

## Russian inflation touched a nerve in September

The September elections catalyzed a sharp spike in CPI to 7.4% in September and 7.5% YoY in early October, a meaningful deviation from earlier forecasts. Deteriorating global inflation trends amid elevated expectations of Russian households and corporates may force the Bank of Russia to return to aggressive monetary policy actions



A supermarket in St. Petersburg, Russia

# 7.4

September CPI, % YoY

up from 6.7% in August

Higher than expected

### Inflation: A series of unfortunate events

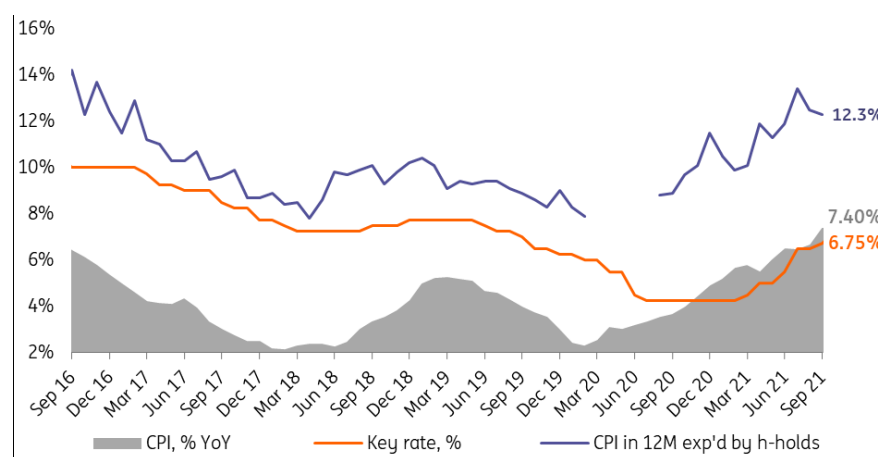
Inflation has been the source of bad news for the most part of this year, but in September it got worse. The spike from 6.7% year-on-year in August to 7.4% YoY in September and 7.5% YoY in the beginning of October outpaced the [latest](#) 7.3% YoY expectations and is 0.3 percentage points higher than the rate we and the market expected only a month ago. Most importantly, core CPI

jumped from 7.1% to 7.6%, the highest level since April 2016.

Here are our key observations and takeaways from the latest CPI print:

- Both headline CPI and households' inflationary expectations are now back to levels seen in 2016, when Russia was still suffering the consequences of the 2014-15 ruble devaluation, and the Bank of Russia was conducting a transition to inflation targeting through extremely tight monetary policy (Figure 1). However, this time inflation is accelerating despite the continuous ruble appreciation by 7% to the US dollar year-on-year and 2% year-to-date.

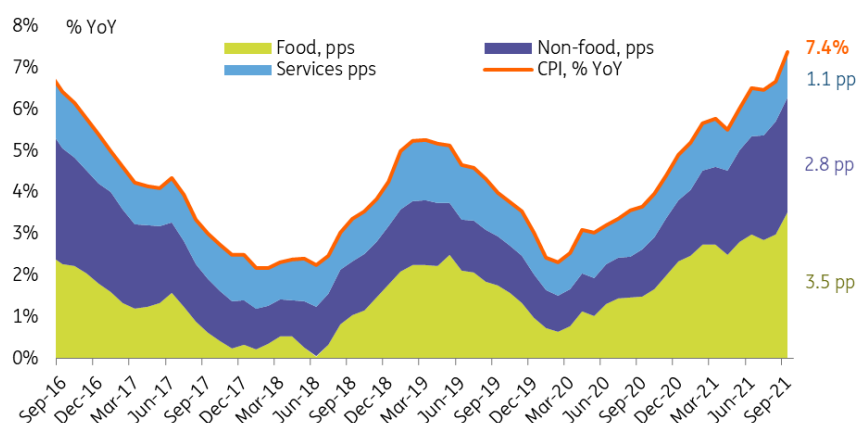
**Figure 1: Russian CPI soared to 7.4% YoY in September amid elevated expectations, confirming upside to the key rate**



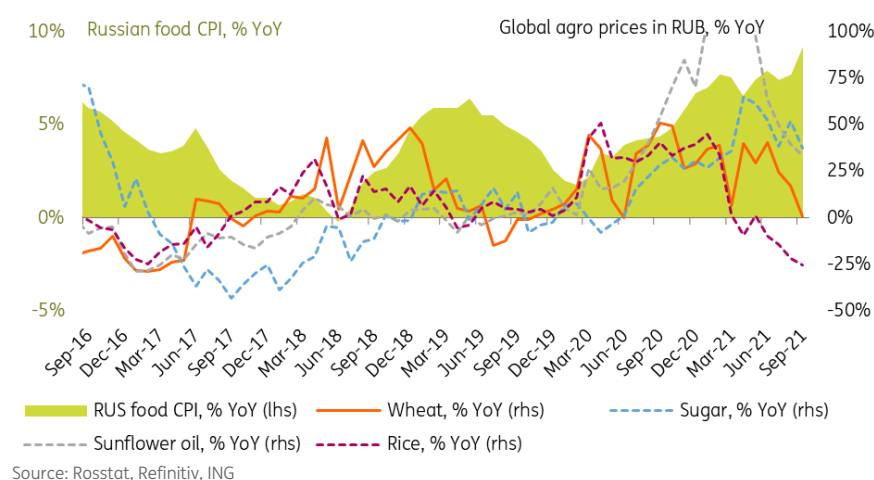
Source: Bank of Russia, Rosstat, ING

- Looking at the structure of the CPI growth, the food segment appears to be the key contributor jumping 9.2% YoY in September and contributing 0.5 out of 0.7 percentage points of the headline CPI acceleration in September vs. August. Non-food and services price growth also picked up, contributing the the remaining 0.2 percentage points (Figure 2).
- Noteworthy, the spike in food CPI took place despite the continued moderation in global agriculture prices, especially in wheat, Russia's key agriculture commodity (Figure 3). Local price pressure was concentrated in meat, dairy, select imported fruit and vegetables.
- Non-food CPI picked up despite the moderation in gasoline price growth (the latter is largely insulated from the global trends). The primary drivers were higher prices on cars (responding to a cut in production due to input shortages), select construction materials (on the continuing yet waning construction boom), and consumer electronics/appliances (due to global shortage-driven restrained imports).
- Acceleration in the services price growth is largely driven by the base effects, but the growing costs of international travel is also noticeable as the late opening of the travel season and cold September boosted demand for popular tourist destinations.

**Figure 2: Upward CPI pressure is seen mostly in food, but other sectors contributed too**



**Figure 3: Food CPI accelerated despite stabilisation of global agro commodities and ruble appreciation**

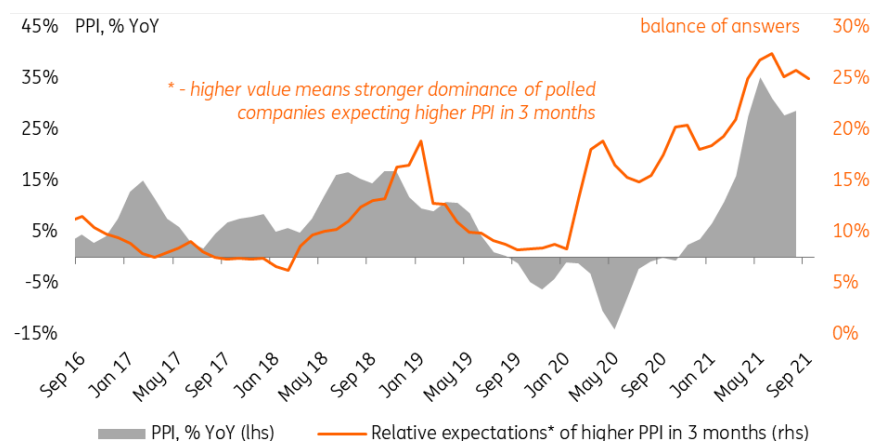


## Latest CPI spike coincides with Parliamentary elections

- The spike in weekly inflation from the normal 0.1% WoW to atypical 0.3% WoW, in the last two weeks took place immediately after the Parliamentary elections. Ahead of those, the government disbursed RUB700bn (c.US\$9.5bn, or 1% of total annual household income) in social support payments in favour of schoolchildren, pensioners, and the military personnel, covering over 40% of the Russian population. The social support, which came in the end of August and early September may have eased the pass-through of elevated producer price inflation and expectations into the local consumer prices.
- The local PPI has been under upward pressure since the beginning of the year, responding mainly to cost inputs, such as higher prices of freight, microchips, agriculture products, and a shortage of labour in construction and agriculture due to disruptions in migration. According to the most recent data, the local PPI and corporate inflationary expectations are

off their peaks, but they still remain at elevated levels (Figure 4). Meanwhile, the [local consumption trend has been showing relative strength](#) even before the social handouts on growing employment and wages.

**Figure 4: Local PPI is off its peaks, but expectations are elevated**

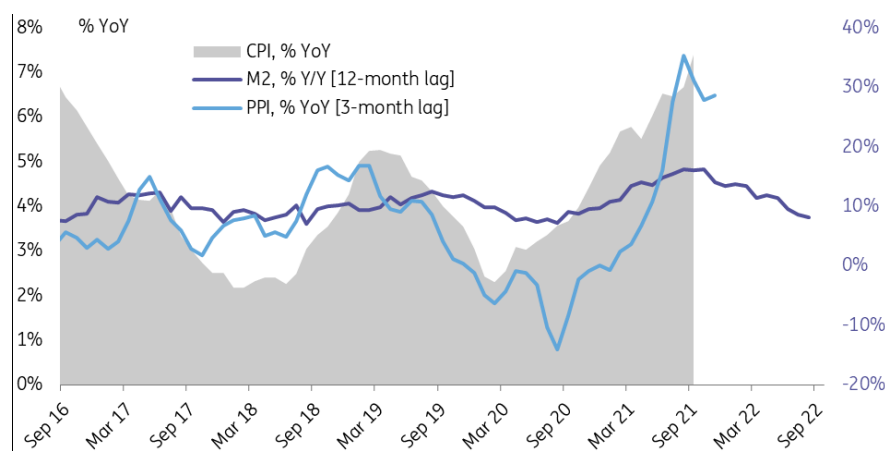


Source: Bank of Russia, Rosstat, ING

## Risks of further negative surprises are high

- Initially, we estimated the inflationary effect of extra social payments at 0.2-0.3 percentage points, but the sharp post-election reaction in consumer prices points at a higher sensitivity, possibly due to delayed side-effects of previous price-control measures.
- Historically, each 10% increase in Russian PPI leads to a 1 percentage point lift in local CPI with a 3-month lag (Figure 5). From that perspective the recent stabilisation in PPI is a positive sign, however its high dependence on external cost inputs is a factor of material uncertainty given the continued global pick-up in prices for freight, commodities, and finished goods.
- The government is signalling a willingness to [tighten the direct fiscal spending in 2022-24](#) and [limit local investments out of the sovereign fund](#) at 0.6% of GDP per year, which should help contain inflation in the medium term. However, an overall fiscal consolidation does not preclude a potential increase in the social spending in case of a disappointing household income trend.
- A 1.2 percentage point jump in CPI seen in 4Q20 is creating a higher base effect for 4Q21, however a similar base effect from 9M20 did not prevent a noticeable CPI acceleration year-to-date, contrary to initial expectations.
- The recent spike in new Covid cases amid high mortality and relatively modest vaccination rate could be seen as a potential constraint to economic growth in case new lockdowns are needed, but the experience of previous mobility restrictions does not point at a definitive disinflationary effect.
- The decelerating monetary supply growth (caused by negative cash and retail deposit dynamic in the last 12 months) seems to be the only strong disinflationary factor for the foreseeable future. Historically, a 10% slowdown in the M2 growth has corresponded to a 1 percentage point decline in the CPI growth with a 12-month lag (Figure 5).

**Figure 5: Forward-looking indicators point at CPI stabilisation, but PPI volatility remains a risk**



Source: Bank of Russia, Rosstat, ING

## Key rate hike cycle still has steam

The huge CPI surprise of September-October pushes our 2021 expectations to 7.0% and 2022 forecast to the 4.5-5.0% range.

More importantly, the current CPI trend means a noticeable deviation from the trajectory implied by the [Bank of Russia's medium-term forecast](#). Even if the current pick-up in inflation is caused largely by non-monetary and temporary factors, it still warrants a reaction from the CBR in order to address local expectations that are currently elevated and unanchored. We now see the key rate ceiling at 7.50%, and the deteriorating global inflationary trend continues to pose an upward risk to this view.

We are now more confident that at the upcoming CBR meeting on 22 October the CBR will increase the key rate by a higher-than-usual 50 basis points to 7.25%, raise the official year-end CPI forecast to 6.5-7.0%, express doubts in the return to the targeted 4% in 2H22, and guide for a further increase in the key rate.

At the same time, we note that Bank of Russia somewhat downplayed the importance of the September spike in CPI, citing noisy data and possible contribution of seasonal factors. This suggests that the monetary authorities are still undecided on the pace of the rate hike cycle and may opt for a more gradual increase in the key rate. This (less likely) approach would have the advantage of showing high consistency with the previous communication and minding the uncertainties related to the new wave of Covid-19 infections in Russia.

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