13. BELARUS

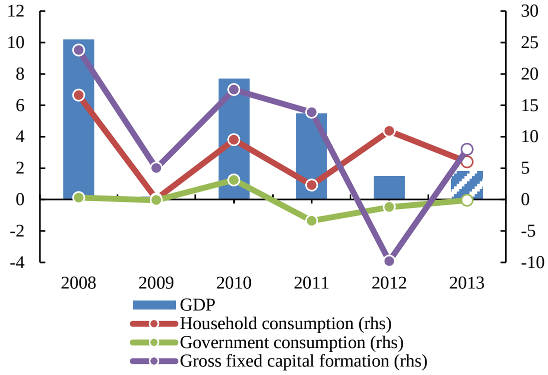
- ***Tight policies and currency depreciation contribute to impressive, although temporary, current account adjustment in 2012.***
- ***But also lead GDP growth sharply down.***
- ***Inflation slows down steeply, but pressures re-emerge in early 2013 following significant income policy relaxation.***
- ***Authorities fail to use improved macroeconomic environment to kick-start major structural reforms required for moving towards a fully-fledged market economy.***

Macroeconomic and financial developments

The strong policy tightening required to contain the 2011 balance of payments crisis and tame inflation, helped the Belarusian authorities restore macroeconomic stability in 2012, although this came at the expense of a significant weakening of the economic activity. GDP growth slowed down to 1.5% in 2012 from 5.5% in 2011 and 7.7% in 2010. In addition to the policy tightening, weakening demand by the country's key export markets, the EU and Russia, also contributed to the moderation of activity. This was especially pronounced in the final quarter of the year when GDP contracted by 1.5% year-on-year despite the low base.

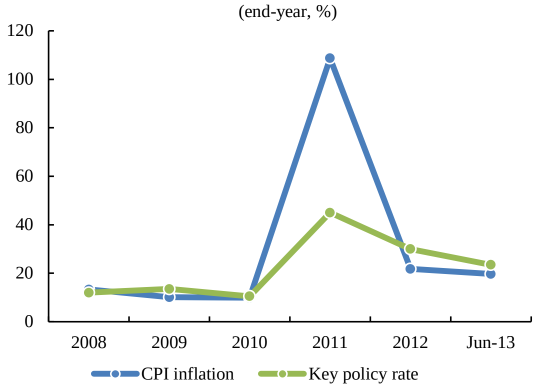
On the demand side, net trade became the main growth driver in the first months of 2012 as a result of an impressive export boom that was supported by favourable terms of trade, increased supply of crude oil by Russia (that is re-exported to other markets) and the positive impact from the 2011 devaluation. Imports were kept subdued by weak purchasing power, but also by limited investments by both the state and businesses. Private consumption was weak in the first half of the year but gradually gained strength following a significant relaxation of the income policies and recovering credit growth. On the production side, industry expanded by 6.3%, while agriculture by 6.0% in 2012. However, they were held back by the nearly double-digit contraction of the construction industry.

Graph IV.13.1: **Belarus - GDP**
(year-on-year % change)



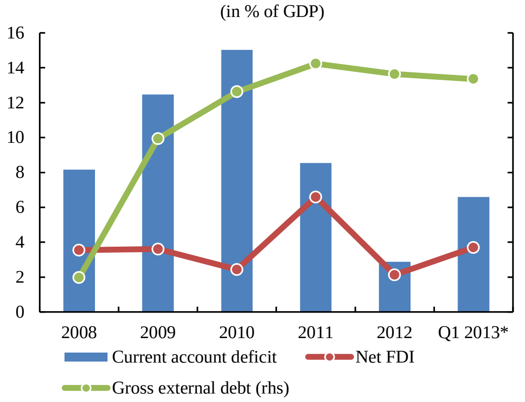
Sources: National Statistical Committee; Commission Staff forecast for 2013

Graph IV.13.2: **Belarus - Inflation and monetary policy**
(end-year, %)



Source: National Statistical Committee

Graph IV.13.3: **Belarus - Current account and debt**
(in % of GDP)



Source: National Bank of Belarus; * - annualised

Economic activity remained weak in early 2013, negatively affected by the unfavourable external environment (namely the recession in the euro area and the slowdown in Russia), as well as by the erosion of the competitive gains from the 2011 devaluation. The limited room for fiscal manoeuvre (in view of the significant increase in external debt service and the inflationary environment) also acted as a drag on economic activity. As a result, GDP growth amounted to only 1.1% in January-May, leaving the authorities' ambitious 8.5% official growth target for the year out of reach.

Household consumption and investments were the growth drivers in early 2013, reflecting accommodative monetary and income policies. At the same time, net trade had a strong negative impact as exports dropped by 20% due to weak external demand. Looking forward, expansionary policies may support economic activity in the short term. However, in the absence of resolute structural reforms, they would only serve to further weaken the macroeconomic fundamentals of the country, raising the risk of another self-induced crisis.

The year 2012 was marked by very expansionary income policies, mostly ahead of the September parliamentary elections. As a result, the average wage increased by 22% in real terms during the year, exceeding productivity growth by a large margin (estimated at 4%). This contributed to the worsening trade dynamics evident since mid-2012, but also to the persistently high inflationary expectations and renewed depreciation pressures on the exchange rate. The possible continuation of this accommodative income policy represents a major risk for the Belarusian economy as it could easily bring back to the fore external vulnerabilities and hinder the inflation moderation that the authorities have been seeking.

Consumer inflation decelerated markedly in 2012 (from more than 100% year-on-year in January to less than 22% at the end of the year) due to tight monetary and fiscal policies, significant intervention by the state in price setting, as well as base effects. In response to the improved inflationary outlook and exchange rate appreciation in the first half of 2012, the central bank gradually eased its tight grip, cutting the key refinancing rate by 15 percentage points to 30% in September. It temporarily suspended the policy easing due to renewed inflationary pressures and concerns about the expansionary wage policies and currency depreciation. Rate cuts resumed in March 2013, with the key policy rate being reduced to 23.5% by June. The central bank pledges a prudent stance throughout the year in its objective to ensure price stability. This will be a challenging task in view of the still high inflationary expectations, excise tax hikes and the gradual increase of the subsidised utility tariffs, which suggest the 12% official inflation forecast could prove optimistic.

On a more positive note, fiscal policies remain prudent and there are no signs of relaxation for the time being. The fiscal easing undertaken in 2010 was among the factors that led to the 2011 balance of payments crisis. However, public finances were tightened afterwards and remained on a cautious path in 2012, with the general government recording a surplus of 0.7% of GDP. ([91]) For 2013, the authorities target a balanced budget that will be supported by a tightening of the budget constraints of the state-owned enterprises and an increase of the recovery rates for utility and transport tariffs from their very low current levels. Excise tax increases should provide a boost to the revenue side as well. Risks for the budget stem mainly from an overly optimistic growth projection as well as a significant increase of public sector wages and pensions. Overall however, the fiscal stance remains prudent. If it is combined with a reduction of the quasi-fiscal operations, this will ensure public debt remains under control. The general government public debt-to-GDP ratio is estimated to have declined from 46% at the end of 2011 to 36% at the end of 2012 and is likely to hover around this level in 2013.

On the external front, there was a remarkable adjustment in 2012 as the current account deficit was brought down to only 2.9% of GDP from 8.5% in 2011 and 15.0% in 2010. This was the result of the strong export growth that was fuelled by the currency devaluation, windfall gains from exports of solvents, and significant improvement in the terms of trade. ([92]) Weakening imports,

([91]) These figures should be treated with caution as they do not include quasi-fiscal operations and contingent liabilities arising from directed lending.
([92]) The latter was mainly due to a lower energy delivery prices agreed with Russia at the end of 2011.

reflecting the tightened policy stance also added to this. However, these favourable conditions had largely disappeared by the end of 2012, following a significant relaxation of demand policies that largely eroded the competitiveness gains from the 2011 devaluation. Relatively high domestic inflation resulted in a 14% appreciation of the real effective exchange rate in 2012. A trade dispute with Russia over exports of solvents also contributed to the worsening export performance, which became especially pronounced in early 2013. As a result, the annualised current account deficit jumped to 6.6% of GDP already in the first quarter. On the financing side, net FDI more than halved in 2012 as privatisation came to a halt, while other investments recorded an outflow due to company deleveraging, in particular in the first half of the year. At the same time, international reserves have stabilised around USD 8 billion, or two months of imports (a relatively low level), despite the growing external debt repayments.

The increase in foreign debt service, which is projected to double in 2013, will be a key policy challenge in the medium term. The authorities seem to have sufficient financing space for the time being as they can rely on the USD 880 million that remain of the bailout loan of the Eurasian Anti-Crisis Fund (although this lending is subject to relatively tight conditionality) and foreign currency borrowing from the domestic market. ([93]) Further soft loans by Russia and China should not be excluded either, although such support may not come without economic and political strings. In the future, a new agreement with the IMF could significantly ease the risks arising from the significant external debt bill and the high current account deficit. However, the IMF Board seems to remain reluctant to enter into a financial arrangement with Belarus without a bolder macroeconomic adjustment and a systemic reform programme.

The external debt position of the country also remains a source of vulnerability despite the moderate decline in the debt-GDP ratio in 2012. Gross external debt accounted for 54% of the GDP at the end of 2012, more than twice the 25% ratio seen at the end of 2008. Within this, state external debt more than tripled in four years. The high share of short-term indebtedness (almost 40%) is also a cause for concern. It affects mostly state-owned companies and could act as a serious impediment to their investment activity, but also poses contingent liabilities for the state.

The Belarusian banking system weathered well the 2011 crisis, but remains exposed to the fragile macro-economic situation. A recent surge in foreign-currency lending, mainly to unhedged borrowers, poses a serious risk for the sector and underlines the need for the central bank to strengthen prudential controls. Although the controversial state-subsidised lending through commercial banks has been significantly downscaled, it remains in place and there are risks that the Development Bank could be used as a new channel for such non-market practices. Although the central bank has improved its monitoring of the banking system, risks remain due to the dominance of state-controlled banks that still do not operate entirely on market principles.

Structural reform challenges

Progress with structural reforms was very limited in 2012, as the authorities focused their efforts on achieving, and then retaining, macroeconomic stability. They also did not show enough determination to utilise the favourable window of opportunity for accelerating reforms arising from the stability gains and the favourable gas deal with Russia. In fact, there was some retreat in privatisation with the abolishment of the 2011-13 sell-off list and the *de facto* nationalisation of two confectionery producers. Moreover, a draft presidential decree foresees reinstating state control over privatised companies, even if the company is fully in private hands. Price controls and state subsidies remain, while, as noted, lending under government programmes is still not completely abolished, which leads to an inefficient allocation of financial resources and creates contingent liabilities for the state.

Other structural issues that have to be addressed include the restructuring of the state-owned enterprises, including by tightening budget constraints and moving to a more flexible way of planning of their production strategy. The authorities consider economic modernisation as

([93]) Belarus agreed on a USD 3 billion bail-out programme with the Eurasian Anti-Crisis Fund (EurAsEC) in the middle of 2011. As of June 2013, USD 2.1 billion have been disbursed.

their top priority in 2013. However, progress in that direction has been very modest and would require some resolute steps in terms of strengthening corporate governance, changing the ownership structure, facilitating access to financing by the private sector and ensuring a level playing field for all business actors. Improving the investment climate and focusing on the still nascent SMEs sector is also a must. In the monetary and financial area, reforms are needed to encourage competition, privatise the state-dominated banking sector and further strengthen the independence of the central bank. There was some progress with the latter in early 2013, when amendments to the law on the central bank entered into force. In another positive development, some price and foreign exchange restrictions were lifted, while a differentiated scheme for household utility bills was introduced with the objective to raise recovery rates and ease fiscal costs for the state.

The two economic crises Belarus experienced in less than four years clearly indicate the authorities should focus on a gradual transformation of the current growth model that has become exhausted. Priorities should be given to improving productivity through encouraging private sector development and to restructuring and privatising state companies as well as to fostering an investor-friendly and transparent business environment. This would enable the country to reduce its reliance on Russia's energy subsidies required for keeping afloat energy-intensive, and sometimes inefficient, industries.

Risks and outlook

In the short-term, risks are on the downside due to insufficient policy predictability, excessive focus on meeting quantitative targets as well as an unfavourable external environment due to weak activity in the euro area and Russia. The poor policy track record with structural reforms, as well as the historically high inflation and the low level of international reserves, at a period when Belarus faces significant external debt repayments, also tilt the risks in the negative direction. At the same time, the arrangement with the EurAsEC not only mitigates the risks stemming from debt payments but can also be a source for reforms in view of its relatively tight conditionality. This goes especially for privatisation, which could not only ensure significant proceeds (also beefing up the weak foreign exchange reserve position) but could also act as a source of technology transfer and productivity growth.

In the medium term, the major risk stems from the inability, or unwillingness, of the authorities to seek deep and comprehensive structural reforms that would ultimately change the current growth model of the country. The on-going strong economic reliance on Russia (through soft loans and large-scale energy subsidies) tends to perpetuate Belarus' structural problems (such as low energy efficiency and high dependence on imported energy).

At the same time, the Customs Union with Russia and Kazakhstan could be used in a beneficial manner by institution strengthening and improving weaknesses in areas such as competition legislation. Further trade deepening could be also supportive for growth in the longer term. In this respect, recent moves by the authorities for a faster accession to the WTO are welcome.

Table IV.13.1:

Belarus - Main economic indicators	2009	2010	2011	2012	2013
Output and prices					
Real GDP (% change)	0.2	7.7	5.5	1.5	1.8
GDP nominal (USD, billion)	49.2	55.1	58.8	63.2	65.5
GDP per-capita (USD)	5,178	5,810	6,212	6,674	6,931
CPI inflation (%, average)	13.0	7.8	53.2	59.2	18.3
CPI inflation (%, end-period)	10.1	9.9	108.7	21.8	14.5
Average wage (% real change)	0.1	15.0	1.9	21.9	7.0
Social indicators					
Unemployment (%, registered, end-period)	0.9	0.7	0.6	0.5	0.5
Population (million, end-period)	9.5	9.5	9.5	9.5	9.5
Fiscal sector					
Total revenue (% GDP)	45.7	41.5	38.7	40.7	42.8
Total expenditure (% GDP)	46.4	43.3	35.9	40.0	42.5
General government balance (% GDP)	-0.7	-1.8	2.8	0.7	0.2
Gross public debt (% GDP)	34.9	42.0	43.4	36.9	n.a.
Monetary and financial indicators					
Key policy rate (%, end-period)	13.5	10.5	45.0	30.0	15.0
Broad money M3 (% change)	23.1	31.9	121.2	45.1	3.7
External sector					
Trade balance (% GDP)	-11.4	-13.6	-2.0	4.6	n.a.
Current account balance (% GDP)	-12.5	-15.0	-8.5	-2.9	-8.5
FDI (net, USD billion)	1.8	1.3	3.9	1.3	3.0
FDI (net, % GDP)	3.6	2.4	6.6	2.1	4.6
Gross external debt (% GDP)	44.8	51.5	55.6	54.1	53.0
Gross reserves (USD billion, end-period)	5.7	5.0	7.9	8.1	8.0
Reserves (months of next year's imports)	1.8	1.3	1.9	2.0	2.1
Exchange rates					
Exchange rate (rouble per EUR, average)	3,885	3,950	6,432	10,713	11,400
Exchange rate (rouble per USD, average)	2,793	2,978	4,623	8,336	8,750
Real effective exchange rate (- appreciation)	-4.5	-5.0	-17.8	3.8	n.a.

Sources: National authorities, IMF, Commission Staff estimates for 2013.