Russia: Inflationary pressure muted so far

Inflation picked up in March, but much more modestly than expected and remains comfortably below the 4.0% target. We see acceleration in coming months due to RUB depreciation and global agro inflation, but the inevitable drop in consumer demand will be a constraint. The central bank will choose between a hold or cut in 2H20, depending on CPI trajectory

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Russian CPI has more room to go

Russian CPI accelerated from 2.3% year on year to 2.5% YoY in March, which is well below the 2.8% YoY suggested by the preliminary weekly data and 2.7% YoY consensus. We generally agree with the common view that inflationary risks are 1) not as high as in the previous episodes of market turmoil and 2) not as relevant for the key rate. Meanwhile, we still see reasons to expect a further pick-up in CPI in the next couple of months:

- **Food products**, which account for 38% of the consumer basket and so far has only seen a very modest pick-up in price growth from 1.8% to 2.2% YoY last month, **have further room for a price spike, mainly due to the global recovery in grain prices**. According to Bloomberg data, global wheat price growth in US$ terms picked up to 24% YoY in March vs.

a relatively flat 2019, while in RUB terms grain prices soared to 51% YoY due to USDRUB depreciation. Historically, each 10 percentage point of grain price growth in RUB terms translated into an extra 1.0 pp to Russian food prices and 0.4 pp to overall CPI. Based on this sensitivity, **Russian CPI can pick up by 2 pp from the current 2.5% YoY level in the coming months.** A potential cut in the Russian grain export quotas (which could have contributed to the spike in global grain prices) may somewhat lower the local price sensitivity, but much like most protectionist measures it is unlikely to efficiently contain price growth in the longer term.

- **Non-food products**, (35% of the consumer basket) also having picked up in price growth very modestly from 2.3% to 2.5% YoY, **have yet to experience the effect of recent RUB depreciation.** As an example, local prices on import-heavy consumer electronics are up only 1.5% year-to-date, which seems modest relative to the 21% USDRUB depreciation in the same period. Historically, the pass-through effect of FX moves are seen in inflation over a period of 3-6 months. In that sense, the pick-up in inflation seen in March appears to be just the initial response to panic buying of some products, both food and non-food, given the uncertainties related to anti Covid-19 quarantine measures in place since the last week of March. Overall, while **the overall sensitivity of the Russian CPI has reportedly declined from 1 pp per each 10% depreciation before 2014, it is still not nil – at around 0.3-0.5 pp per each 10% ruble depreciation** – which may prevent CPI from showing fast deceleration in 2H20.
- **Services segment**, which so far showed no acceleration in price growth from 3.0% YoY, **might face upward pressure from demand by the upper-income households** (according to Bank of Russia, around one-third of Russian households have savings accounting for around 28% of GDP), which can afford substituting the lack of international travel (spending on which totaled around US$45 billion, or 3% of GDP, in 2019) and respond to local personal movement restrictions with various local services, which are still largely available. Generally, we would advise against overestimating the disinflationary role of the consumer demand drop in Russia: even the 9.5% YoY drop in household consumption seen in 2015 did not prevent CPI from temporarily accelerating to 17% YoY with the subsequent return to the targeted 4% only two years later.

Bank of Russia is likely to ignore the spike

Overall, we see CPI accelerating to 4.5-5.0% YoY by mid-year, mostly on the expected spike in food prices, with the recent ruble depreciation and potential local demand from higher-income households limiting the pace of subsequent disinflation. Governmental measures, aimed at limiting the inflationary impact may somewhat flatten the curve, but are unlikely to counter the general trends.

The good news is that Bank of Russia in its recent key rate decision (to hold at 6.0%) and during the newly introduced weekly briefing by the governor, indicated that it is ready for the upcoming inflationary spike, but sees it as temporary and is unwilling to respond by raising the key rate. As a result, based on our somewhat pessimistic view on CPI we continue to expect an unchanged key rate until the year-end, however we admit that depending on the shape of the CPI curve, Bank of Russia may put cutting the key rate back on the agenda as early as 2H20.

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