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The outlook was prepared in compliance with ACRA's General Principles of Socioeconomic Indicators Forecasting.

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Stressful scenarios are becoming more likely for the Russian economy.

The Russian Economy: Update on the outlook up to 2022 and alternative scenarios

- **The updated outlook for 2019-2022 mainly concerns the estimates on the long-term consequences of growing protectionism in world trade and the level of short-term equilibrium interest rates in Russia.** The increase in VAT rate will trigger a one-time rise in the customer price index by 1-1.2 percentage points at the end of 2018 through the beginning of 2019. At least until mid-2019, oil prices in rubles will remain at a historically high level and therefore there will be a temporary surplus in the federal budget. Adjusting the macroeconomic outlook from April 2018, we are reviewing our expectations regarding the possibility of new sanctions against Russia and assessing the probability of this occurrence of this event as higher. We also predict the worsening of the negative impact of protectionist measures on the US and Chinese economies.
- **Six external risks, which are able to significantly affect the Russian economy, have become more likely.** The analysis of the possible consequences of these risks leads to two additional macroeconomic scenarios. In the scenario with financial stress, the Russian economy can expect a decline in GDP by 2-3% in 2019 or 2020. In the scenario without financial stress, it can expect a slowdown in growth over the abovementioned two years to less than 1%.
- **The trade war between China and the US could lead to a temporary slowdown in the growth of their economies.** The reason for this is the reduction in trade turnover between the two countries and the inability to quickly change trading partners or move production facilities from an exporting country to an importing country. In the scenarios without financial stress, China's economic growth could slow down by 1 percentage point and the US's by about 0.5 percentage point. There will also likely be a temporary increase in background inflation.
- **Credit growth, similar to what has happened in China over the past few years, in most cases (as experience shows), ends in a crisis of confidence** or the reevaluation of assets as a result of market shock. In China, the situation is mitigated by continued strong growth prospects (urbanization potential, etc.) and the widespread practice of providing explicit and implicit government guarantees.
- **The commissioning of pipeline capabilities in the US in the second half of 2019 may lead to a significant reduction in oil prices in the world market.** This effect is likely to outweigh the sanctions-related reduction in oil exports from Iran and the consequences of new OPEC+ arrangements.

Table 1. Baseline scenario of the macroeconomic outlook for 2015 through 2022 (for the Alternative scenarios, see Appendix, pg. 11)

Indicator	UoM	Actual			Estimate	Forecast			
		2015	2016	2017	2018	2019	2020	2021	2022
Key external environment indicators									
Urals price	USD/bbl	51.3	42.3	53.5	72	63	59	61.6	62.8
Global GDP[1]	% y-o-y	2.8	2.5	2.6	2.6	2.1	1.8	1.8	1.8
US GDP	% y-o-y	2.9	1.5	2.3	2.5	1.5	1.6	1.7	1.7
China GDP	% y-o-y	6.9	6.7	6.8	6.4	5.6	4.4	4.0	4.0
EU GDP	% y-o-y	2.3	2.0	2.4	1.8	1.4	1.5	1.6	1.7
Production indicators									
Market GDP	RUB bln	83,234	86,044	92,082	101,458	106,299	110,688	116,234	123,081
Real GDP growth rate	%, y-o-y	-2.5	-0.2	1.5	1.6	1.4	1.5	1.4	1.4
Fixed investments	RUB bln	13,897	14,749	15,967	16,973	17,906	19,070	20,310	21,630
Fixed investments real growth rate[2]	%, y-o-y	-10.1	-0.2	4.4	3.2	2.9	2.6	2.5	2.5
Industrial output index[3]	%, y-o-y	-0.8	1.3	1.0	2.7	1.2	0.9	0.9	1.2
Retail turnover	RUB bln	27,538	28,317	29,804	31,443	33,393	35,430	37,449	39,509
Balance of payments indicators									
Export of goods	USD bln	341	282	354	433	401	405	422	420
Import of goods	USD bln	193	192	238	240	251	274	284	297
Annual average USD exchange rate	RUB/USD	61.3	67.2	58.3	63.1	64.1	60.1	61.2	62.6
Annual average EUR exchange rate	RUB/EUR	68.0	74.4	65.9	70.0	73.4	74.6	75.6	75.2
Labor market and income									
Average wage	RUB/month	34,012	36,740	39,148	42,628	45,480	48,482	51,632	54,934
Real disposable income	%, y-o-y	-3.2	-5.9	-2.0	2.7	1.4	2.0	1.8	1.6
Population	mln	146.3	146.6	146.8	147.0	147.0	147.1	147.1	147.2
EAP[4]	mln	76.6	76.6	76.1	75.4	75.6	74.9	74.3	73.0
Unemployment	% of EAP	5.6	5.5	5.2	5.2	5.3	5.3	5.3	5.3
Financial market prices and indicators									
Inflation (CPI[5])	%, Dec/Dec	13.2	5.4	2.5	4.2	4.6	4.0	3.9	3.8
Key interest rate (as at year-end)	%	11.0	10.0	7.75	7.5	6.75	6.5	6.25	6.0
5-year zero-coupon OFZ rate	%	9.9	8.3	7.2	8.8	7.4	6.9	6.5	6.5
Private deposit rate (> 1 year)	%	9.4	7.8	6.7	6.3	6.5	6.2	5.5	5.4
Non-financial sector bank lending rate (> 1 year)	%	13.7	12.5	8.6	9.0	9.1	8.2	8.0	7.7
Budget									
Federal budget balance	% of GDP	-2.3%	-3.4%	-1.8%	1.6%	1.6%	0.8%	1.1%	1.4%

Source: ACRA

[1] Real growth rate according to the World Bank Methodology.
[2] Physical volume growth index corrected by the investment deflator.
[3] Under the new methodology after adoption of the Russian Classification of Economic Activities 2.
[4] Economically Active Population.
[5] Consumer Price Index.

Six events creating risk for the growth of the Russian economy

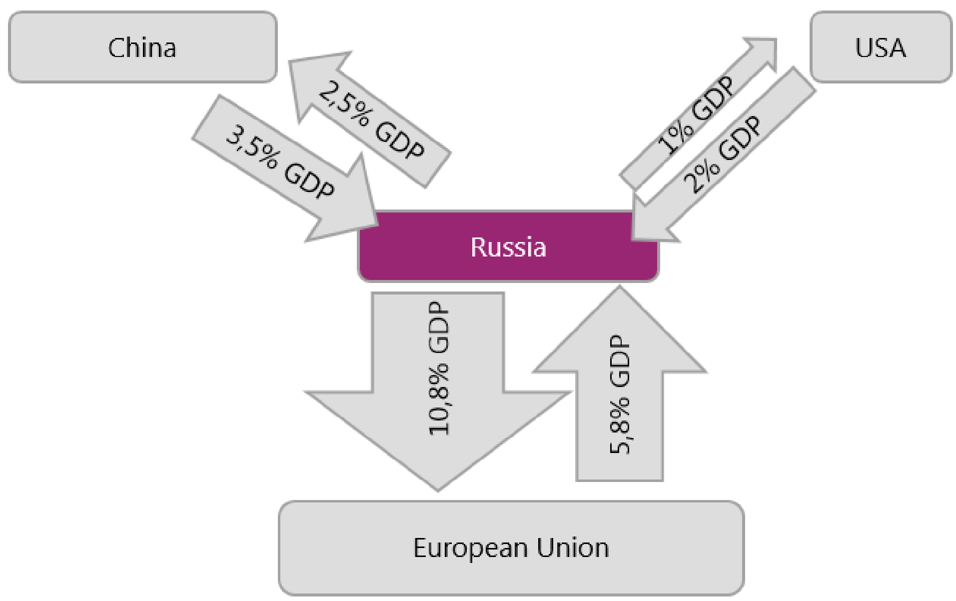
The reduction in the working-age population, the transition to lower inflation, the growth in the amount of Asian countries in trade and financial relations, the implementation of declared economic policy measures, and the preservation of the already imposed sanctions – these structural effects will define the development of the Russian economy for the next 5-10 years. We believe this trend, the quantitative characteristics of which are described in the baseline scenario (see Table 1), is the most likely course of events at the current moment.

However, reacting to the change in conditions of external markets, the Russian economy can significantly deviate from this trend. Russia is a small open economy. A large part of the economic events in countries that are trade partners and countries that Russia is financially connected with is reflected in internal economic indicators. One of the most important channels capable of creating market shock is exports and external portfolio investments (incoming and outgoing). Russia's weak product diversification in exports leads to high fluctuations in cost. Because of the various motives that drive investors, portfolio investments tend to exhibit higher volatility than direct ones.

We see six external risks that are capable of substantially influencing the Russian economy (with sufficiently high probability or force) via the abovementioned channels from 2019 through 2020. The realization of these risks in two combinations provides two different scenarios, Alternative and Alternative + Financial Stress (see Table 2).

The first implies that the development of the trade war between China and the US, as well as other protectionist measures in world trade, could lead to a decrease in demand for Russian exports. The reason for this would be the slowdown of economic growth in the countries with which Russia trades. In the same scenario, investments in oil production and transport while oil prices were high would lead to a shock in the oil market and a substantial decline in the equilibrium price.

Figure 1. Trade with countries in which stress can lead to economic downturn in Russia



Sources: FCS of Russia, ACRA's calculations

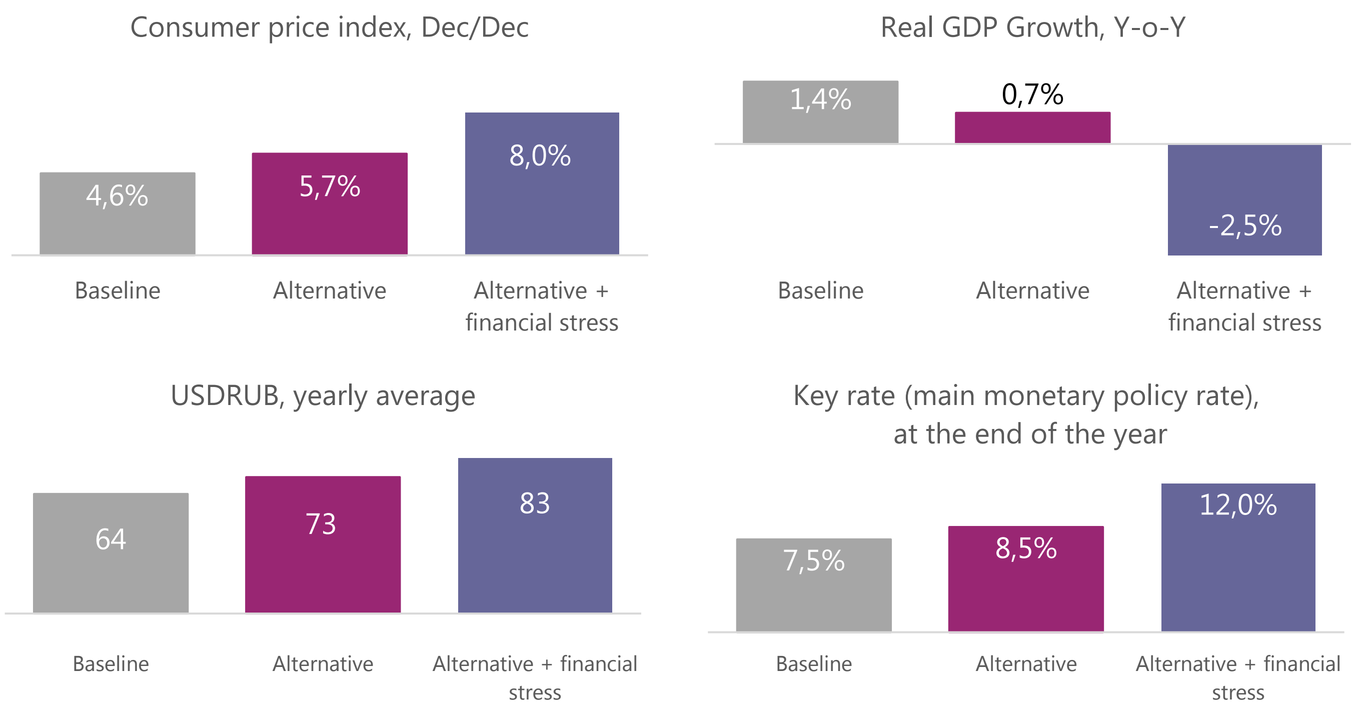
Implicit linkages between companies that will be directly affected by trade contraction and higher global rates, and those that will not be affected by these factors, can increase information imbalance and trigger an even greater crisis of confidence in a wide range of organizations. If the regulator's reaction is late or counter-cyclical policy opportunities are limited, this problem could escalate into financial crises, the developments of which we describe in the scenario "Alternative + Financial Stress." These crises include the likelihood of a recession in the US, a debt crisis in China, and budget crises and recessions in various European countries.

Table 2. Components of macroeconomic scenarios for Russia

Event	Event likelihood for 2019–2020	Negative impact on the Russian economy	Baseline	Alternative	Alternative + Financial Stress
Endogenic recession in the USA	Medium	Strong			(+)
Demand for Russian exports drops by more than 1% due to trade wars	Medium	Strong	+	++	++
The US imposes new sanctions against Russia in November 2018	High	Medium	+	+	+(+)
Supply shocks impair prices in commodity markets	Medium	Medium		+	(+)
Debt crisis in China	Low	Medium			(+)
Budget crisis in some European countries	Medium	Weak			(+)

Source: ACRA

Figure 2. Comparison of key indicators for scenarios of economic development in Russia for 2019 (an expanded list of indicators is provided in the Appedix, pg. 11)



Source: ACRA's calculations

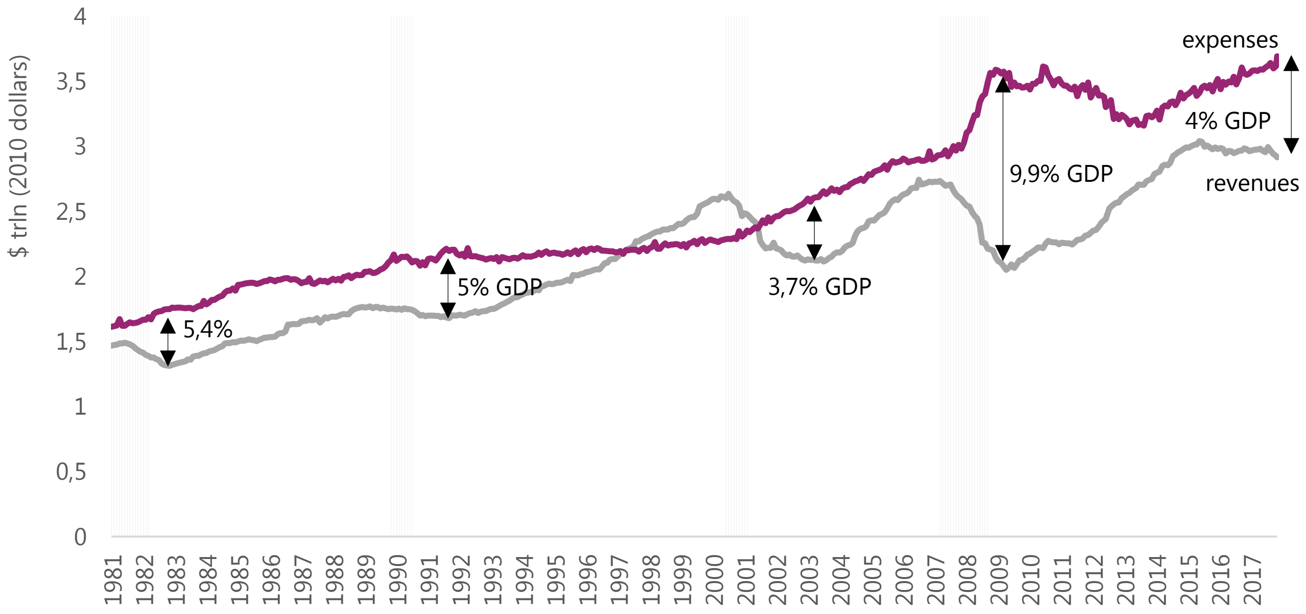
Concerns of a possible endogenous recession in the US are supported by high asset prices and a flat yield curve.

After the 2008 recession, the US economy recovered and by the vast majority of factors achieved pre-crisis conditions. However, there are reasons to believe that at the present moment, the instruments of economic policy are not as ready for the next recession as they were before 2008. In addition to this, the amount of factors that are able to speed up the onset of a recession has increased.

In the beginning of the 1990's, interest expenses in the US hit a historic high (22-23%). The growth from 15% starting at the end of the 1970's was connected with the high interest rates of the 1980's (a result of high inflation after the shock of oil prices).

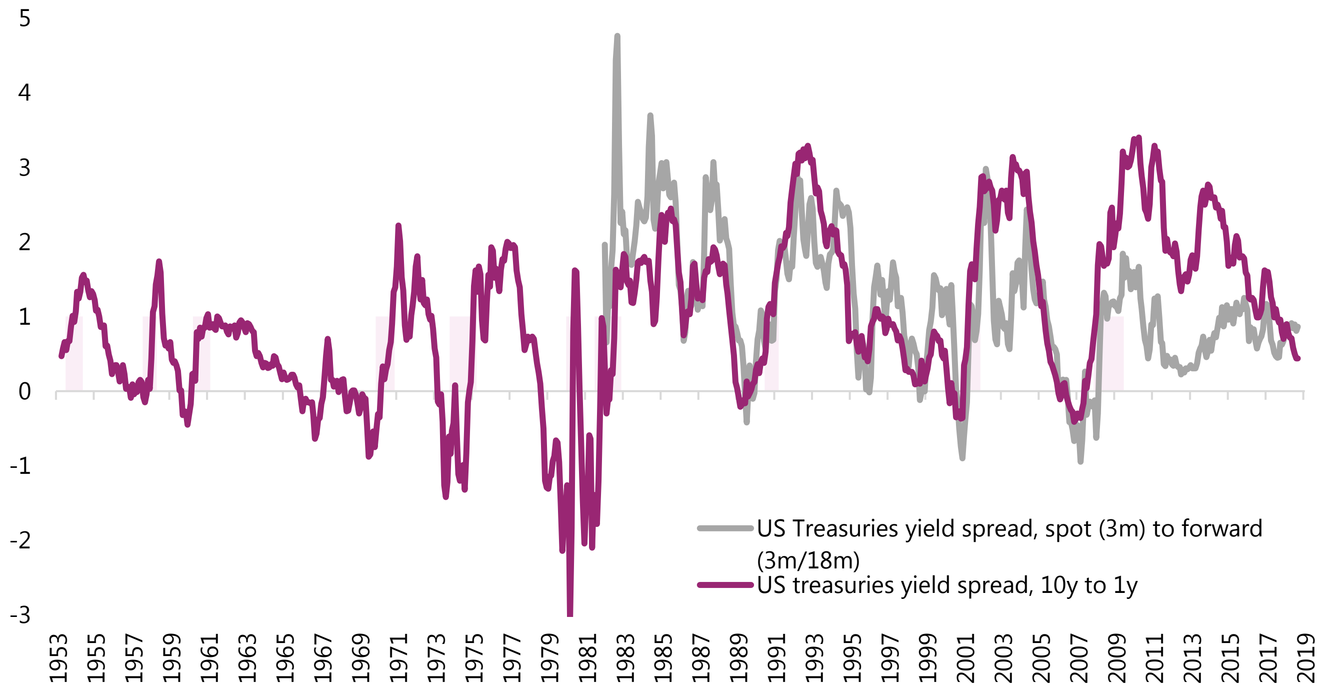
Structural shifts have occurred in the budget deficit on a federal level. Over the past 40 years, the need for a stimulating fiscal policy in times of a recession lead to deficit growth of up to 4-5.5% of GDP. For seven years after this, the negative balance returned to average values (1.5-2.5%) or even surplus, similar to after the economic reform of the late 1990's (see Figure 3). But now the deficit, which reached 10% in 2009, is not returning to a low level, and at the rate of economic growth that is close to potential, is 4% of GDP and growing. It is still difficult to evaluate the effect of budget initiatives from the start of 2018, but in short and medium term periods they will most likely create additional unbalancing pressure at the level of 0.5-1.0 percentage points of the GDP. The situation where the expected deficit (4-5% of GDP) exceeds the expected growth rate of nominal GDP (4%) is unstable. The amount of non-interest expenses in budget expenses is decreasing as they are being replaced by interest expenses. Taking into account that long-term interest rates on public debt are increasing as a result of the short-term rates of the US Federal Reserve, we believe that the current destabilization could lead to a portion of non-flexible interest expenses growing over the course of five years from 12% to 16.5-17%. The procyclical increased deficit and growth in the amount of non-flexible expenses that occur in good years in the case of a new recession reduces the ability of the budget to react to it, which can lead to the worsening of this decline.

Figure 3. Fluctuations in the US federal budget are losing countercyclicity.



Sources: US Treasury, FRB of St. Louis, ACRA's calculations

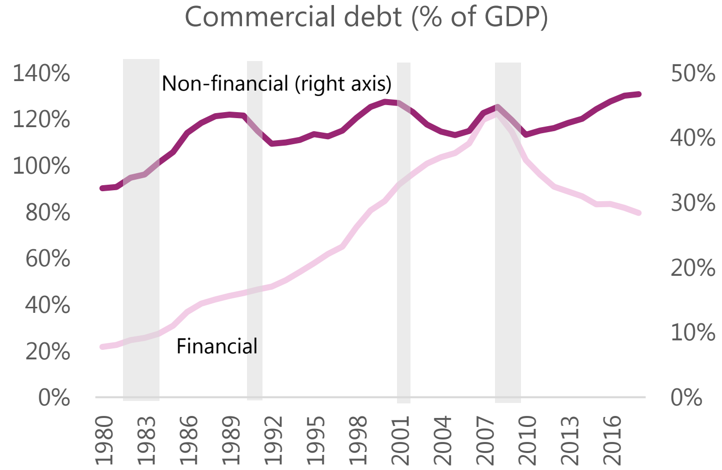
Figure 4. US Treasury bond yield spreads used to estimate the probability of a recession (the transition to the negative area is considered a signal)

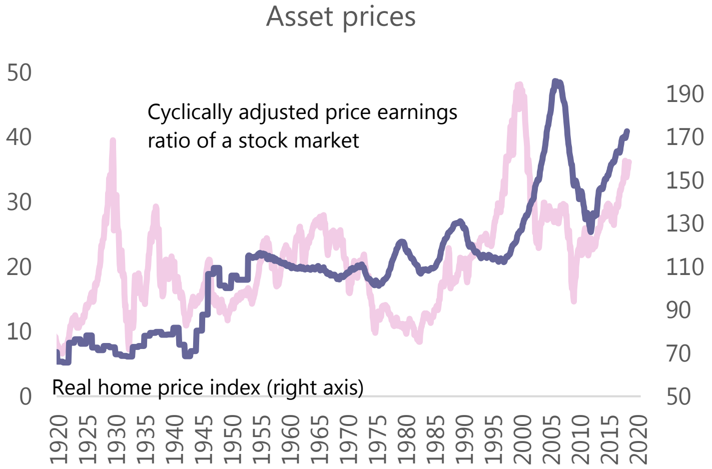


Sources: FRB of St. Louis, ACRA's calculations

The maturity spread on treasury bonds in the US is considered to be a good leading indicator of recession.[6] In mid-October, 2018, the difference between returns on ten-year and one-year bonds was still positive (about 0.4 percentage points), but is decreasing. The extrapolation of the decline rate allows us to expect an inversion in early 2019. Over the past 60 years, in eight out of nine cases, yield curve inversion anticipated a recession 9-24 months before its start as well as the growing expectations of monetary policy easing (see Figure 4). The indicator worked regardless of the types of events leading to recession, which garnered confidence in the indicator even despite the fact that the mechanism that creates such a stable correlation is not fully understood.

Figure 5. In most cases, a recession in the US precedes a period of accelerated credit growth or a surge in asset prices (current prices are very high by historical standards)





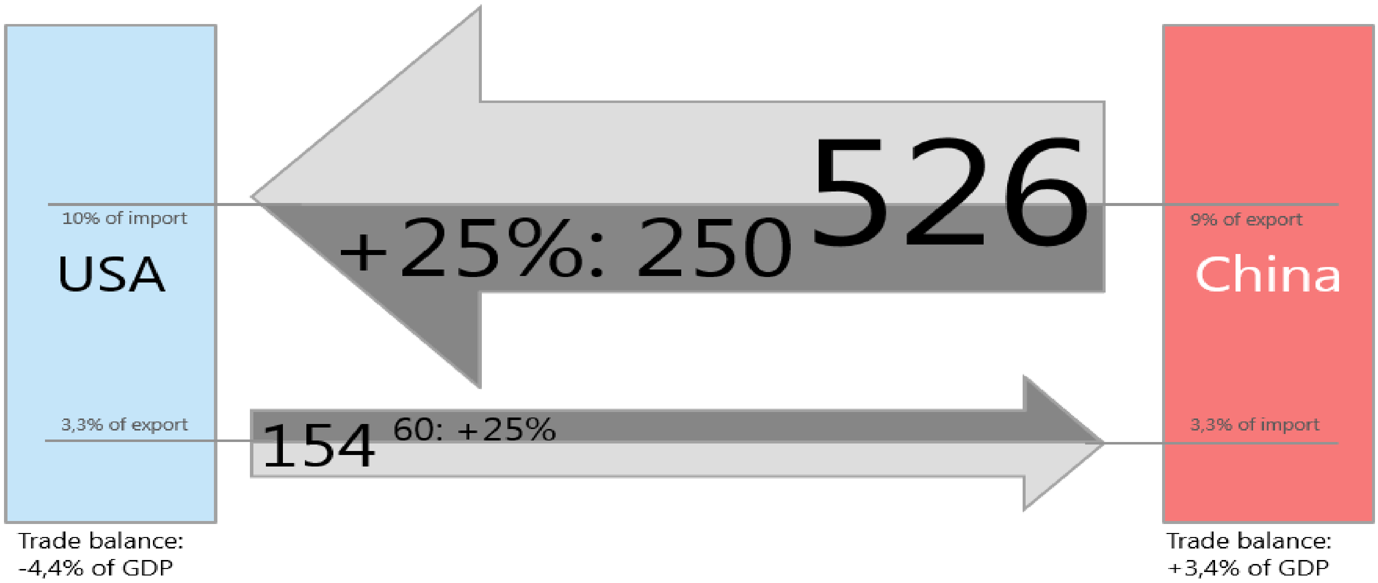
Sources: FRB of St. Louis, Robert Shiller's calculations (http://www.econ.yale.edu/~shiller/data.htm), ACRA's calculations

[6] See, for example, Michael D. Bauer and Thomas M. Mertens (2018), "Economic Forecasts with the Yield Curve," FRBSF Economic Letter 2018-07

The trade war will slow down the economic growth of the US and China and lower the volume of world trade

The increase in tariffs on imports of specific categories, in otherwise equal conditions, raises domestic prices for these categories and reduces trade volume. Taking into account the current situation, it is reasonable to believe that by the beginning of 2019 around half of the US and China's turnover volume will be taxed at a rate of 25% with a weighted average of 5.2% and 2.4% before increase. This raises the domestic prices of goods and will stimulate import substitution for similar goods from other countries as well as investment in domestic production capacity. However, such a substitution requires a few years to take place (which is not always possible). Therefore, in the short-term period it is logical to expect a surge in prices and a reduction in the consumption of these goods in both countries.

Figure 6. Outlook on the state of the trade war for the start of 2019



Source: ACRA's calculations

These events can have a statistically significant impact on the US and Chinese economies. The markets of these two countries depend on each other to a high degree (see Figure 6). In 2019, the trade war could "cost" China -1-1.2 percentage points of economic growth and +0,5-1.0 percentage points of inflation for one year. As for the US, the impact is likely to be less noticeable, slightly less than China: -0.2-0.6 percentage points (higher domestic market capacity will help). The US imports mainly from China and imposes additional tariffs on intermediate goods, while China imports final goods. Therefore, a stronger increase in inflation is possible in the US. The current assessment is +1-1.3 percentage points for one year.

Intermediate goods used in the production of goods for final use.

The quantitative values take into account only the normal reaction of importers and exporters to the tariff configuration, shown in Figure 6, and do not take into account possible compensatory influences of economic policy.

The influence on the US could intensify if the lists of goods grow; if the financial status of companies directly connected to the reduction of cross-border trade (ensuring 5-8% of GDP) worsens, which will cause not only a crisis of confidence in these companies, but in their counterparties as well. With fairly rapid development, the following situations could be possible: growth in asymmetrical information, a sharp fluctuation in the prices of financial assets, a period of heightened financial stress, local liquidity crises, and short-term economic decline.

The possibility of a debt crisis in China

The potential of amplified negative effects of a trade war exist in China as well as in the US. In particular, the increased growth over the past 3-4 years of poorly regulated sectors of finance, the increase in the share of short-term credit, the observed growth of defaults (and the size of companies with reduced creditworthiness) in the debt securities market.

The possible negative reaction of China's financial market to the increasing uncertainty of and reduction in trade volume is mitigated by the nature of the market itself (it is less connected to the global financial market) and the widespread practice of explicit and implicit debt guarantees in the expanded public sector. In addition, the fundamental prerequisites for economic growth remain substantially more powerful than in most of the world's major economies. Potential urbanization and the transition to an economy based to a large degree on domestic demand have not yet been realized. Therefore, in none of the alternative scenarios do we expect China's economy to fall into a recession. However, in our opinion, reduced growth rates and fluctuation in interest rates and exchange rates are quite likely.

At the present moment, ACRA and its colleagues from the Chinese rating agency Golden Credit are developing instruments to measure levels of financial stress in the Chinese economy as well as conducting research on the country's structural features and the potential of its debt market. The first results will be presented at the end of 2018.

All scenarios indicate new sanctions on Russia in November

See ACRA's analytical commentary "US residents hold 8% of Russian sovereign debt" from August 17, 2018.

We believe it is likely that in November 2018, sanctions on the purchase of new issues of Russian debt securities by Americans and American organizations will be enforced. Our assessment is based on the fact that this measure will not affect the interests of Americans investing in Russian bonds if they hold the previously issued Russian state debt until it is repaid. Moreover, from the start of the year to the end of the summer about a quarter of US holders sold their bonds. They are likely to reduce even more by November. Of the possible measures laid out in Lindsey Graham and Robert Menendez's economic bill from August 2018, this measure is relatively easy to control and has the most understandable potential impact. Finally, the introduction of some of the sanctions listed in the bill does not contradict the goals of the main political forces in the United States. Our prediction on the long-term effect of the restrictions on purchasing Russian debt securities is an upward shift by 0.5-0.7 percentage points of the cost of ruble borrowing by the state due to the reduction of the base of potential investors (relative to the scenario without restriction).

Another possible direction for new sanctions is the ban on payments made in US dollars by Russian banks[7] (events that we believe are less likely and therefore have not included them into the baseline scenario). If the measure is used in the way that was discussed in August, the use of corresponding Russian state bank accounts in American banks could be banned. This reduces the liquidity of Russian bank assets allocated in the US and creates problems for US holders in fulfilling payment

[7] The bill on strengthening anti-Russian sanctions, introduced in the US Senate in early August 2018, contains a paragraph with the following information: "...use all possible powers of the President ... to the extent necessary to block property transactions and other transactions related to the interests of one or more of the Russian financial institutions listed in subparagraph (b) if the property or interests are in the United States, are of U.S. origin or are in the possession of a U.S. citizen" Below this paragraph six Russian state banks are listed: Vnesheconombank, Sberbank, VTB, Gazprombank, Russian Agricultural Bank, Promsvyazbank.

obligations. In the worst case, if this measure is supplemented by "secondary" sanctions for organizations not from the United States, the liquidity of assets of Russian state banks may fall as well as in other countries. In such a case, the Bank of Russia would likely create a special instrument to support currency liquidity for state-owned banks, the source of currency for which may be international reserves.

The main area of uncertainty in such a scenario is the potential changes in the competitive position of state banks in the Russian banking market. The competitive position of non-state Russian and foreign banks for the niche of ensuring settlements of residents with non-residents is possible in one form or another. It is reasonable to assume that for some time trade and financial cross-border transactions will be associated with increased transaction costs. As a result, the temporary decline of these transactions is possible.

Risks of the oil market are on the supply side

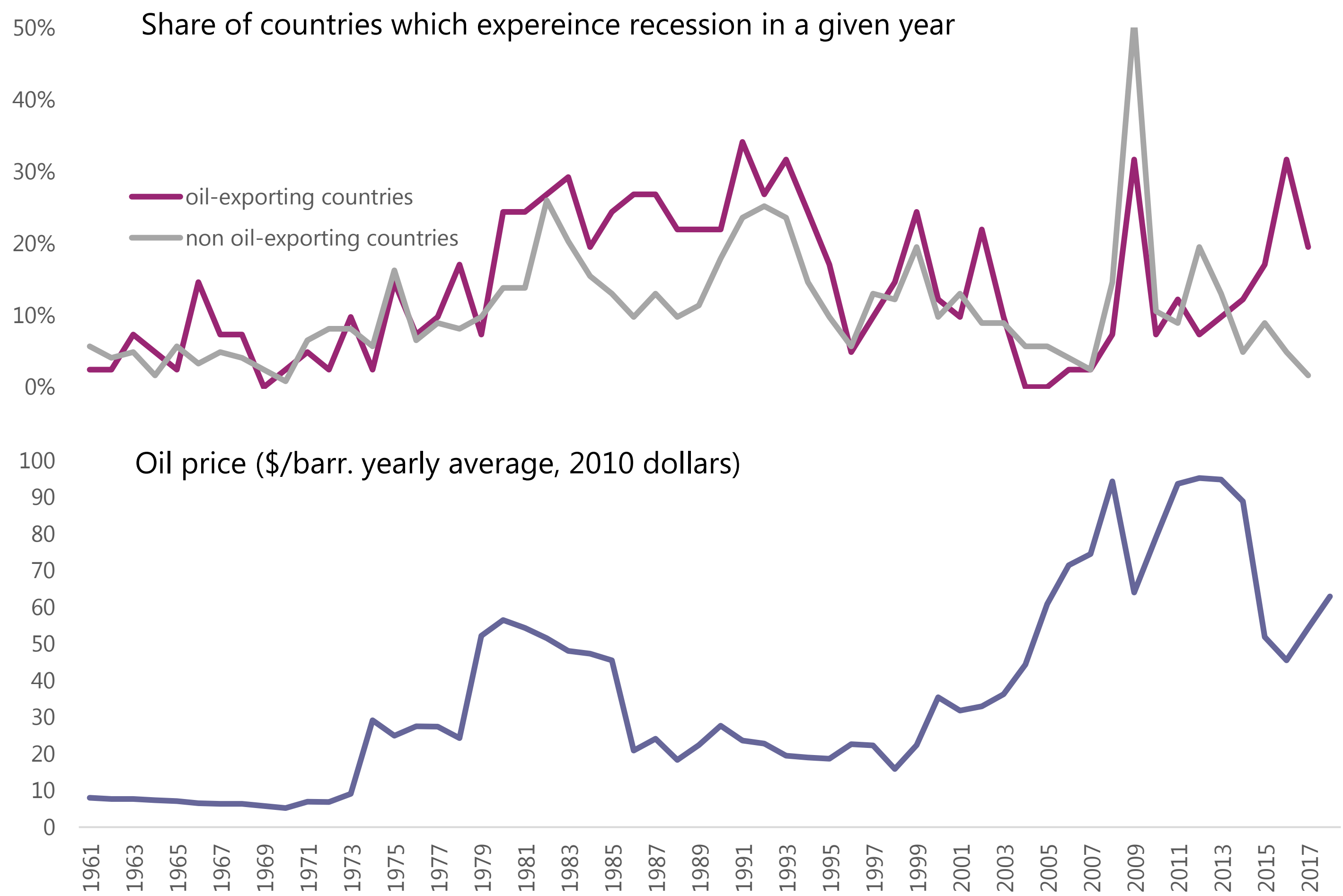
See ACRA's research "One third of commodity exporters pushed into recession by oil price shock" from October 21, 2016.

Commodity price fluctuations are one of the most important economic indicators. Commodities are not only the predominant part of Russian exports, but also react to changes in the global market environment as a whole. Oil exporting countries often suffer from recessions after drops in oil prices and during times of high world interest rates whereas non-oil exporting countries suffer in times of high, real oil prices (see Figure 7)[8].

The current surge in prices above $75 per barrel is largely associated with the threat of US sanctions, including restrictions on oil exports from Iran. By November 2018, it could fall by 0.5-1 million barrels per day (at the beginning of 2018, export had already dropped by at least 0.5 million barrels per day) relative to potential. In 2019, the main risks of the oil market will also be focused on the supply side. It will become clear at the beginning of the year whether the old agreements under the OPEC+ agreement on limiting production will be replaced by a new mechanism, what it will be and whether, according to the new mechanism, production will be limited at current oil price levels. By the third and fourth quarters of 2019, a significant amount of pipeline capacity is planned to be built in the United States. This will increase the amount of crude oil that can be delivered from production areas. The joint multidirectional action of these three events is likely to lead to the maintaining of world prices at an elevated level until mid-2019 and to their significant reduction (by 15% or more) in the second half of the year.

[8] For the calculations in Figure 7, countries with an average balance of foreign trade in oil and oil products > 1% of GDP were considered as oil exporting, while countries with a balance of <-1% of GDP were considered as non-oil exporting.

Figure 7. Oil exporting countries often suffer from recessions after drops in oil prices and during times of high world interest rates, whereas non-oil exporting countries suffer in times of high oil prices.



Source: ACRA's calculations

Appendix. Key indicators of alternative scenarios for Russia.

Alternative Scenario

Indicator		UoM	Actual			Estimate	Forecast	
			2015	2016	2017	2018	2019	2020
Key external environment indicators	Urals price	USD/bbl	51.3	42.3	53.5	72	52	52
	Global GDP	% y-o-y	2.8	2.5	2.6	2.6	2.1	1.8
	US GDP	% y-o-y	2.9	1.5	2.3	2.5	1.1	1.2
	China GDP	% y-o-y	6.9	6.7	6.8	6.4	5.2	4.0
	EU GDP	% y-o-y	2.3	2.0	2.4	1.8	1.0	1.1
Production indicators	Market GDP	RUB bln	83,234	86,044	92,082	101,458	107,901	113,765
	Real GDP growth rate	%, y-o-y	-2.5	-0.2	1.5	1.6	0.7	0.8
Balance of payments indicators	Export of goods	USD bln	341	282	354	433	321	330
	Import of goods	USD bln	193	192	238	240	207	239
	Annual average USD exchange rate	RUB/USD	61.3	67.2	58.3	63.1	73.0	71.5
	Annual average EUR exchange rate	RUB/EUR	68.0	74.4	65.9	75.7	87.6	85.8
Labor market and income	Real disposable income	%, y-o-y	-3.2	-5.9	-2.0	2.7	0.4	0.8
	Unemployment	% of EAP	5.6	5.5	5.2	5.2	5.4	5.4
Financial market prices and indicators	Inflation (CPI)	%, Dec/Dec	13.2	5.4	2.5	4.2	5.7	4.5
	Key interest rate (as at year-end)	%	11.0	10.0	7.75	7.5	8.5	8.0
	5-year zero-coupon OFZ rate	%	9.9	8.3	7.2	8.8	8.9	7.0
Budget	Federal budget balance	% of GDP	-2.3%	-3.4%	-1.8%	1.6%	0.3%	0.3%

Alternative Scenario + Financial Stress

Indicator		UoM	Actual			Estimate	Forecast	
			2015	2016	2017	2018	2019	2020
Key external environment indicators	Urals price	USD/bbl	51.3	42.3	53.5	72	38	56
	Global GDP	% y-o-y	2.8	2.5	2.6	2.6	0.8	1.3
	US GDP	% y-o-y	2.9	1.5	2.3	2.5	-1.5	0.3
	China GDP	% y-o-y	6.9	6.7	6.8	6.4	3.9	4.0
	EU GDP	% y-o-y	2.3	2.0	2.4	1.8	0.2	1.0
Production indicators	Market GDP	RUB bln	83,234	86,044	92,082	101,458	106,835	111,761
	Real GDP growth rate	%, y-o-y	-2.5	-0.2	1.5	1.6	-2.5	0.3
Balance of payments indicators	Export of goods	USD bln	341	282	354	433	259	351
	Import of goods	USD bln	193	192	238	240	182	243
	Annual average USD exchange rate	RUB/USD	61.3	67.2	58.3	63.1	83.2	69.0
	Annual average EUR exchange rate	RUB/EUR	68.0	74.4	65.9	75.7	99.8	82.8
Labor market and income	Real disposable income	%, y-o-y	-3.2	-5.9	-2.0	2.7	-3.1	-1.8
	Unemployment	% of EAP	5.6	5.5	5.2	5.2	6.2	5.6
Financial market prices and indicators	Inflation (CPI)	%, Dec/Dec	13.2	5.4	2.5	4.2	8.0	4.3
	Key interest rate (as at year-end)	%	11.0	10.0	7.75	7.5	12.0	9.5
	5-year zero-coupon OFZ rate	%	9.9	8.3	7.2	8.8	10.2	6.9
Budget	Federal budget balance	% of GDP	-2.3%	-3.4%	-1.8%	1.6%	-2.5%	0.5%

Source: ACRA

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