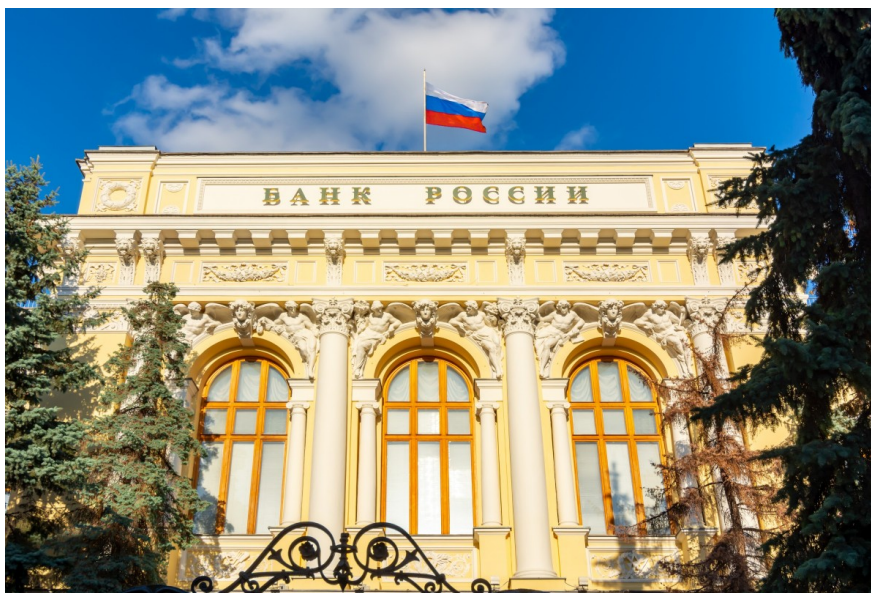


Russian key rate to approach double digits in February

We expect Bank of Russia to make a 100 basis point hike, reaffirm its hawkish guidance, and raise official CPI and key rate guidance for 2022. Foreign politics will have little to do with it. In terms of Russian asset markets, investors look minded to position for a slightly stronger ruble – but only via limited loss strategies



Central Bank of Russia building in Moscow.

9.50%

Key rate expected for 11 February

a 100 basis point hike

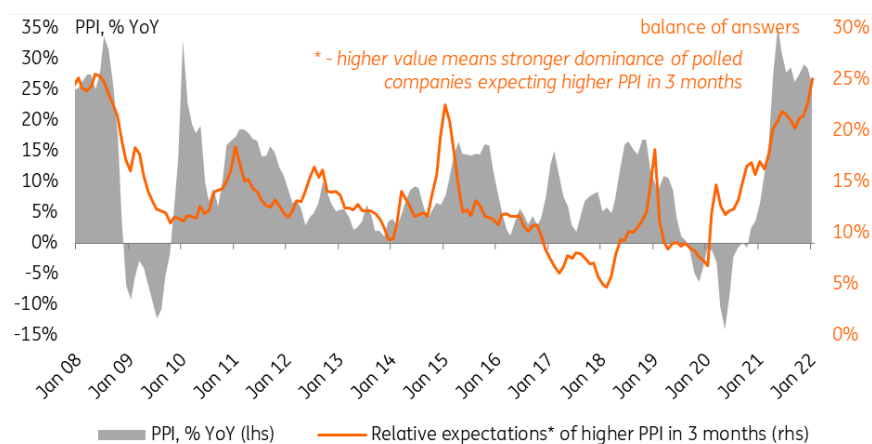
January's local indicators call for a hawkish approach

This Friday, Bank of Russia will have a core monetary policy meeting, meaning that the rate decision will be accompanied by a revision in the medium-term forecasts. We believe, the **recent economic data calls for a more hawkish approach** than what was hinted at the time of the [previous meeting](#) on 17 December.

- After a brief [plateau of 8.4% YoY](#) in November and December 2021, the Russian CPI continued to [crawl upwards](#) and is likely to have reached 8.8-9.0% year-on-year last month, based on preliminary weekly data, driven by both food and non-food segments. We expect this preliminary takeaway to be confirmed by the 9 February release of January CPI.
- Inflationary expectations by households moderated by 1.1 percentage points in January, but remained at an elevated level of 13.7%, the highest since 2016. Meanwhile, the pro-inflationary bias in the corporate expectations continued to increase, returning the worst reading since 2008 amid a close to record-high PPI increase (Figure 1) in the 25-30% YoY range.
- Despite the macroprudential restrictions and 425 basis point increase in the key rate in 2021, local bank lending growth continued to accelerate and outperform funding in both corporate and retail segments. Adjusting last year's banking data for FX revaluation effects, corporate loan growth accelerated from 7% to 17%, retail lending accelerated from 14% to 25%, while retail deposits picked up from 4% to 6% only. More importantly, retail lending growth is now increasingly reliant on non-mortgage segment (Figure 2).
- According to [preliminary estimates](#) by the Bank of Russia, Russian year-end economic activity in December exceeded expectations on strong external and local demand. In part, this conclusion is confirmed by higher-than-expected industrial output growth of 6.1% YoY in December, driven by local manufacturing (not just export-driven commodity extraction) and presumably supported by seasonal year-end spending splurge by the state budget. The consumer side of the story is yet to be confirmed by the full set of statistical data to be released on 9 February.

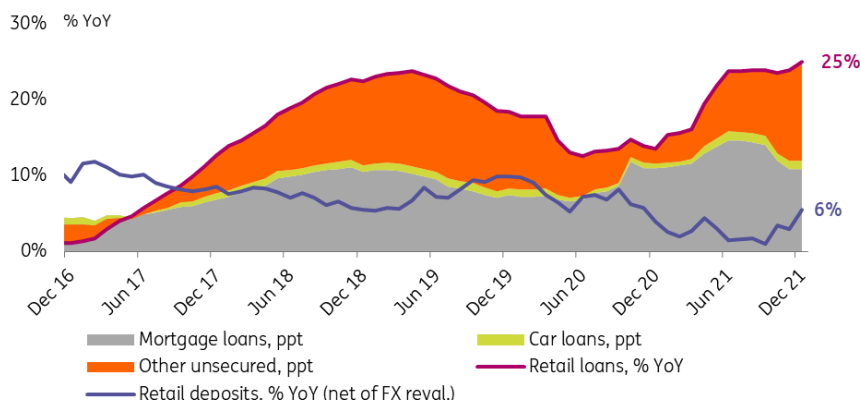
In short, the tightening in the monetary conditions seen since 2021 has not yet been strong enough to increase the preference for savings in the non-financial sector, and the latter is still needed to limit the corporate sector's ability to pass on the increased costs onto the end consumers. Bearing that in mind, **we deem our initial 0-50 basis point hike expectations too cautious and see a 50-100bp range as more realistic for 11 February. We also doubt that Bank of Russia will be able or willing to call a ceiling in the current hike cycle at this point.**

Figure 1: Corporate inflationary expectations hit a 14-year high in January, amid high PPI growth



Source: Bank of Russia, ING

Figure 2: Retail lending keeps accelerating, increasingly relying on consumer segment



Source: Bank of Russia, ING

Medium-term forecasts to shift towards a more pro-inflationary scenario

The scope of official forecast revision is one of the key questions ahead of the 11 February meeting, given that CBR's **current official year-end CPI expectations of 4.0-4.5% and average key rate guidance of 7.3-8.3% for 2022 no longer look relevant** and are contested by [analysts](#).

We believe Bank of Russia's [Monetary policy guidelines](#) released last September provide an idea about the scale of upcoming forecast revision vs. the current baseline. On the list of alternative scenarios provided by the central bank, "Global Inflation" appears to be the most adequate to the current development. It assumes a stronger-than-expected recovery in global economic activity, longer-than-expected supply chain disruptions, higher-than-expected inflation and faster-than-expected tightening of the monetary policy by the major central banks. The resulting higher-than-expected inflationary pressure and expectations in Russia would necessitate a tighter monetary policy stance in Russia vs. the baseline. That scenario seems to be materialising:

- According to the January poll by [FocusEconomics](#), absolute majority (50%+) of the 96 polled analysts expect global container and semiconductor shortages to significantly ease not earlier than in 2H22-2023 and see that the balance of risks to the medium-term inflation outlook skewed slightly to the upside.
- IMF has [increased](#) global CPI rojections by 0.6 percentage points for 2022 and 0.2ppt for 2023, driven by the US and Euro area.
- Inflationary pressure in the US, EU, and other regions has been exceeding expectations lately, leading to tightening in the rhetoric by the Federal Reserve, ECB, and other central banks.

CBR's Global Inflation Scenario suggests 2022 year-end CPI at 5.0-5.5% and average key rate of 8.8-9.8%, and we believe the actual figures to be released this Friday to match or slightly exceed those levels. This would mean that a double-digit key rate will not be out of the question for this year.

A hike bigger than 100 basis points is unlikely in February

We doubt that foreign policy tensions will play an important role in Bank of Russia's monetary policy decision this time. In other words, we do not see CBR increasing the step of its hike from the 100 basis points, to which the market became accustomed since the end of 2021.

- At times of previous rounds of foreign policy tensions Bank of Russia stressed that they are willing to act on facts, not risks.
- At times of heightened market volatility CBR prefers to address it directly, i.e. through adjusting its [operations on the FX market](#) and reiterating its readiness to provide liquidity to banks and markets in case of further deterioration.
- The ruble's 6% depreciation to USD in 1-26 January, followed by a 4-5% recovery to date, may contribute to further deterioration in inflationary expectations by households and corporates, but given its short-term nature the inflationary effect is unlikely to be material at this point.
- At 9.50% key rate and expected year-end CPI of 5.5-6.0%, the Russian real key rate would be at 3.5-4.0%, already competitive vs. peers (second only to Brazil's 5.6%). A further increase in the rate is unlikely to be as efficient in boosting Russia's attractiveness to portfolio investments as suspension of FX purchases or actual decline in the foreign policy risks. According to preliminary estimates, non-resident outflow from the local currency state bonds (OFZ) slowed to US\$0.3bn last week after spiking to US\$0.7bn in each of the preceding two weeks.
- Parallels to the experience of December 2014, when the CBR was forced to make a shocking hike from 9.5% to 17.0%, would be irrelevant given that Russia is no longer in transition from managed FX float to inflation targeting, sanctions are no longer a 'black swan', and banks are no longer dependent on the funding from the Bank of Russia.

Nevertheless, it does not mean that a bigger than 100 basis point hike will be completely out of the question this Friday. We suspect the overall upside to the current key rate exceeds 100 basis points, and it will be CBR's judgement call on how many steps to take on the path to the top floor.

FX purchases likely to remain suspended for a while

While technically not a monetary policy issue, during the press conference, the CBR Governor Nabiullina will most certainly be asked about the timeframe for the return of market foreign exchange (FX) purchases that were suspended on 24 January in response to the foreign policy-driven ruble sell-off. We doubt that the governor will give a definitive guidance.

- Last week, the ruble returned to levels seen right before the suspension, but it still remains c.1.5-2.0 RUB/USD weaker than at the end of 2021, when the current round of foreign policy tensions started.
- In January, Russia enjoys a very strong current account surplus on combination of high commodity prices and seasonal drop in imports. We do not exclude that on 9 February Bank of Russia will report a current account surplus in the US\$15-20bn range for January. At the same time, that surplus is likely to be offset by the net private capital outflow of up to US\$15bn and US\$1.7bn net portfolio outflow from OFZ. This means that the ruble's position remains vulnerable from the balance of payments perspective.
- Unless the market FX purchases restart this month, the CBR will end February with US\$13bn

in FX purchases backlog that will need to be caught up with later. Meanwhile, given the previous communication by the government, up to US\$36bn in local investments could be made out of the sovereign fund in 2022-24. This means that at current oil&gas prices CBR can hypothetically keep the market purchases suspended until the end of May, treating it as a frontrun mirroring of upcoming investments.

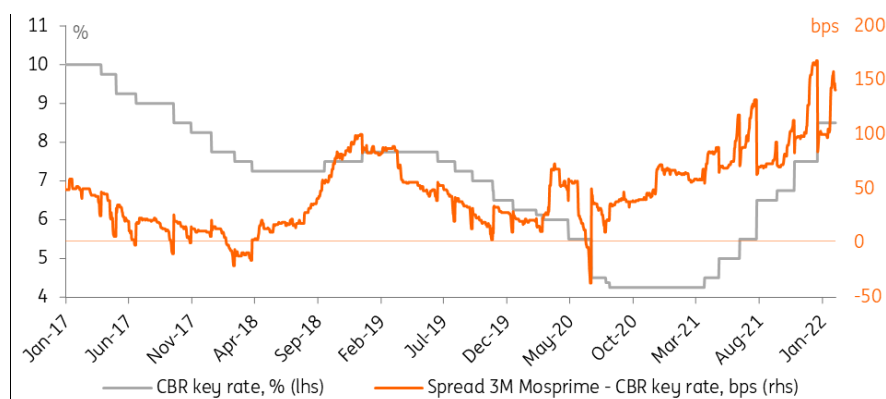
The market is ready for a 100-150 basis point hike in the next 3 months

Ahead of the 11 February, the analyst consensus seems to be hovering around 9.5% (a 100 basis point hike), but the range of estimates vary from 9.0% to 10.0% (50-150bp hike), suggesting that the upcoming decision is not seen as straightforward.

Bank of Russia refrained from directly fine-tuning the expectations ahead of the self-imposed 'week of silence', but the released reports on banking sector, inflationary expectations, and economic trends are hinting at a hawkish bias, in our view.

We also do not exclude that the Bank of Russia opted against making additional comments because it might be happy with the market expectations. Looking at the interbank market (Figure 3), the participants seem to be pricing in a 100-150 basis point increase in the key rate over the next three months. Bond yields are around 100 basis points higher now than at the time of the previous CBR meeting, however, it would be problematic to dissect this increase into a higher foreign policy premium and deterioration in inflationary expectations.

Figure 3: Local market seems to pricing in 100-150bp increase in the next 3 months



Source: Bank of Russia, Refinitiv, ING

FX and Debt: Geopolitics not CBR to determine the next big move

It looks fair to say that investors are minded towards reduced tensions in eastern Ukraine, where the ruble has recovered about 4-5% off its late January lows, local equity markets (be they MOEX or RTS-\$) are 10% off the lows and the Russian 5 year USD Sovereign Default Swap now trades at 200bp (versus nearly 260bp in late January).

We doubt that the CBR hiking rates +/- 25bp away from the consensus of +100bp will make much

material difference to RUB or local government bond pricing – though in an environment of less geopolitical tension the ruble would continue to perform well amidst bearish flattening of the yield curve.

The reality is that there is just too much uncertainty over coming weeks as to whether diplomatic efforts produce results or various levels of sanction risk materialise. Where derivatives trading is available, it does seem there is interest to position on the long side of ruble – but only where limited loss strategies can be guaranteed.

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