

Russia surprises with a 25bp rate hike

The Central Bank of Russia (CBR) surprised markets by raising its key rate by 25bp to 7.50% today. Future rate hikes will depend on how inflation and economic growth perform compared to the CBR's expectations and also on the external environment.



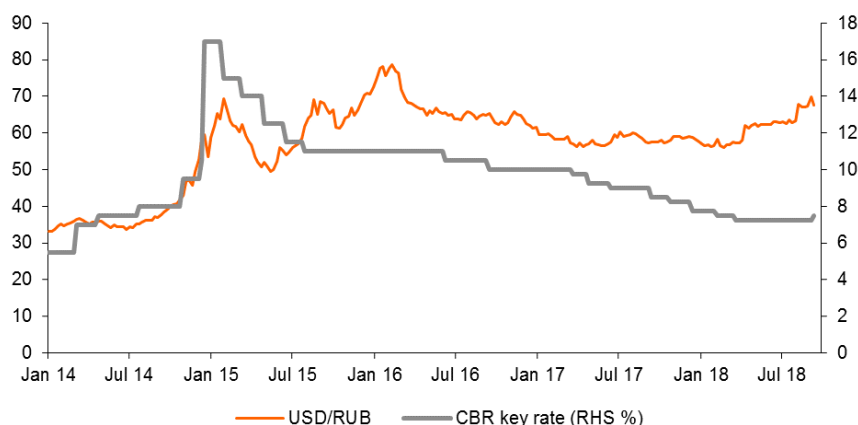
The Head of Russia's Central Bank, Elvira Nabiulina

Inflation risks prompt action from the CBR

The key reasons for the CBR's rate hike today included higher inflation risks based on the high degree of external uncertainty and its impact on financial markets. According to the CBR, a further rise in yields in developed markets, capital outflows from emerging markets and geopolitical risks could contribute to continued high financial market volatility – so influencing Rouble and inflation expectations.

The necessity of further increases in the key rate will depend on inflation and economic growth performance compared to the CBR's expectations and also to external risks and the reaction of financial markets.

CBR hikes rates for the first time since 2014



Source: Bloomberg

Revised growth and inflation forecasts

At the same time the CBR published revised forecasts, with annual inflation to reach 5-5.5% by the end of 2019 (from 4-4.5% previously), FY18 GDP growth remaining at 1.5-2.0%, and FY19 growth cut to 1.2-1.7% (previously 1.5-2.0%).

The CBR now expects to see annual CPI at 3.8-4.2% (vs. 3.5-4.0% in previous forecasts) by the end of 2018 with inflation peaking in 1H19 and reaching 5.-5.5% by the end of 2019. Close to the end of 2019 quarterly inflation is expected to reach 4.0%, with annual inflation to reach the 4.0% target in 2020 (in line with previous expectations). The CBR's forecasts take account of the ban on FX purchases by the Minfin, the expected VAT rate hike and the impact of recent financial market volatility. These factors will have the biggest impact on inflation in the first half of 2019. When it comes to GDP forecast changes, increased state infrastructure spending near end-2019 and in 2020 is expected to lead to increased GDP growth.

Ministry of Finance FX purchases also suspended until year end

In another move to support the RUB, the CBR also suspended FX buying under the Finance Ministry's Fiscal Rule until year-end. This activity would normally be worth around US\$6bn of FX buying against the RUB each month and thus an extension of the suspension is consistent with the view that Russian authorities are concerned about the external environment and pressure on the Rouble into year-end. As the CBR noted today the current account surplus is enough to service external debt. Thus the suspension of FX purchases could be enough to offset any capital outflows driven by negative external risks.

A surprise move

Our view. The decision to hike rates was unexpected for us and for the market, where "no action" was the consensus. Together with the ban on FX purchases, this will add stability to the local FX market. USD/RUB dropped by 1.5% to 67.50 and OFZ yields pared 10-11bp gains ahead of the decision and are now flat to the close.

Inflation pressure has certainly worsened due to the external environment (with EM capital outflows, DM yield growth, and geopolitical risks), with this and the VAT tax hike at the beginning of

2019 the key drivers behind the decision. What is more important is that the CBR has kept the option to make further rate hikes if needed to stabilize Russian financial markets on the back of higher uncertainty. The words "sanctions" and "potential sanctions" were substituted with references to the "negative external environment" and "geopolitical risks" - this does not change key message from the CBR that it is ready to take measures (not only rate hikes) if required.

Rouble outlook

Consistent with a better EM environment this week on the back of a Turkey rate hike and soft US CPI, today's move could see some further modest gains in the RUB to the 67.00/67.30 area.

However, we doubt investors will want to chase the RUB too much firmer. More aggressive sanctions against Russia will be debated in the US Congress into and after US mid-term elections and, given a backdrop of rising US rates and unresolved trade issues, we maintain a view that USD/RUB will be trading back above 70 over coming weeks and months.

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