

A hawkish Bank of Russia to decide its angle of attack this week

The Bank of Russia is likely to raise the key rate and give a hawkish signal this Friday. What steps the CBR will choose is uncertain, but that's not so important in the big picture. The new inflation wave calls for something bigger than 25 basis points; medium-term CPI limits it to 50. But the ultimate decision may be dictated by something else entirely



Governor of the Bank of Russia, Elvira Nabiullina

Big local inflation surprise calls for at least a 50 basis point hike

Another interesting Friday is in store for Russia-watchers. Analysts seem to be split between a 25 and 50 basis point hike in the key rate from the current level of 6.75%. The broader range of market participants is even more diverse, with some not excluding a 100 basis point move as an extreme case scenario. Against this backdrop, we would identify ourselves as moderates. We believe the Bank of Russia (CBR) will be realistically deciding between a 25bp and 50bp hike, and consider the latter option to be slightly more likely.

The key reason to expect something bigger than the standard 25bp step is the new wave of negative CPI surprises

The key reason to expect something bigger than the standard 25bp step is the new wave of negative CPI surprises. Remember, the CBR governor explained September's return to the cautious 25 basis point step by the lack of signs of CPI overspeed vs. the trajectory expected by the CBR at that time – 5.7-6.2% by the end of 2021 and 4.0-4.5% by the end of 2022. Meanwhile, the [September spike to 7.4% YoY](#) and further acceleration to 7.6% by the middle of October is a meaningful challenge to official expectations. The government has already revised its 2021 year-end projections by 1.6 percentage points to 7.4%, and the Central Bank will probably make a large revision at the upcoming meeting.

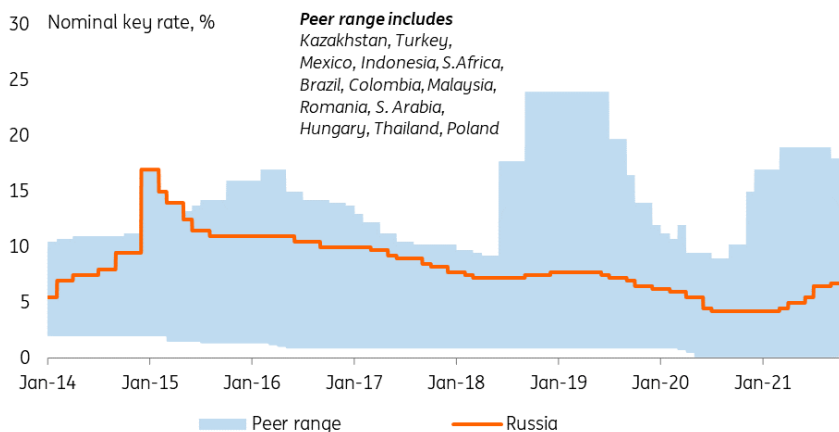
By the logic of earlier communication, the CBR is committed to responding to higher inflation risks regardless of their nature (be it monetary, non-monetary) in order to prevent second-round effects caused by elevated and unanchored inflationary expectations by economic agents. We believe the current situation makes a 50 basis point hike a reasonable response within CBR's own framework.

There are reasons to be cautious, too

At the same time, we would not expect the board to realistically discuss more aggressive options in response to the recent spike in inflation. There are quite a few reasons to maintain a cautious stance.

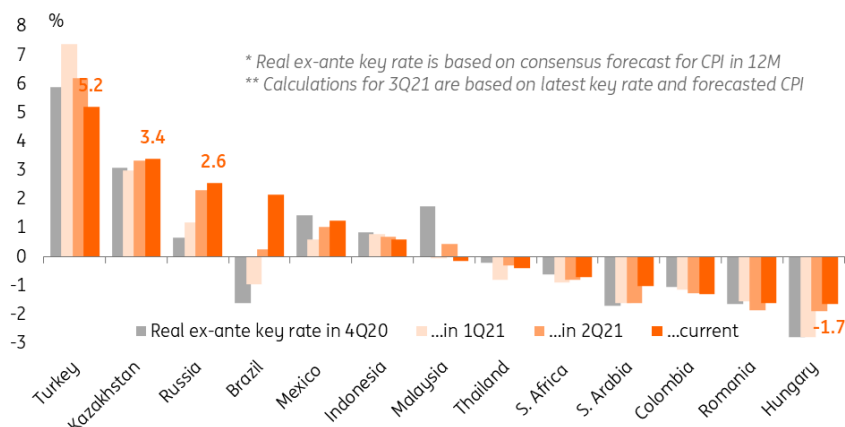
- Bank of Russia was already proactive in raising the key rate by 250 basis points since the beginning of the year, somewhat ahead of peers, putting it close in the upper bound of the spectrum after Turkey and Kazakhstan (Figure 1).
- In terms of real rate, Russia also looks aggressive enough. Comparing the key rate level to the forward-looking market CPI expectations (Figure 2), the Russian real rate made a considerable increase over the last 12 months from 0.5-1.0% to 2.5-3.0%, the second biggest increase after Brazil, helping Russia maintain its position in the top-3 countries in terms of real rate. The current level is slightly above the 1-2% equilibrium range, which allows for some leniency even in case of further deterioration in the inflationary expectations.
- The inflationary expectations by households and companies (Figure 3) are indeed elevated, but in the last couple of months went down a bit from their peaks. Importantly, the next dataset covering October is supposed to be out on 25 October, i.e. after the 22 October CBR meeting.
- With only 2.5 months before the year-end, the role of the 2021 CPI forecast is clearly not as important as the longer-term view. Noteworthy, the government decided against revising its 4.0% outlook for 2022, which puts a material upward revision of the CBR's 4.0-4.5% forecast under question. The CBR representatives already downplayed the September and October CPI data as noisy and driven largely by harvest and other one-off factors.
- Potential additional arguments against a material deterioration in the official 2022 CPI view include the continuous attractiveness of Russian assets to foreign investors (Figure 4), the ruble's defensive performance vs. peers (Figure 5) and US dollar, as well as [tight budget policy signal for 2022](#) regardless of how realistic it looks at the moment.

Figure 1: Russian nominal key rate up 250bp year-to-date



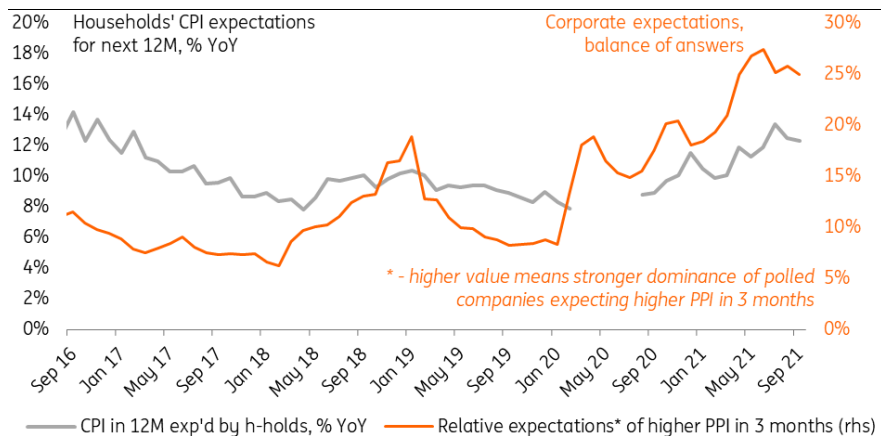
Source: Refinitiv, ING

Figure 2: Russia noticeably tightened the real rate over the last 12 months



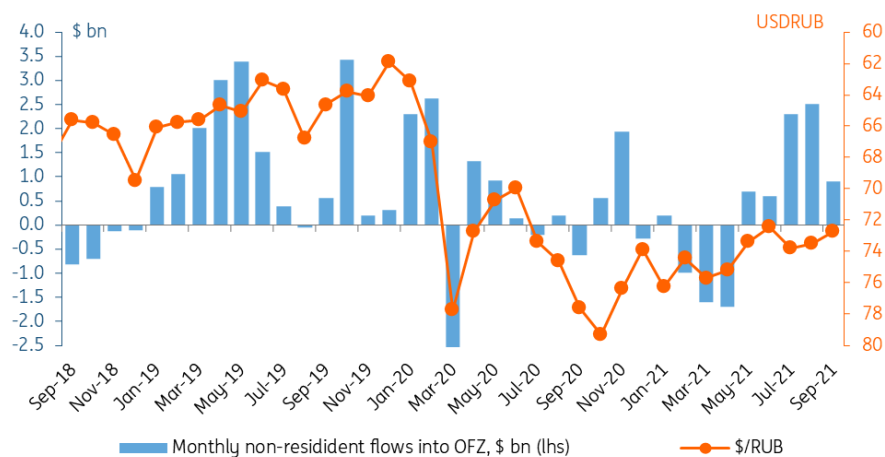
Source: Refinitiv, ING

Figure 3: Personal and corporate CPI expectations elevated but off peaks



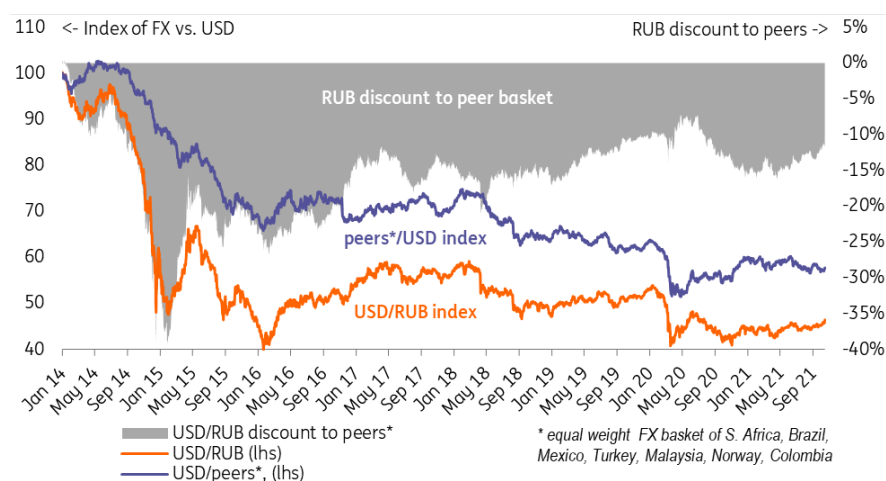
Source: Bank of Russia, ING

Figure 4: Russia remains attractive portfolio investment destination



Source: Bank of Russia, Refinitiv, ING

Figure 5: Ruble has relative strength vs. EM/commodity peers



25 basis points: a less likely but also plausible scenario

There are at least two reasons why Bank of Russia could still decide opt to stick to the regular 25 basis point step this Friday.

- First, to account for the growing uncertainties around the epidemic in Russia. The fourth wave of infections (Figure 6), growing mortality (Figure 7), and sluggish vaccination progress (Figure 8) has already led to minor tightening in the mobility restrictions in some regions. Full-scale lockdowns are not in the base case scenario, but should be considered as a risk. We would not consider this as a strong argument against more aggressive tightening given that the previous experience of covid waves and lockdowns does not give compelling evidence of the disinflationary consequences of those.
- Second, no change in the 4.0-4.5% CPI forecast for year-end 2022 and a regular 25 basis point hike might potentially be seen as a reassuring signal to the market, a sign of the CBR's confidence in the temporary nature of the current spike. However, such an approach could also be seen as a bit of a gamble, bearing reputational risks for the monetary authorities in case the optimistic view fails to materialise.

Figure 6: Russia has entered fourth wave of Covid infections

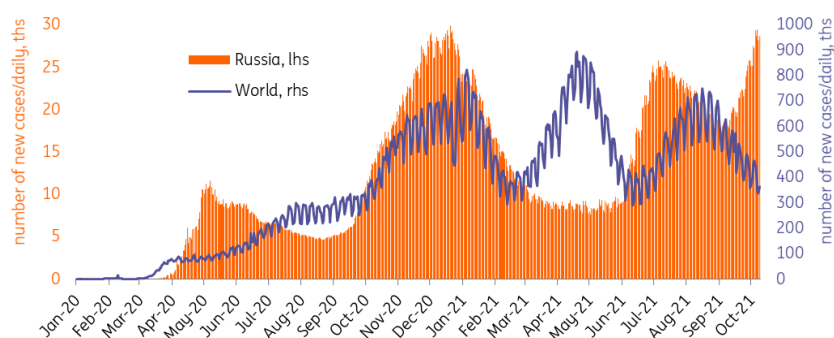
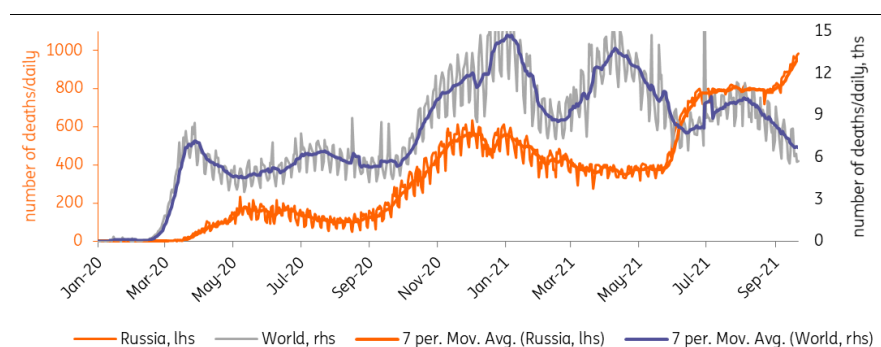
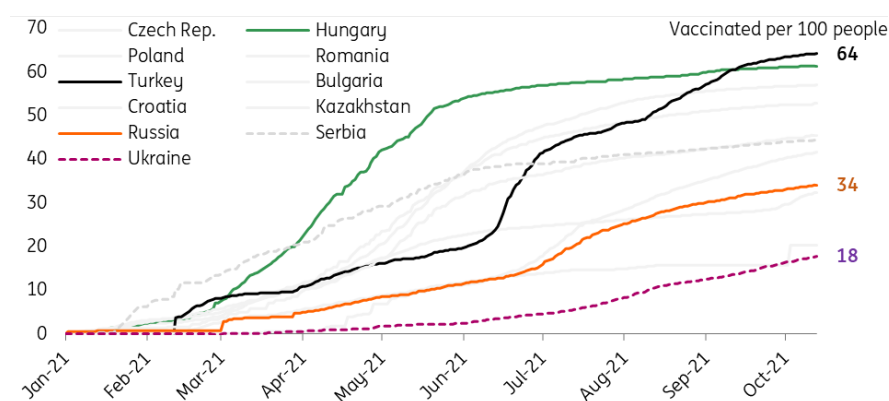


Figure 7: Mortality is at a record high



Source: CEIC, ING

Figure 8: Vaccination in Russia remains sluggish vs. peers



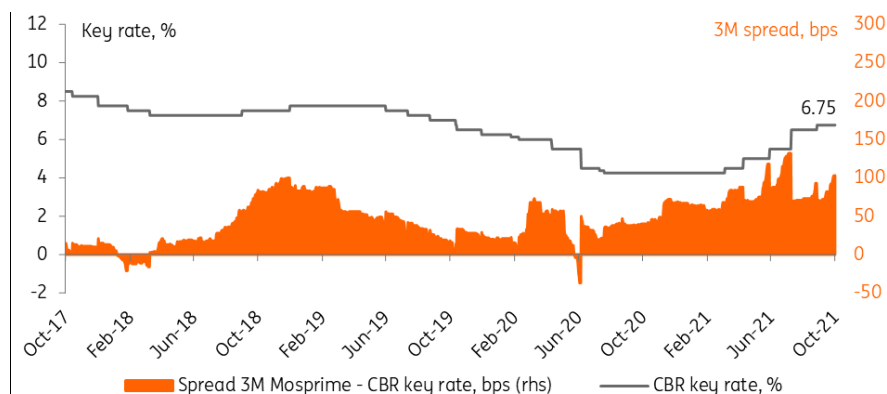
Source: CEIC, ING

The signal to remain hawkish, anyway

The good news is that the uncertainty about the 22 October key rate decision is probably not as important for the markets that are focused on the longer-term signal. And there is much more clarity about that. Given the continuous deterioration in the global inflationary context, recently confirmed by the updated IMF projections, the balance of inflationary risks is tilted to the upside, calling for reiterated hawkish commentary from the CBR. For now, we continue to see 7.50% as the medium-term key rate ceiling, with a higher level also not excluded in case of further upward CPI surprises.

Another piece of good news is that the market seems to be ready for this. The money market spreads (Figure 9) are pricing in a 50-100 basis point key rate hike within the next 3 months (October plus December meetings). The longer term rates (Figure 10) are driven more by the global EM risk mood, while local strengths such as the healthy fiscal position, are somewhat offset by foreign policy risks.

Figure 9: The market is ready for a 50-100 bp hike within 3 months



Source: Refinitiv, ING

Figure 10: Longer-term rates to remain driven by global risk mood



Source: Refinitiv, ING

Implications for the ruble

The ruble is the world's best performing emerging currency this year and it is not hard to see why. The CBR's front-loaded tightening cycle has delivered very attractive 7%+ yields at a time when [Russia's current account surplus is running in the 7-8% of GDP area](#). While MinFin FX purchases partially sterilize some of this large surplus, higher energy prices do though support higher RUB valuations. We expect USD/RUB to gravitate to the lower end of a 70-75 trading range in the near term.

Yield curve dynamics are also supportive of the rouble where a very flat curve discourages FX hedging of exposure to the bond market. For example, why invest in high yield 10 yr OFZs at 7.50% when hedging RUB FX exposure costs the investors 7%+ p.a. through the three month forwards?

Given what should be a hawkish press conference we doubt a 25bp instead of a 50bp hike would do too much damage to RUB long positions assuming the CBR makes clear that the tightening cycle is on-going. Any correction in USD/RUB on perceptions of a less aggressive-than-expected CBR should prove temporary.

In the longer run, a stronger dollar environment and persistent foreign policy risks should limit the scope of RUB appreciation to USD, but the opportunities in EUR/RUB are not exhausted.

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