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Central Bank Unexpectedly Hikes Interest Rates

By The Moscow Times

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The Central Bank unexpected hiked overnight interest rates by 0.25 percent to 8.25 percent to head off rising inflation, in a move that economists have criticized and fear may slow Russia's growth further. The hike goes into force Friday.

Inflation has been creeping up all summer, fueled by a poor harvest that is putting upward pressure on prices. Food accounts for about a third of the average Russian shopping basket, so a poor harvest feeds quickly into inflation figures.

Annualized inflation rates already broke the Central Bank's year-end target of 6 percent when they topped 6.3 percent on Monday. The regulator started the year predicting about 6 percent inflation for the whole year, but more recently it has been forced to raise its forecast due to the harvest, and now Russia is on track for at least 7 percent inflation. Russia started this year with inflation at a 20-year low of under 4 percent.

"A poor grain harvest and inflation in related sectors remained the major driver of high inflation in early September: egg prices rose 2.8 percent since the beginning of the month, wheat flour 1.7 percent, wheat bread 0.8 percent and chickens 0.7 percent. The effect of regulated tariff revision seems to be evaporating, as heating tariffs grew only 0.6 percent and water supply tariffs rose 0.3-0.5 percent over last week," Troika Dialog said in a note last week.

However, economists have been arguing for months that the Central Bank should not be in the business of fighting food-price-related inflation, as those price-rises are due to an act of God and have nothing to do with fiscal management, argues Ivan Tchakarov, chief economist for the CIS and Russia at Renaissance Capital, a view that is also taken by Danske Bank and Troika Bank analysts.

"The Central Bank's move will barely affect this sort of inflation," said Yevgeny Gavrilenkov, chief economist at Troika Dialog.

Trying to bring food-related inflation down by increasing interest rates inevitably leads to distortions in the economy that do as much damage as inflation. On the fiscal score, the Central Bank has done a good job and the underlying inflation, due to economic not atmospheric factors, is all in hand. It says that "core" inflation accelerated to 5.5 percent in August and that this is the part of inflation that should be attributed to monetary factors and not to food prices.

Once the food spike passes, inflation should come down again, as the Central Bank's increased lending to the banking sector — the bank has just announced an expansion of lending by 1 trillion rubles — is totally under the regulator's control, and it can switch this off at any point to bring inflation down without the need to hike rates. The Central Bank is waiting for some confidence to return to companies that will spur growth to do this. In effect, this lending to banks is Russia's own version of quantitative easing that, unlike in Europe and the U.S., has already been running for months.

Elena Kolchina, head of fixed income at Renaissance Asset Mangers, said: "Inflation this year will probably come in at 6 to 7 percent, but it is expected to stabilize at around 4.5 to 5.5 percent in the medium term."

Still, given the years that Russia suffered from hyperinflation, inflation remains a sensitive issue, and the Central Bank has only recently tried to switch from maintaining exchange-rate stability to targeting inflation. It seems the central bankers had a bit of relapse this week and have gone back to their old ways.

Analysts at Danske Bank said in a note that the hike will not help the economic recovery: "Despite slowing economic growth, Bank Rossii's main target has become inflation. The Russian economy grew 4 percent year-on-year in Q2 '12 versus 4.9 percent in Q1 '12. The economy expanded 2.6 percent year-on-year in July versus 3.8 percent year-on-year in June... We believe that tightening monetary policy does not help much to restrain price growth in Russia, as it does not have much of a monetary nature."

And the Central Bank may have more hikes up its sleeve now, as this hike shows a change in policy. VTB Capital analysts say that another 0.25 percent hike could be in the works.

The next policy meeting is scheduled for early next month.

"A hike from the Central Bank should be treated as a step aimed at containing inflation expectations and building the regulator's credibility within the inflation-targeting framework. At the same time recent market developments showed that under the current framework, liquidity conditions may matter more than the outright level of base rates," VTB said in a note.

The missed inflation target at the start of this month was one contributing factor to the rate hike, but this week's strong lending results was another. Consumer lending was up 43 percent over the first half of this year, at what the Central Bank considers to be "overheating" levels. The regulator says consumer-lending growth of 28 percent is the maximum comfortable level. However, consumer borrowing contrasts strongly with corporate lending, which is rising much more slowly and leading to a slowdown in industrial production.

"The Central Bank yesterday surprised the market with a 25bp hike in rates, suggesting an intention to keep the 6 percent full-year inflation target. While we consider this decision as appropriate given the overheated retail lending market, we also believe that it might be too late to affect this year's inflation trend," said Natasha Orlova, chief economist with Alfa Bank, in a note Friday. She is predicting year-end inflation of 6.7 percent.

The important thing is whether this rate hike will cause the already slowing economy to slow further. The Central Bank seems to be taking the line that current growth — although less than boom-time levels — is robust, and it can afford to tackle inflation without hurting growth too much. That view is not shared by many Moscow economists.

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