BELARUS: Economy at a crossroads

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Growth in Belarus was sluggish in the first half of 2014. It seems, however, that a modest upturn has now set in; it should contribute to an average GDP growth of close to 2% for the year as a whole. At present, policy is focused on preserving a teetering macroeconomic equilibrium, which is being bolstered by mobilising short-term external financial resources. This course is likely to linger on up until the presidential elections scheduled for mid-2015, the outcome of which will play a key role in determining the country's political landscape.

Growth in Belarus was sluggish in the first half of 2014 but a modest upturn seems to be underway. In the course of the year, economic activity has been reviving, albeit at a slow pace: after a sluggish 0.9% year-on-year rate of growth in the first quarter, GDP growth picked up to 1.6% in the second quarter resulting in a 1.2% average rate for the first half of the year. Recent monthly indicators suggest that growth continued to pick up momentum in the third quarter.

On the supply side, good performance in the services sector (apart from construction) contributed to aggregate growth. After a downturn that continued for a year and a half, industrial production also seems about to turn the corner. On the demand side, private consumption provided a modest boost to economic activity, supported by a continued rise in real incomes, while fixed investment experienced a downturn. The current statistics available at the moment of writing do not allow for a detailed assessment, nevertheless, it appears that net exports made the most significant contribution to GDP growth in the first half of 2014 thanks to an ongoing significant reduction in the trade deficit. The observable adjustment in trade flows partly reflects protective policy measures by the authorities seeking to support local producers and exporters and measures seeking to restrain imports. The resumption of production and exports of potassium fertilisers (a key export item) after a disruption in 2013 (due to a dispute with the Russian business partner Uralkali) also contributed to this change.

Since the 2011 balance of payments crisis, the economy of Belarus has been muddling through, seeking new direction. However, policy so far has not addressed the underlying root cause of the crisis – an overvalued real exchange rate which is not consistent with economic fundamentals. The authorities have been reluctant to take any far-reaching corrective policy measures towards a more stable macroeconomic equilibrium as these would imply a painful adjustment. Instead, the key efforts at a high policy level have been focused on attracting additional external financial resources aimed at supporting an unstable macroeconomic equilibrium. However, the sustainability of such a policy course is highly questionable. While preserving it until the upcoming presidential elections in 2015 seems manageable, a major adjustment is probably to be expected in the not too distant future thereafter.

During some 15 years preceding the 2011 crisis, Belarus experienced a period of unprecedented, high economic growth which produced impressive outcomes: between 1995 and 2011 real GDP (as reported by the national statistics) tripled. However, what might at the surface appear as an economic miracle did not have sound economic fundamentals. Indeed, one of the core drivers of growth throughout most of the past couple of decades have been the implicit transfers from Russia originating in below market prices charged for the supplied oil and gas and amounting to several billion euro per year. Part of these implicit subsidies was channelled directly to recipient firms (distorting market conditions) and another part generated fiscal revenue and resided in the state coffers.

More generally, the Belarusian economy benefited from close economic ties with Russia and cross-border economic cooperation. Thus during the past decade, strong import demand in Russia supported growing exports of Belarusian engineering products and capital goods (partly thanks to the supply chains preserved from the past) thus contributing to the revival of these sectors of the Belarusian economy.

While this external stimulus supported general economic growth and contributed to relatively balanced public finances, it also produced significant distortions in the Belarusian economy, resulting from populist income policies and activist old-fashioned industrial policy. In particular, during the past decade the government has been pursuing an aggressive investment promotion campaign in the public sphere and in state-owned firms through subsidised directed credit channelled through the banking system. One piece of evidence hinting at overinvestment in this period is the fact that the average rate of gross capital formation (as a percentage of GDP) in the decade up to 2013 was 34%. However, in the absence of proper market-based intermediation through a well-functioning financial system these investment decisions were hardly consistent with efficient resource allocation. In addition, the excessive money supply associated with massive directed credit has been feeding into persistent high inflation in Belarus.

A typical example epitomising the prevailing populist policy stance was the target announced in 2010 to raise average monthly wages in Belarus to the equivalent of USD 1,000 by 2015. This target has been pursued through the two instruments affecting dollar income: nominal wages and the nominal exchange rate. On the one hand, the government encouraged generous increases in nominal wages; these originated in the public sector but then spilled over to the business sector. On the other hand, the National Bank was subverted to pressure by the government to put brakes on the depreciation of the Belarusian rouble which, in principle, follows a floating exchange rate.

While the 2011 currency crunch partly echoed the repercussions of the global economic and financial crisis, it was to a large extent the outcome of the inconsistency of such a policy course which had produced an unsustainable real exchange rate appreciation. The authorities were then forced to accept a more that 200% depreciation of the nominal exchange rate which was a major policy setback, making void the above-mentioned wage target. Concomitantly, the implicit transfers from Russia through subsidised imports of oil and gas have become less reliable and predictable in latest years. The establishment in 2010 of the Customs Union with Russia and Kazakhstan and later of the Eurasian Economic Union, to be formally launched in 2015, played a role in this as it turned out that some of these subsidies were inconsistent with the general economic principles of these integrative economic structures.

The 2011 crisis and the recent changes in the external economic environment prompt the need for a major change in the policy course towards restoring a more stable macroeconomic equilibrium. The decades of unsustainable policies have resulted in the accumulation of significant distortions and structural imbalances in the economy. However, instead of policy reforms, the authorities have sought to attract supplementary short-term external financial resources in an attempt to preserve the status quo, at least in the short run. Consequently, real exchange rate appreciation resumed again after 2012 and by mid-2014, the level of the real exchange rate – which initially had dropped significantly – was approaching its 2011 peaks.

During the past 2-3 years, the authorities have been resorting to all possible sources of balance of payment support, but mostly Russian and Russia-dominated official ones. In June 2011, the Anti-Crisis Fund managed by the Eurasian Development Bank approved a USD 3 billion financial credit to Belarus, of which USD 2.56 billion has been disbursed to date. In addition, in 2013-2014 Belarus raised or negotiated credits from Russia's Sberbank (government guarantee for a USD 1 billion loan that Belarusian potash manufacturer Belaruskali took from Sberbank) and Vnesheconombank (USD 2 billion), as well as sovereign loans from the governments of Russia and China (close to USD 1 billion in total) and a number of smaller official loans. On top of that, in 2014 Belarus negotiated with Russia derogations from Eurasian Economic Union rules on oil export duties, which are equivalent to an up to USD 1.5 billion direct Russia-Belarus government-to-government transfer in 2015. Belarus is also considering a Eurobond issue in 2015 amounting to USD 1 billion (after it made its debut on the Eurobond market in 2010-2011 with two subsequent issues totalling USD 1.8 billion). IMF support has not been negotiated in this period, after some difficulties experienced in the course of the implementation of a 2009 stand-by arrangement and related to strict IMF conditionality.

Thus the underlying policy strategy in recent years appears to have aimed to maintain the status quo – and prevent at any cost an economic collapse accompanied by a plunge in living standards – and buy time, at least until the key presidential elections scheduled for mid-2015. During the past two decades, rising welfare has been one of the declared flagship political achievements and the authorities have been rather cautious about possible reversals. However, in the years after 2008, this has been achieved at the expense of large current account deficits (of the order of 10% of GDP or even higher in much of this period) and, consequently, growing external indebtedness.

The present policy course – implying the need to raise continuously new and ever-increasing balance of payments support – is difficult to sustain in the medium and longer run. Addressing the root causes of the balance of payments crisis would require regaining competitiveness by a combination of lasting real exchange rate depreciation and structural reforms supporting productivity gains. Macroeconomic stabilisation accompanied by sustainable disinflation and contributing to a notable reduction in interest rates is also a key prerequisite for establishing a healthy economic environment. Sooner or later, the authorities will have to face these painful adjustment measures; apart from political considerations, the timing of adjustment will depend on the ability to continue to finance the balance of payments deficit. Thus in a medium-term perspective, the Belarusian economy appears to be at a crossroads between the status quo and a new policy course leading to a more sustainable growth pattern.

In the short term however, the Belarusian economy is likely to get a modest boost resulting from the Russian ban on food and agricultural imports from the EU. Given its geographic location, in the current circumstances the Belarusian food and agricultural exports to Russia will only be limited by production capacity and the capacity to meet Russian quality and phytosanitary regulations. There are also ongoing negotiations with neighbouring EU countries on cooperation in the processing in Belarus of agro products originating in other countries. These developments could provide some support to the economic upturn in the second half of the year.

Given the above, stronger economic activity in the second half could contribute to an average GDP growth for the year as a whole of close to 2%. As regards the macroeconomic environment, no major changes are expected before 2016 and given a continuing favourable push from Russia (both traditional and agro-driven), modest GDP growth should continue in Belarus. The country has also regained some international recognition after mediating between the EU and Russia during the Ukrainian conflict which may ease its access to international financial markets to secure much-needed balance of payments support.

The forecast envisages the start in 2016 of a gradual adjustment process in line with the propositions outlined above. Such an adjustment would impact negatively on domestic demand but could contribute to gradual disinflation and give a further boost to exports.

Table 1 / Belarus: Selected Economic Indicators

	2010	2011	2012	2013 1)	2013 January-June	2014 January-June	2014 Forecast	2015 Forecast	2016 Forecast
Population, th pers., average 2)	9,491	9,473	9,465	9,466	.	.	9,475	9,490	9,510
Gross domestic product, BYR bn, nom.	164,476	297,158	530,356	636,784	283,424	337,385	764,900	907,700	1,111,000
annual change in % (real)	7.7	5.5	1.7	0.9	1.4	1.2	1.8	2.3	2.0
GDP/capita (EUR at exchange rate)	4,300	3,900	5,200	5,700	.	.	.	.	.
GDP/capita (EUR at PPP)	10,500	11,100	11,800	11,800	.	.	.	.	.
Consumption of households, BYR bn, nom.	88,470	139,955	244,863	323,927	144,363	177,527	.	.	.
annual change in % (real)	9.5	2.3	10.8	12.2	16.3	5.1	5.0	4.0	2.0
Gross fixed capital form., BYR bn, nom.	64,698	113,230	178,455	235,234	96,163	105,532	.	.	.
annual change in % (real)	17.5	13.9	-11.3	7.5	9.9	-7.5	-2.0	-2.0	0.0
Gross industrial production									
annual change in % (real)	11.7	9.1	5.8	-4.8	-4.2	-1.0	0.0	2.0	4.0
Gross agricultural production									
annual change in % (real)	2.5	6.6	6.6	-4.0	1.5	-4.3	.	.	.
Construction industry									
annual change in % (real)	15.8	17.9	-11.7	7.4	2.8	-6.7	.	.	.
Employed persons, LFS, th, average	4,666	4,655	4,577	4,518	4,534	4,491	4,500	4,550	4,600
annual change in %	0.5	-0.2	-1.7	-1.3	-1.1	-1.0	.	.	.
Unemployed persons, LFS, th, average	.	.	.	.	.	.	.	.	.
Unemployment rate, LFS, in %, average	.	.	.	.	.	.	.	.	.
Reg. unemployment rate, in %, end of period	0.9	0.7	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Average monthly gross wages, ths BYR	1,217	1,900	3,676	5,139	4,771	5,680	.	.	.
annual change in % (real, gross)	15.0	1.9	21.5	18.2	20.5	3.6	.	.	.
Consumer prices (HICP), % p.a.	7.8	53.2	59.2	18.3	21.0	17.2	18.0	16.0	20.0
Producer prices in industry, % p.a.	13.6	71.4	76.0	13.6	16.5	11.3	.	.	.
General governm.budget, nat.-def., % of GDP	-	-	-	-	-	-	-	-	-
Revenues	41.6	38.7	40.5	41.9	45.4	41.6	.	.	.
Expenditures	44.2	35.9	39.8	41.8	43.5	41.4	.	.	.
Net lending (+) / net borrowing (-)	-2.6	2.8	0.7	0.2	1.9	0.1	0.0	-1.0	-2.0
Public debt, IMF-def., % of GDP	41.0	45.9	38.7	35.8	.	.	.	.	.
Central bank policy rate, % p.a., end of period 3)	10.50	43.23	30.00	23.50	25.0	21.5	.	.	.
Current account, EUR mn 4)	-6,187	-3,518	-1,446	-5,804	-2,757	-1,961	-4,000	-4,000	-3,000
Current account, % of GDP	-15.1	-9.5	-2.9	-10.8	-11.1	-7.7	-7.3	-7.1	-5.5
Exports of goods, BOP, EUR mn 4)	18,311	28,499	35,391	27,701	14,275	13,729	27,500	28,000	28,500
annual change in %	26.3	55.6	24.2	-21.7	-26.3	-3.8	-0.7	1.8	1.8
Imports of goods, BOP, EUR mn 4)	25,251	30,913	34,952	31,183	15,260	13,918	28,500	29,000	28,500
annual change in %	29.5	22.4	13.1	-10.8	-12.9	-8.8	-8.6	1.8	-1.7
Exports of services, BOP, EUR mn 4)	3,583	3,906	4,901	5,578	2,625	2,605	5,500	5,600	5,700
annual change in %	37.1	9.0	25.5	13.8	17.6	-0.7	-1.4	1.8	1.8
Imports of services, BOP, EUR mn 4)	2,247	2,334	3,140	3,937	1,766	2,068	3,900	4,000	3,900
annual change in %	43.9	3.9	34.5	25.4	26.8	17.2	-0.9	2.6	-2.5
FDI inflow, EUR mn 4)	1,041	2,787	1,137	1,703	1,275	983	.	.	.
FDI outflow, EUR mn 4)	38	87	121	199	77	8	.	.	.
Gross reserves of NB, excl. gold, EUR mn	2,591	4,648	4,390	3,589	4,874	3,432	.	.	.
Gross external debt, EUR mn 4)	21,449	26,305	25,518	28,807	30,120	29,821	.	.	.
Gross external debt, % of GDP	52.2	71.3	51.9	53.5	56.0	54.6	.	.	.
Average exchange rate BYR/EUR	4,007	8,051	10,778	11,834	11,400	13,296	14,000	16,200	20,300
Purchasing power parity BYR/EUR	1,653	2,814	4,762	5,696	.	.	.	.	.

1) Preliminary. - 2) According to census October 2009. - 3) Refinancing rate of NB. - 4) BOP 6th edtion.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.