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Russia: assessing the impact of trade restrictions

In August, the Russian government introduced restrictions on food imports from the EU, the US, Canada, Australia and Norway, which target imports of meat, fish, poultry, cheese, and fruit and vegetables. The introduction of trade restrictions could result in higher inflationary pressures in 2014-2015, although a lot depends on the ultimate duration of these measures. In this report we attempt to estimate the inflationary impact of recent trade restrictions as well as CBR's monetary policy response.

Out of the USD41bn of food imported, the restrictions are likely to affect USD11bn-worth of deliveries, i.e. 40% of the total imports of these categories for meat, fish, poultry, and fruit and vegetable products (USD28bn). The restrictions will affect more than 60% of the total food imports from countries affected by these measures.

Given the need for substitution of food imports from the European Union, the United States, Norway, Australia and Canada, the Russian authorities have negotiated with Latin American countries, on possible imports of fish from Chile, meat from Brazil and Argentina, and the importing of more fruit and vegetables from Turkey, Azerbaijan and other countries. In our view, as the ban was set to last for a year, the scope for domestic import substitution is limited.

We believe that, even despite the substitution of US, EU, Norwegian, Canadian and Australian goods with goods from Latin America, Africa and the Middle East, the shortage in restricted items could lead to price increases in the respective markets on average by 5-10% within the next 12-18 months. This, in turn would translate into 1.5pp of headline CPI. We also believe that the effect of the government's control of food prices would have only limited effect and temporary on price growth. Accordingly, we revise our inflation forecast for December 2014 from 6.5% yoy to 7.4% yoy, and from 5.4% yoy to 6.0% yoy for December 2015.

Additional inflationary pressures may be addressed by the CBR via higher rates though policy activism may be tempered in part by uncertainty over the duration of such drivers as ruble weakness and trade restrictions. Before the beginning of August monetary authorities expected the inflation to decline in 2H14 (in case no additional adverse shocks emerge) on the back of the dissipation of the effects of ruble depreciation and lower regulated tariffs growth as well as subdued demand-push pressures. Nonetheless in view of food import restrictions as well as the resurgence of ruble weakness, the prospects of lower inflation throughout the rest of 2014 are becoming dimmer and may call for additional policy actions from the CBR.

We believe that the CBR would react to food inflation shock and accommodate the first round impact on inflation and monitor second round effects possibly tightening the monetary policy if needed further. Although we believe that second round effects of food prices could be limited, more important is the fact the food price shock could negatively affect inflation expectations, which, in turn, could also be addressed via further tightening of monetary policy. We expect the CBR to raise the key rate by 50bps (for it to reach 8.50%) in the autumn period on the back of increasing risks to the medium-term inflation outlook.

Russia imposes restrictions on food imports from US, EU, Norway, Canada and Australia

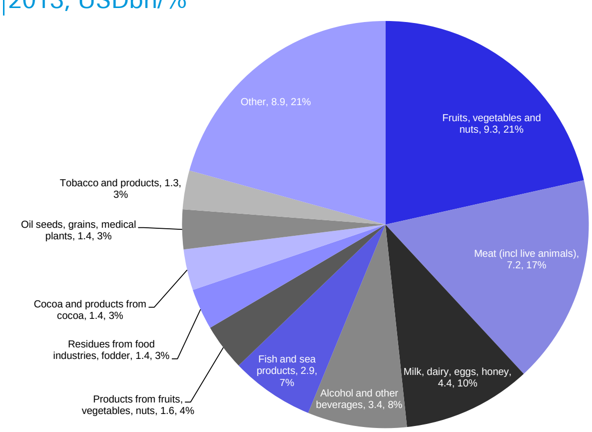
In August, the Russian government has introduced restrictions on food imports from the EU, the US, Canada, Australia and Norway. These trade restrictions cover imports of the following product groups:

- meat of bovine animals – fresh, chilled
- meat of bovine animals – frozen
- pork – fresh, chilled or frozen
- meat and edible offal of poultry – fresh, chilled or frozen
- meat – salted, in brine, dried or smoked
- fish and crustaceans
- milk and dairy products
- vegetables, edible roots and tubers
- fruit and nuts
- sausages and similar products of meat
- finished products, including cheese and curd based on vegetable fats
- milk products from vegetable fat

The trade restrictions are to last for 12 months, with the government having the capability to change the time-frame of these sanctions.

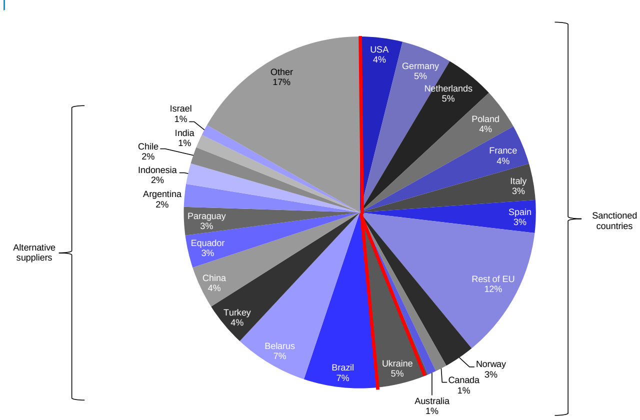
In terms of external trade, these restrictions imply a significant reduction of imports from the respective countries. In 2013, total food imports amounted to c.13% of the total USD324bn imports to Russia. In terms of the food import structure, according to customs statistics, the main import items were fruit and vegetables (21%), meat (17%), milk, dairy products, eggs and honey (10%), alcohol and beverages (8%), and fish and sea products (7%).

Figure 1: Russian food imports by product groups, in 2013, USDbn/%



Source: Federal Customs Service, UNCTAD, Rosstat, Deutsche Bank

Figure 2: Food imports by countries, 2013

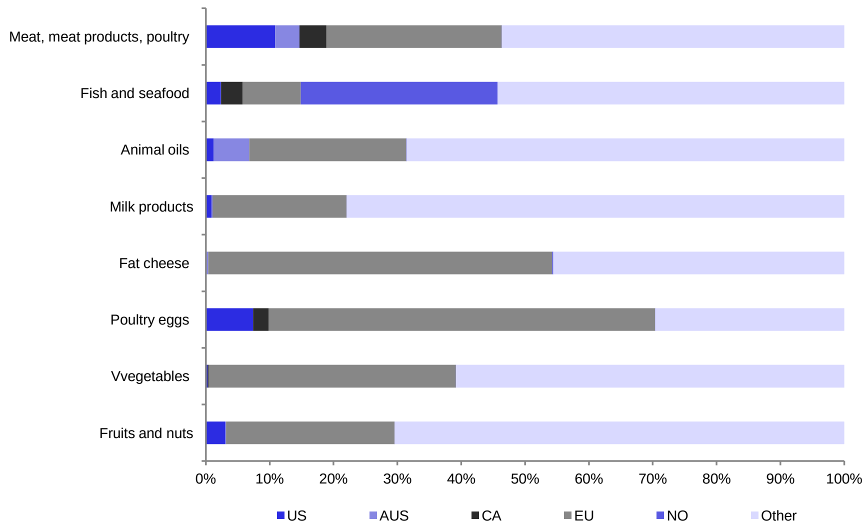


Source: Federal Customs Service, UNCTAD, Rosstat, Deutsche Bank

Russia's import profile also suggests that the share of food imports from the countries that are subject to food sanctions accounts for more than 45% of food imports to Russia, with the EU being a major supplier (35%, of which Germany 4.6%, Netherlands 4.6%, Poland 3.8% and France 3.7%), the United

States accounting for 3.9%, Norway 2.8%, Canada 1.1% and Australia 0.8%. The most significant impact of food restrictions is likely to come from the import bans versus EU and Norway, which hold dominant positions in the delivery of meat, fish, poultry, cheese, and fruit and vegetables.

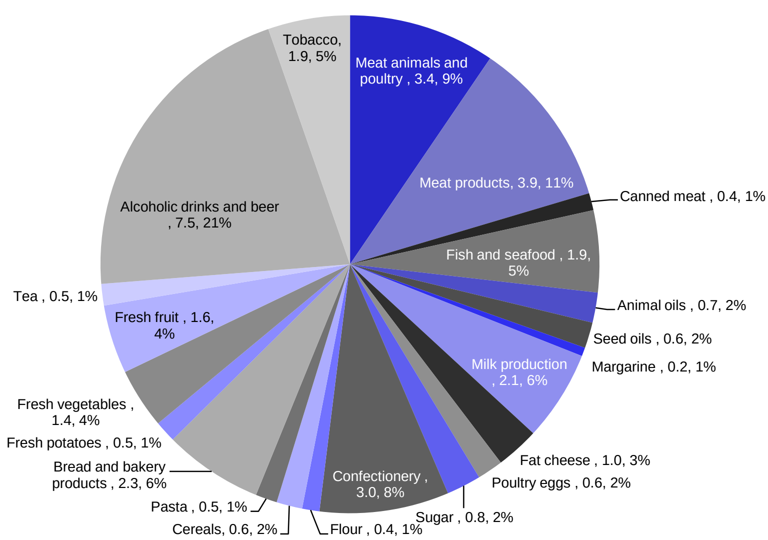
Figure 3: Share of imports of sanctioned countries by product groups



Source: UNCTAD, Deutsche Bank

Overall, out of the USD41bn of food imported in 2013, the restrictions are likely to affect USD11bn-worth of deliveries, i.e. 40% of total imports of these categories for meat, fish, poultry, and fruit and vegetable products (USD28bn). The restrictions will affect more than 60% of total imports from restricted countries.

Figure 4: Share of imports on sanctioned countries by product groups



Source: UNCTAD, Deutsche Bank

While the trade effect of restrictions is significant, the impact on consumption is contained. We estimate the total level of food imports at roughly 12% of total food consumption. Although the imports of meat, fish, poultry, cheese, and fruit and vegetables account for around 20% of the consumer basket, the share of consumption from the sanctioned countries is around 8.4%.

Figure 5: Share of restricted items in Russia's consumption

	RU domestic consumption	Total imports	EU, NO, US, AUS, CA
Items subject to restrictions, USDbn	131.8	27.76	11.11
Food import total, USDbn	350.1	41.61	17.8
Items subject to restrictions, USD bn, % consumed	100%	21.1%	8.4%
Food import total, % consumed	100%	11.9%	5.1%

Source: Rosstat, CBR, UNCTAD, Deutsche Bank estimates

Given the necessity for the substitution of food imports from the European Union, the United States, Norway, Australia and Canada, the Russian authorities have negotiated with Latin American countries, with possible imports of fish from Chile, meat from Brazil and Argentina, and the importing of more fruit and vegetables from Turkey, Azerbaijan and other countries.

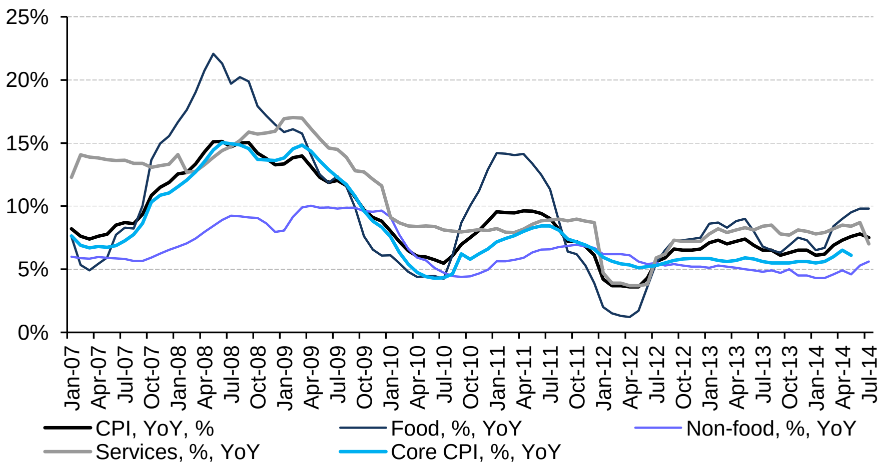
In our view, as the ban was set for the duration of a year, the ability of domestic import substitution is quite limited, so that the bulk of products will be imported from the above-mentioned counties. For example, according to *Vedomosti* sources, given Russia's conditions, it is possible to increase salmon production to 50,000-70,000 tons, while imports from Norway in 2013 amounted to 105,000 tons[1].

[1] http://www.vedomosti.ru/library/library-investigation/news/32226311/pischevoj-barer; http://www.vedomosti.ru/newspaper/article/736681/chinovniki-zaveli-cenovoj-razgovor

Impact of trade restriction on CPI

We believe that the introduction of trade restrictions could result in higher inflationary pressures in next 12-18 months, although a lot will depend on the ultimate duration of these restrictions. We estimate the impact of ruble weakness and trade restrictions could add up to 1.5pp in 2014-2015 for the growth in consumer prices.

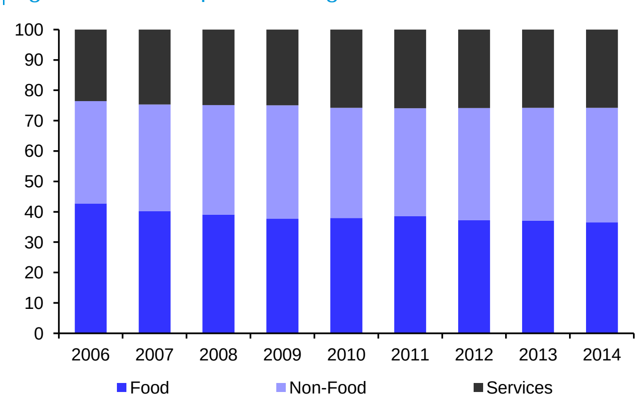
Figure 6: CPI dynamics by components



Source: Rosstat, Deutsche Bank

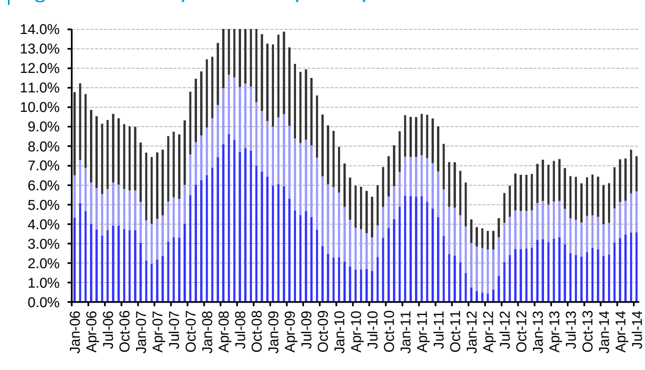
The first weekly CPI prints after the implementation of trade restrictions recorded an atypical surge in prices (which could be viewed as the initial impact of these restrictions). The most recent weekly inflation print (19-25 August) recorded price growth of 0.1% wow for the second week in a row. This, in turn, pushed the yoy inflation rate higher to 7.6% yoy from 7.5% yoy a week ago. The year-to-date figure stood at 5.5% (with the month of August contributing 0.1pp) vs. 4.5% ytd in 2013.

Figure 7:CPI component weights



Source: Rosstat, Deutsche Bank

Figure 8: CPI dynamics by component contribution



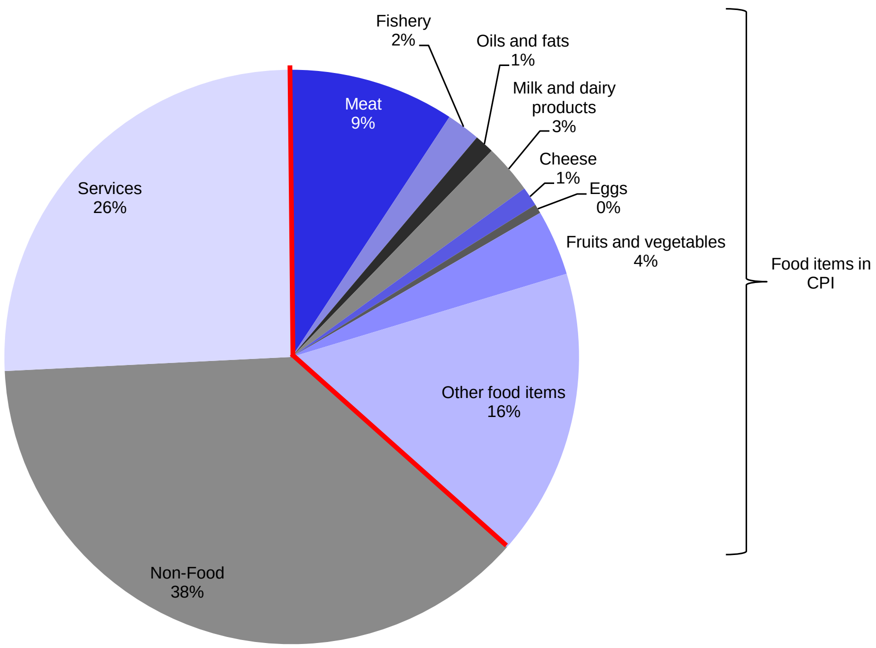
Source: Rosstat, Deutsche Bank

According to Rosstat, the growth in consumer prices was mainly driven by food items, especially those whose imports were restricted; namely, pork prices were up by 0.9% wow (0.5% wow and 0.2% wow in the previous two weeks), frozen fish prices increased by 0.5% wow (0.3% wow and 0.1% wow in previous two weeks), cooked sausage prices accelerated by 0.5% yoy after two consecutive weeks of 0.3% wow growth and cheese was up by 0.4% wow

(0.2% wow and -0.1% wow in previous two weeks). Prices on apples increased by 0.5% wow (0.2% wow and 0.3% wow in previous two weeks), while the rest of fruits and vegetables continued to get cheaper, -2.5% wow vs. -2.9% wow a week earlier.

Overall, food items represent c.37% of the consumer basket, declining from more than 50% at the end of the 1990s. Within the current basket, the share of restricted items is around 20%, with the highest share being taken by meat and meat products (9%), followed by fruit and vegetables (4%) and milk and dairy products (3%).

Figure 9: Composition of consumer basket weights used for CPI calculation

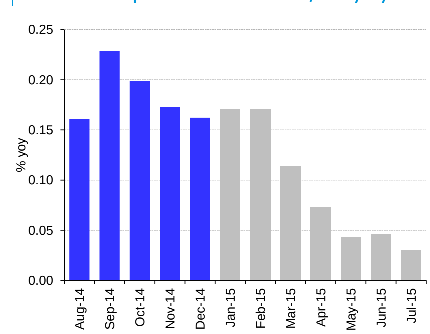


Source: Rosstat, Deutsche Bank

According to our estimates, the price effect of Russia's trade restrictions could vary in the range of 1.0-2.0pp over the next 12-18 months. We believe that, even despite the substitution of US, EU, Norwegian, Canadian and Australian goods with goods from Latin America, Africa and the Middle East, the shortage in restricted items could lead to price increases in the respective markets on average by 5-10%, which would translate into a 1.5pp[2] increment to headline CPI. We also believe that the effect of the government's control of food prices would have only limited effect and temporary on price growth.

Given the seasonality in CPI dynamics, we expect almost half of the total to be incorporated in prices, mainly in October-December, especially in dairy and milk products, as well as in the fruit and vegetables segment, while 1H15 is likely to be affected by higher prices on meat and fish, with around a 1.3pp increase to be expected over the period of August-February. These factors will put upward pressure on inflation, by 0.9pp this year and 0.6pp in 2015. As a consequence, we raise our inflation forecast for December 2014 from 6.5% yoy to 7.4% yoy, and from 5.4% yoy to 6.0% yoy for December 2015.

Figure 10: Additional CPI growth due to food import restrictions, % yoy



Source: Deutsche Bank

[2] We derive on the basis of price elasticities of certain food categories derived by Burggraf, Kuhn, Zhao, Glauben and Teuber in their research paper *"Economic Growth and Nutrition Transition: an Empirical Analysis Comparing Demand Elasticities for Foods in China and Russia"* in 2014 as well as profit/EBITDA margins for Russian retail companies estimated by Deutsche Bank

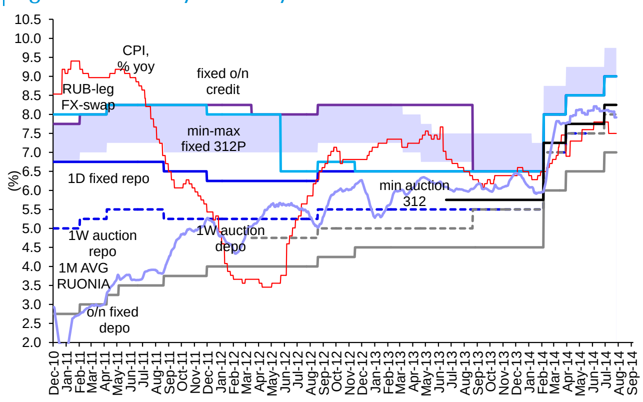
Monetary policy reaction

Additional inflationary pressures may be addressed by the CBR via higher rates though policy activism may be tempered in part by uncertainty over the duration of such drivers as ruble weakness and trade restrictions. In August Russia's government representatives have stated on several occasions that Russia's trade restrictions could be phased off in case of lower trade restrictions from the West.

Throughout the past several months a number of developments have altered CBR's expectation of the time-frame and the path of disinflation. In June CPI surged to 7.8% yoy on the back of ruble depreciation along with higher growth in food CPI. Although yoy CPI growth declined to 7.5% yoy as of 21 July, the pace of CPI deceleration was below monetary authorities' expectations. This is despite the fact that monetary conditions have been tightening since March 2014 as lending and money supply growth slowed down.

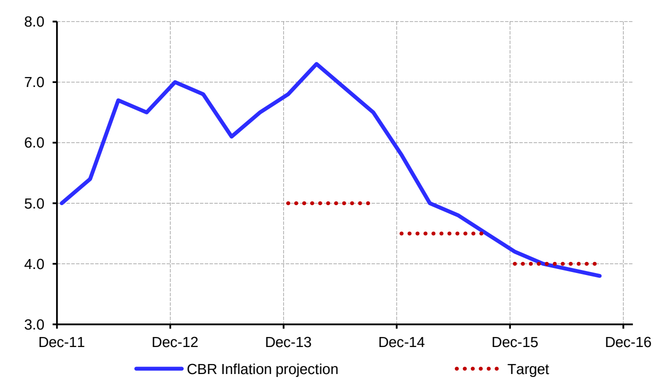
At that time, monetary authorities expected inflation to decline in 2H14 (in case no additional adverse shocks emerge) on the back of the dissipation of the effects of ruble depreciation and lower regulated tariffs growth as well as subdued demand-push pressures. Nonetheless in view of food import restrictions as well as the resurgence of ruble weakness, the prospects of lower inflation throughout the rest of 2014 are becoming dimmer and may call for an additional policy action from the CBR.

Figure 11: Policy rates dynamics



Source: CBR, Bloomberg Finance LP, Rosstat, Deutsche Bank

Figure 12: CBR inflation projection (as of June 2014)



Source: CBR's June Monetary Policy Report, Deutsche Bank

At the end of July the monetary authorities raised the key policy rate by 50bp to 8.00% in light of increased inflation risks. According to the CBR, the adopted decision was aimed at slowing the CPI to the target level of 4.0% yoy in the medium term. The CBR declared that it would further tighten the monetary policy if high inflation risks persist. The move by the CBR to raise rates in our view reflected the balance of risks on the macroeconomic front that are skewed significantly at this stage towards high inflationary pressures vs. concerns on the growth front.

We believe that the CBR would react to this shock and accommodate the first round impact on inflation and monitor second round effects possibly tightening the monetary policy if needed further. Although we believe that second round effects of food prices could be limited, more important is the fact the food price shock could negatively affect inflation expectations, which, in turn, could also be addressed via further tightening of monetary policy. We expect the CBR to raise the key rate by 50bps (for it to reach 8.50%) in the autumn period on the back of increasing risks to the medium term inflation outlook.

Appendix 1

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