BELARUS: External shocks impose a painful macroeconomic adjustment

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The Belarusian economy has been hit hard by the indirect impact of the recent plunge in oil prices. Thanks to a modest upturn in the second and third quarters, GDP growth for 2014 as a whole remained positive. Faced with severe balance of payments constraints, the authorities have had to accept a sharp exchange rate depreciation. The repercussions of the ongoing adjustments will probably result in an unwelcome economic contraction in 2015. Some measure of growth might return in 2016 and 2017.

Despite falling below the expectations of the authorities, a modest recovery was under way through much of 2014. However, with the unexpectedly sharp fall in oil prices towards the end of 2014 and their strong negative effect on Russia – Belarus' key trading partner and donor – the external economic environment was becoming increasingly harsh. In December it became clear that a painful macroeconomic adjustment was unavoidable.

Understanding such effects on a non-oil-producing country like Belarus requires looking into their sources and mechanisms. There were two main such channels – real and financial – through which the Belarusian economy has been affected. The channel of transmitting real effects is associated with the strong ties to the Russian economy, which is Belarus' main export market. The weakening of the Russian economy resulting from the drop in oil prices led to a shrinking demand for Belarusian exports in the final months of 2014. In addition, Russia started introducing trade protection measures, with a further negative impact on Belarusian exports. Some of these measures were justified by Russia as aiming to prevent the re-export from Belarus of goods originating in the EU that are banned for import in Russia. In any case, a number of these measures were rather controversial, given the Eurasian Customs Union of which both Belarus and Russia are members, and provoked political tensions between the two countries. On top of that, Belarus suffered significant export losses due to the crisis in Ukraine, which is also among Belarus' main markets.

Additional external shocks originating in Russia were transmitted through financial channels. Thus, the sharp depreciation of the Russian rouble which accompanied the fall in oil prices resulted in financial losses for Belarus in bilateral rouble-denominated trade in the final months of 2014. This prompted the Belarusian authorities to request renegotiating trade deals with Russia and their revaluation in US dollars. This, in turn, was another source of tensions between the two countries. In addition, the Russian rouble depreciation implied competitiveness losses for a number of local manufacturers due to the emergence of attractive import opportunities from Russia. The surge in consumer imports from Russia contributed to the deterioration of the external balances in November-December.

Another financial blow to the Belarusian economy is due to the reduction in foreign exchange revenue resulting from the plunge in oil prices at the end of 2014. Despite not being an oil producer, Belarus re-exports considerable quantities of oil imported from Russia at preferential prices. These arrangements, regulated through a framework of bilateral agreements, are equivalent to hefty implicit financial transfers from Russia. Although their value has been progressively declining in recent years, they still represent a significant balance of payments support (de facto Russian subsidy) to Belarus. However, the fall in oil prices in late 2014 translates directly into a drop in the foreign exchange and fiscal revenues related to these transactions.

The combined effect of these shocks resulted in shrinking foreign exchange revenues and led to escalating balance of payments tensions, generating strong downward pressure on the exchange rate. This was reinforced by contagion from Russia where the rouble was under a severe attack. All this provoked panic purchases on the Belarusian foreign exchange market as well as withdrawals of forex deposits in December. Faced with this situation, the authorities intervened with a set of rush – and eclectic – policy measures. On 20 December 2014, the National Bank introduced a combination of quasi capital controls in the form of increased (to 50%) mandatory sales of foreign exchange revenue by exporters and a 30% levy on the purchase of foreign exchange on the currency markets (in effect, a dual exchange rate system implying an artificial 30% margin between the ‘buy’ and ‘sell’ rates). At the same time it raised its short-term lending rate to commercial banks from 24% to 50%. Restrictions on the expansion of commercial banks’ credit activity as well as widespread price controls on the retail market were also put into effect. On top of that, the authorities introduced extra levies on the exports of key export commodities such as oil and potash, a measure seeking to support both the fiscal balance and the balance of payments.

The main objective of these measures was probably to avoid an outright currency depreciation (which would be a repeat of a similar episode in 2011) and its implications as well as to dampen somewhat the immediate effect of the shocks on the population at large. There was also a political backlash of the worsening economic situation: at the end of December, President Lukashenko carried out a far-reaching overhaul of the government, including a changeover at the Prime Minster level. The Head of the National Bank was also replaced.

However, the in-built inconsistency of some of the December measures soon became much too evident to be ignored. The most controversial among those measures – the dual exchange rate – gave immediate though short-lived re-birth to a street black foreign exchange market, as had also happened during a previous similar episode in 2011. The dual exchange rate in combination with price controls also created plenty of black or grey market arbitrage opportunities for a number of economic agents while establishing a highly uneven playing field for many among them. In the event, some of the palliative measures did not last for long and the authorities gradually started lifting or modifying them soon.

Already in January 2015, the foreign exchange levy was first reduced and then completely eliminated. This was equivalent to the de facto recognition of a depreciation of the Belarusian rouble by some 30%. As of 9 January, the National Bank switched, in its policy mix, to a reference basket of currencies (consisting of the euro, the US dollar and the Russian rouble) instead of the US dollar alone. Also in January, the National Bank raised its basic refinancing rate from 20% to 25% but reduced the short-term lending rate from 50% to 40%. As of 1 February all restrictions on the commercial banks' credit activity were lifted. In February, price controls were also loosened somewhat (mostly on imported goods) but as of the moment of writing a number of restrictions on locally produced goods still remain in force. These controls are clearly not consistent with the recognition of the exchange rate depreciation and sooner or later they will have to be removed. Anecdotal evidence suggests that prices not subject to controls were rapidly adjusting upwards already at the beginning of 2015.

Obviously, there will be deep and lasting repercussions of the macroeconomic turbulence that occurred at the turn of the year. Importantly, this was probably the beginning of an adjustment towards a more stable macroeconomic equilibrium that seemed inevitable anyway but which the authorities had been trying to delay as much as possible, at least until after the 2015 presidential elections. In recent years, by resorting to all possible sources of external funding, Belarus was attempting to support a level of the exchange rate which was inconsistent with the balance of payments fundamentals. The December 2014 crisis – triggered by the drying-up of some of these sources – was a clear sign that this policy course was no longer sustainable.

While the currency crisis overshadowed other developments, Belarusian economic performance in 2014 was lacklustre anyway. GDP growth for the year as a whole was just half of what the authorities had targeted ex ante. Public sector finances experienced mounting problems, with public revenue (which is directly associated with the level of oil prices) also falling below targets. In the second half of the year, the government had to abandon a number of public investment projects resulting in a sharp drop in gross fixed capital formation for the year as a whole. On average, private consumption was on the rise in 2014 (reflecting the pre-election policy stance of the authorities), but at a much lower rate than during the previous two years.

Both manufacturing and agriculture registered a modest upturn in 2014 as a whole and there was a period when they received an extra boost due to increased Russian import demand related to the EU and Russian (counter) sanctions but these effects were soon offset by the negative shocks of the last quarter. Recent anecdotal evidence suggests that, faced with financial problems, large firms are shedding labour. However, in the absence of reliable LFS statistics it is difficult to gauge the labour market effects of the crisis. The one star performer in 2014 was the sector of potash ('Belaruskali' being one of the largest producers in the world), which registered record-high levels of output and exports of potash fertilisers.

As long as world oil prices remain at the lows recorded at the turn of 2014/2015 Belarus will remain under negative external pressure exerted through the real and financial transmission channels outlined above. As of the moment of writing there are no signs of a reversal and these factors are likely to prevail in the short run. Thus the main challenges that Belarusian policy-makers will be facing in 2015 will continue to include tight conditions on the key Russian market, contracting export revenues, and continuing balance of payments and fiscal constraints. In the current circumstance, the Eurasian Economic Union that entered into effect in January 2015 has so far not lived up to the expectation of providing a further boost to trade and economic ties between its members.

While the current account deficit dropped considerably in 2014, the balance of payments will remain a major source of policy concern in 2015 when Belarus is facing considerable foreign debt service payments (estimated at about USD 4 billion). In the current environment, its borrowing conditions on the international financial markets have deteriorated and the authorities will need to consider carefully whether they will go ahead with the envisaged Eurobond issue in 2015. In its approaches to international capital markets, Belarus may try to capitalise on the recent Minsk summit on Ukraine, but the prospects for that are not clear yet. On the other hand, it will probably be difficult for Belarus to raise from its traditional donor, Russia, external funding at levels comparable to those of previous years. Thus, the macroeconomic adjustment that started already in December 2014 is likely to deepen further in 2015.

The combined effect of these factors can be expected to curb both domestic demand and economic activity. By and large, the economy of Belarus seems to be embarking on a downward trend and will probably enter a recession in 2015. The authorities will probably seek to avoid at any cost a contraction in personal consumption – something that may be politically damaging in the eve of the presidential elections (expected in the autumn of 2015). However, preventing the erosion of real incomes in the current economic environment will be challenging. Given the fiscal constraints, public investment is likely to be further curtailed. A revision of the 2015 government budget seems all but inevitable given the fact that it was adopted under a very different macroeconomic framework. In the face of the continuing fiscal problems, the authorities announced a new privatisation programme in an attempt to support cash revenue. However, the fiscal balance in 2015 will probably be in the negative territory.

The National Bank has signalled additional tightening of its monetary stance in an attempt to prevent further depreciation of the exchange rate. This, together with the continuing price controls, will seek to prevent inflation from catching up with the nominal exchange rate depreciation, hence engineering a real exchange rate depreciation consistent with the macroeconomic adjustment. However, the carryover inflationary push will remain to be felt also in the years after 2015.

Given the recent developments, the outlook for the Belarusian economy has deteriorated considerably compared to the autumn of 2014. Overall, the repercussions of the ongoing adjustment will probably result in an unwelcome economic contraction of some 2% in 2015. Economic performance in 2016-2017 will depend both on the future dynamics of the external environment and on the sustainability of the macroeconomic adjustment. The current forecast assumes a modest improvement in the external environment in these years as well as a relatively tight macroeconomic policy stance. However, GDP growth of more than 1-2% is highly unlikely.

Table 1 / Belarus: Selected Economic Indicators

	2010	2011	2012	2013	2014 1)	2015	2016	2017
							Forecast	
Population, th pers., average 2)	9,491	9,473	9,465	9,466	9,475	9,490	9,510	9,530
Gross domestic product, BYR bn, nom.	164,476	297,158	530,356	649,111	778,456	953,600	1,207,400	1,453,500
annual change in % (real)	7.7	5.5	1.7	1.0	1.6	-2.0	1.3	2.0
GDP/capita (EUR at exchange rate)	4,300	3,900	5,200	5,800	6,200	.	.	.
GDP/capita (EUR at PPP)	11,700	12,500	13,200	13,500	13,800	.	.	.
Consumption of households, BYR bn, nom.	88,470	139,955	244,863	318,332	386,900	.	.	.
annual change in % (real)	9.5	2.3	10.8	10.9	3.0	0.5	2.0	3.0
Gross fixed capital form., BYR bn, nom.	64,698	113,230	178,455	244,296	245,000	.	.	.
annual change in % (real)	17.5	13.9	-11.3	9.6	-15.0	-8.0	0.0	2.0
Gross industrial production								
annual change in % (real)	11.7	9.1	5.8	-4.9	1.9	-2.0	1.0	3.0
Gross agricultural production								
annual change in % (real)	2.5	6.6	6.6	-4.2	3.1	.	.	.
Construction industry								
annual change in % (real)	12.9	6.7	-8.6	4.6	-5.3	.	.	.
Reg. employment, th, average	4,666	4,655	4,577	4,546	4,500	4,470	4,470	4,500
annual change in %	0.5	-0.2	-1.7	-0.7	-1.0	-0.7	0.0	0.7
Reg. unemployed persons, th, end of period	33.1	28.2	24.9	21.0	22.5	.	.	
Reg. unemployment rate, in %, end of period	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	5,061	5,995	.	.	.
annual change in % (real, gross)	15.0	1.9	21.5	16.4	0.3	.	.	.
Consumer prices, % p.a.	7.8	53.2	59.2	18.3	18.1	25.0	25.0	18.0
Producer prices in industry, % p.a. 3)	13.6	71.4	76.0	13.6	12.8	.	.	.
General governm.budget, nat. def., % of GDP								
Revenues	41.5	38.7	38.5	40.3	39.0	.	.	.
Expenditures	43.3	35.9	37.7	40.1	39.5	.	.	.
Net lending (+) / net borrowing (-)	-1.8	2.8	0.8	0.2	-0.5	-2.0	-2.0	-1.0
Public debt, EU-def., % of GDP	39.5	45.9	38.5	37.0	35.1	.	.	.
Central bank policy rate, % p.a., end of period 4)	10.5	45.0	30.0	23.5	20.0	.	.	.
Current account, EUR mn 5)	-6,187	-3,518	-1,446	-5,702	-3,000	-2,000	-1,500	-1,500
Current account, % of GDP	-15.1	-9.5	-2.9	-10.4	-5.1	-3.8	-2.7	-2.5
Exports of goods, BOP, EUR mn 5)	18,311	28,499	35,391	27,701	27,800	27,000	28,000	29,000
annual change in %	26.3	55.6	24.2	-21.7	0.4	-2.9	3.7	3.6
Imports of goods, BOP, EUR mn 5)	25,251	30,913	34,952	31,183	29,500	28,000	28,500	29,500
annual change in %	29.5	22.4	13.1	-10.8	-5.4	-5.1	1.8	3.5
Exports of services, BOP, EUR mn 5)	3,583	3,906	4,901	5,700	5,900	5,800	5,900	6,000
annual change in %	37.1	9.0	25.5	16.3	3.5	-1.7	1.7	1.7
Imports of services, BOP, EUR mn 5)	2,247	2,334	3,140	3,957	4,200	4,000	4,100	4,200
annual change in %	43.9	3.9	34.5	26.0	6.1	-4.8	2.5	2.4
FDI inflow (liabilities), EUR mn 5)	1,041	2,787	1,137	1,703	1,500	.	.	.
FDI outflow (assets), EUR mn 5)	38	87	121	199	80	.	.	.
Gross reserves of NB, excl. gold, EUR mn	2,591	4,648	4,390	3,589	2,820	.	.	.
Gross external debt, EUR mn 5)	21,449	26,305	25,518	28,555	33,000	.	.	.
Gross external debt, % of GDP	52.2	71.3	51.9	52.1	56.0	.	.	.
Average exchange rate BYR/EUR	4,007	8,051	10,778	11,834	13,220	18,000	22,000	24,000
Purchasing power parity BYR/EUR	1,476	2,512	4,253	5,085	5,937	.	.	.

1) Preliminary and wiiw estimates. - 2) According to census October 2009. - 3) Domestic output prices. - 4) Refinancing rate of NB. - 5) BOP 6th edition.
Source: wiiw Databases incorporating Eurostat and national statistics.