



Bank of Russia stunned OFZ market

OUR TAKE

The Bank of Russia surprised the market with the unusual size of its bigger-than-expected rate hike, lifting the benchmark 75 bps to 7.5% at its core meeting on October 22. This move goes against the regulator's earlier commitment to fine-tune monetary policy using "standard" measures.

Most economists in a survey failed to forecast the move, expecting an increase between 25 bps and 50 bps. The Bank of Russia stopped short of sending a dovish signal and used the same hawkish wording as in September, warning it's too soon to talk about an end to the cycle.

Justifying the decision, the bank said that the balance of inflation risks is still tilted to the upside. Persistent factors are pushing up inflation, as demand still outpaces supply. Against this backdrop, annual inflation has been running at nearly twice the target, accelerating to 7.8% as of October 18. Household inflation expectations jumped in October, the highest since late 2016.

The Bank of Russia now sees inflation ending the year at 7.4-7.9%, compared with 5.7-6.2% in July's official mid-term forecasts. Notably, the forecast for 2022 was left unchanged at 4-4.5%. The central bank sees an average annual interest rate of 7.3-8.3% in 2022 (compared with 6-7% previously) and 5.5-6.5% in 2023 (5-6%). The estimate for 2021 was left unchanged 5-6%. The regulator sees an average annual interest rate of 5.7-5.8% in 2021 (compared with 5.5-5.8% previously), from now until the end of the year, the average key rate is seen at 7.5-7.7%. This means that the central bank may deliver yet another rate hike of up to 100 bps at its last meetings in December, as the bank "holds open the prospect of further key rate rises at its upcoming meetings," according to October's statement.

A much more hawkish tone and the recognition that we are once again outside the "fine-tuning zone" was, in our view, the key takeaway from the past briefing. Since we, like most economists, did not expect the bank to take that hawkish tone, we are to adjust our baseline forecast. It is difficult to project the size of the key rate at the peak of the cycle and when it is reached (so far, based on the current average range, the rate is unlikely to exceed 8.5%). The rate trajectory will essentially depend on how the data evolve. Lending costs are highly likely to be raised at the December 17 meeting. **We expect the rate to end this year at 8%, according to our new baseline forecast.**

MARKET REACTION

OFZs traded within a narrow range, as prices declined during trading sessions in the run-up to the meeting. The regulator's decision came as quite a surprise to the market. Based on the yields of short-term OFZs, investors did not price in the key

rate above 7.5% at its peak. Therefore, the Bank of Russia's "hawkish" tone stunned the market.

Bond yields surged right after the decision and extended gains as Elvira Nabiullina's briefing wore on. The short and medium-term issues came under the most pressure, sending yields 40-45-bps higher. We expect the negative trend to remain in the sovereign bond market in the short-run and the current inverted sovereign curve to go up. Prices are expected to stabilise as soon as the market sees an end to the tightening cycle.

THE BRIEFING HIGHLIGHTS:

- It's too early to speak of the end to the tightening cycle. The key rate may come into the neutral range no earlier than mid-2023. The key rate may be higher and stay at an "elevated level" longer than previously expected.
- The Bank of Russia considered a 100-bps hike at October's meeting. Higher average annual interest rates assume yet another hike at the December meeting. Going forward, the Bank of Russia does not rule out further unconventional steps.
- Drastic changes in CPI projections resulted from this year's crops quality and post-harvest quality preservation and disruptions in global logistics chains. Prices in November and December will largely depend on the harvest completion.
- New lockdown measures are now seen as pro-inflationary. Pro-inflationary effects do little to curb demand, while lockdowns are disrupting supply. New lockdown measures are unlikely to materially affect the GDP growth. Their possible effects are not reflected in the forecast yet.
- A 10% rouble depreciation curbs annual inflation by around 0.5 pt, according to the Bank of Russia. Changes in the exchange rate usually feed through to the prices at a delay, typically over three to six months.
- Inflation is not expected to run below the 4% target in 2022, according to the Bank of Russia forecast.

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