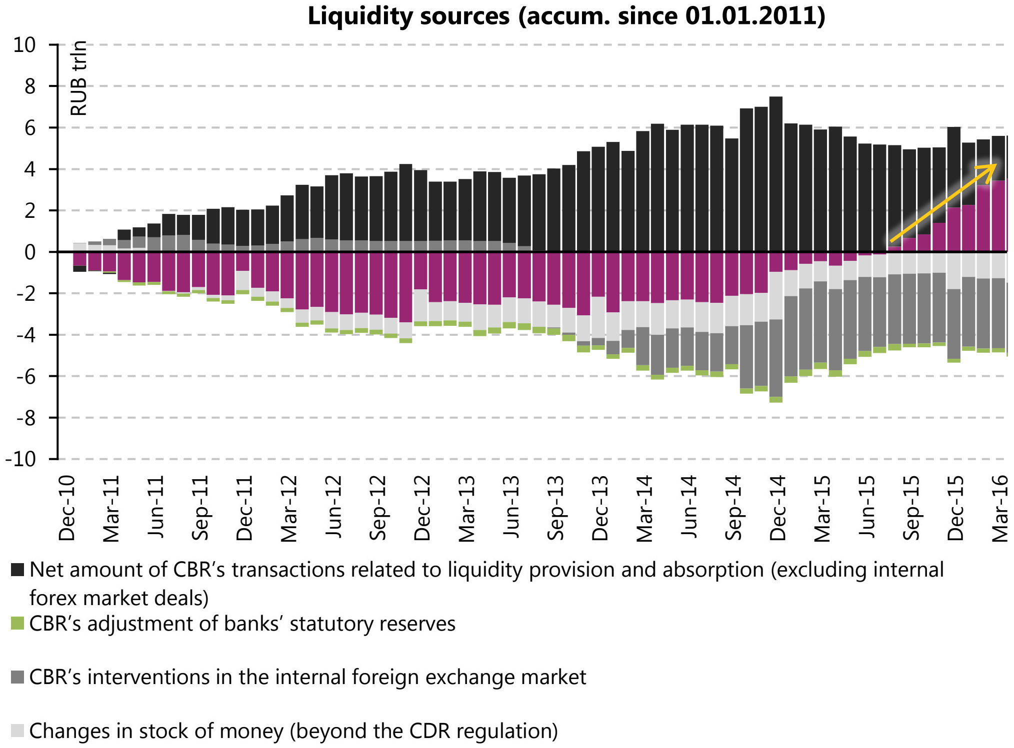
The Bank of Russia will curb monetary inflation by absorbing excess liquidity pouring from the Reserve Fund.

After some expenditures have been cut, the anticipated 2016 budget gap resulting from oil and gas revenues falling will be less than that of the current budget, but will remain considerable and exceed RUB 3 trillion. According to ACRA it may equal RUB 3.5 trillion (4.2% GDP).

While the external environment is not conducive to borrowings, such significant gap may be covered in two main ways: by spending state funds financed through oil and gas revenues or by means of internal borrowings (by ACRA's estimates, privatization may cover only a quarter of the annual gap). The volume of internal debt issues is limited by the internal market capacity and is unprofitable amid the expected interest rates reduction. As for the Reserve Fund, its spending is a sort of free money issuance, independent from the current interest rate level. So this may well be an option the Finance Ministry will go for in order to cover the major part of the budget deficit, as it did last year.

The increasing role in generating sources of liquidity for the banking system will be played by the Ministry of Finance. The Bank of Russia will have to tailor its monetary policy to avoid liquidity surplus, which may spur inflation and impair the stock and exchange markets by boosting growth of stock indices and leading to ruble weakening.

Figure 1. Banking system liquidity is increasingly reliant on budget expenditures



Source: Central Bank, ACRA estimates

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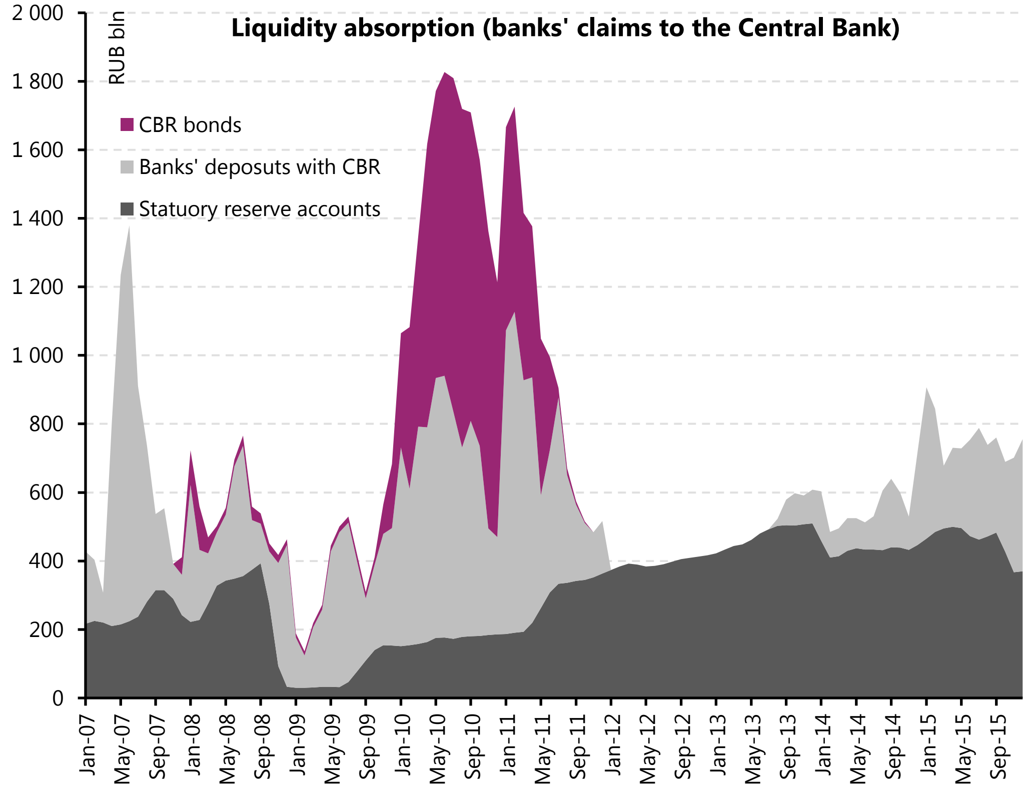
In accordance with ACRA estimates, a mere RUB 3.5 trillion liquidity growth may cause such a level of monetary inflation (other factors being equal) that within 12 months will result in a CPI hike by 2.5-3.0 points, and this is the lower estimate in view of an impact on borrowing activity. The Central Bank considers such growth unacceptable and, therefore, it will have to resort to compensatory measures, i.e. to reduce liquidity provision for auctions and standing facilities. Besides, when liquidity sees its structural deficit replaced by structural surplus, which we anticipate at end summer taking into account the current spending of the Reserve Fund, the majority of CBR transactions with the banking system will be related to absorption. The money market will be guided by CBR deposit rates, which form the floor of the indicative interest rate corridor.

Figure 2. The Bank of Russia has three powerful tools to manage excess liquidity



Source: Central Bank, ACRA estimates

Apart from transactions related to liquidity provision and absorption, the Central Bank has less delicate, but not less effective tools for managing bank liquidity, such as issuance or buyback of bonds, adjustment of the statutory reserve ratio, exchange market interventions and cash volume control. All these tools were used at different times to manage excess liquidity. For instance, early in 2010, the CBR bond issuance allowed for quick absorption of liquidity worth more than RUB 1 trillion. The rest three tools – adjustment of the statutory reserve ratio, exchange market interventions, cash volume control – are more exotic and are used less frequently, as they may create undesirable stimuli in the banking system or cause foreign exchange market volatility. Employing all or some of the mentioned tools, the Central Bank will prevent monetary inflation growth.

As ACRA estimates, the new liquidity management mode will result in three main developments. The assets and liabilities structure of the banking system will change: assets will expand the Central Bank's share, while liabilities will build up the households' and corporates' one. In the household and corporate income structure, the share of interest revenues will increase. The key rate will be declining slower than it might have been expected, as lending terms are set to improve due to short market rates moving closer to the floor of the CBR interest rate indicative corridor. In other words, when the banking system enters the surplus liquidity mode, short-term market rates break away from the key rate and catch up with the rates of absorption.

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