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In Fear of Sanctions, Russia's Central Bank Raises Key Interest Rate

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The Central Bank raised its key interest rate to 8% on Friday.

Russia's Central Bank has unexpectedly raised its key borrowing rate for a third time this year in expectation of heightened international economic sanctions against Russia over the unrelenting crisis in Ukraine.

Russia's main financial regulator increased the key rate from 7.5 to 8 percent on Friday, saying that even in the present situation of slowing economic growth, quelling inflation is its main priority.

The decision comes as Russia is embroiled in the worst political standoff it has seen with the West since the end of the Cold War. The downing of Malaysia Airlines flight MH17 in conflict-torn eastern Ukraine on July 17, which led to the deaths of all 298 people on board, has prompted the United States and European Union to consider more wide-ranging sanctions against Russia unless the government cooperates on de-escalating the conflict.

“Inflation risks have risen, connected, among other things, with the increased political tension and with its possible impact on the dynamics of the national currency rate, as well as with the changes in tax and tariff policies that are being discussed,” the Central Bank said in a statement on its website.

“This decision is both unexpected and controversial,” Alexander Morozov, chief economist for Russia and the CIS at HSBC, told The Moscow Times.

EU ambassadors on Friday reached a preliminary decision to move ahead with economic sanctions, with likely measures to include closing off EU capital markets to state-owned banks and halting future arms sales to Russia, Reuters reported.

According to Morozov, raising the key interest rate was a drastic response to the phantom risk of sanctions, whose content and possible effects cannot yet be known.

“The Central Bank still had other means to deal with inflation, such as making its control of the banks more efficient,” he said.

The Central Bank has already increased its key rate from 5.5 to 7 percent and then to 7.5 percent this year in an attempt to counter the impact that the depreciating ruble has had on the price of imports. The ruble fell 10 percent against the dollar and euro in the early months of this year but has since recovered some ground, hovering around 35.05 to the dollar and 47.22 to the euro on Saturday.

Even as the Russian economy reels toward stagnation, the Central Bank is ready to increase the key benchmark rate again if “high inflation risks persist,” according to the statement. The bank will examine the rate again at a board meeting in September.

Ever since her appointment in June 2013, Central Bank chief Elvira Nabiullina has said that the bank aims to bring inflation down to 3-4 percent in three years' time.

The Central Bank is also aiming to switch to an inflation targeting policy beginning in 2015, at which point it will stop propping up the ruble exchange rate and will make all currency and key interest rates dependent on its inflation target.

This year has clearly thrown a wrench in these plans: Inflation hit 7.8 percent in June and core inflation reached 7.5 percent, according to the bank's Friday statement, which said that inflation should decrease to between 6 and 6.5 percent by year-end.

According to Valery Mironov, chief economist of the Higher School of Economics' Center for Development Institute, the current high rate of inflation poses a direct risk to Russia's economic growth.

“Unless inflation decreases to 4-5 percent, driving interest rates down, it will not be profitable for Russian manufacturers to borrow and invest,” Mironov said.

Russia's Economic Development Ministry said Friday that Russian GDP grew 1 percent in the first half of the year compared with 2013 — a significant dip from growth of 3.4 percent in 2012 and 4.3 percent in 2011, according to the World Bank. The International Monetary Fund earlier this year cuts its 2014 growth forecast for Russia to 0.2 percent — just shy of stagnation.

Following the latest, hardest-hitting round of U.S. sanctions, which targeted leading energy companies Rosneft and Novatek and state-owned banks Gazprombank and Vneshekonombank, some analysts have predicted a slight recession in the second half of this year while others continue to hope for a few decimals of growth.

With access to foreign capital cut off due to the fear of sanctions and resulting high risk assessments of Russian companies in banks abroad, lowering inflation becomes even more important, Mironov said in a phone interview.

“In this situation, the Central Bank's goal is not simply to drive inflation down, but to stimulate growth,” he said.

In addition, a reasonable rate of inflation is key to compelling Russian households to spend more — which, in turn, directly impacts economic growth.

“Half of Russian GDP depends on household expenditures, so if you want to foster growth, you have to quell inflation expectations among the population,” Mironov said.

Staff writer Delphine d'Amora contributed to this report.

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