Economy recovers, but remains structurally vulnerable – digest of the Belarusian economy

During a trip to Minsk on 5 October 2017, Venezuelan President Nicolas Maduro showed strong optimism on economic teamwork with Belarus, but forgot to mention the buildup of outstanding debts.

On 25 October, the National Bank of Belarus gave its overview of the current macroeconomic situation, citing the positive influence of monetary policy.

However, a day later on 26 October, experts from the Eurasian Development Bank were hesitant to confirm good long-term prospects for the Belarusian economy.

Trade policy: diversifying from Venezuela

President Maduro arrived in Belarus on 5 October as part of an official visit. The negotiations with Belarusian President Alexander Lukashenka were concerned mostly with trade and economic cooperation.

In 2016, trade turnover between Belarus and Venezuela equalled only $2m, which is a 92.6 per cent decrease in comparison with 2015 (see Figure 1 below). From January–July 2017, trade turnover reached $5.4m and mostly comprised exports of Belarusian potash fertilizers.

The economic crisis in Venezuela and a sharp decrease in world oil prices are the main reasons for the decline of Belarusian trade with Venezuela, which currently uses its foreign exchange reserves only for the purchase of food, medicines and other socially important goods.

According to Belarusian Scientific and Industrial Association Deputy Chairman Georgy Grits, Venezuela is approaching a default. He bases his view on an appraisal of studies into the country’s default risk made by world rating agencies.

Therefore, the main problem for Belarus coincides not with further development of trade with this former high-income country, but with Venezuelan debts accumulated for already shipped goods in previous years.

The total debt has reached approximately $500m. For example, Venezuelan debts to MTZ (Minsk Tractor Works), a Belarusian producer of tractors, have reached $50m, debts to MAZ (Minsk Automobile Plant), a truck manufacturer, are at $170m, and debts to various Belarusian construction companies amount to $108m.

However, on 8 October, Belarusian Deputy Prime Minister Vladimir Semashka expressed the optimistic view that further cooperation with Venezuela is feasible. He noted that Belarus plans to help increase the production of oil in Venezuela by more than three times. Current production levels sit at less than one million tonnes per year.

Economic growth: the regulator staying firm

On 25 October, the National Bank of Belarus announced the consolidation of positive changes in the economy and monetary sphere during the first nine months of this year.

Specifically, the monetary authorities have admitted that economic growth has started to recover jointly with slowing inflation. Moreover, decreasing interest rates and a continuing process of de-dollarization are the results of a unified macroeconomic policy.

Correspondingly, declining borrowing costs have led to the recovery of business activity and to increased demand for loans by commercial companies, which further strengthen Belarus's banking system. The regulator also drew attention to the significant growth of foreign exchange reserves (see Figure 2 below) caused by the sale of foreign currency by Belarusian citizens.

Moreover, the Chairman of the Board of the National Bank, Pavel Kallaur, has admitted that within two or three years there exists a real possibility to boost foreign reserves up to $10b. At present, Belarus currently is about $3b shy of this mark.

In particular, accumulating net sales of foreign currency by Belarusian citizens, who exchange it to purchase goods and services, and growing exports (for example, from January–August exports increased by 21 percent) may contribute to the achievement of the $10b goal.

However, along with opportunities, risks also arise. The first risk coincides with trade policies that are heavily concentrated and focused on Russia. The plunge in foreign currency earnings from 2015–2016 showed what can happen to the economy when Russia's market falters.

Secondly, the increase in demand for imports of consumer goods may apply pressure on foreign reserves, which in turn may lead to an increase in demand for foreign currency from importers.

Finally, the dynamics of foreign reserves depend not only on foreign exchange earnings, but also on debt expenses. Foreign reserves have increased in 2017, because Belarus both undertook external borrowings and refinanced old debts with Russia. Therefore, the resolution of debts—old and new—will directly affect the volume of reserves.

Monetary policy: hidden threats

However, on 26 October, experts at the Eurasian Development Bank warned that despite the significant improvement of Belarus's macroeconomic situation, the rapid easing of monetary policy (through the decrease of interest rates) carry serious risks for the acceleration of inflation, which may occur in early 2018.

Structural problems, including excessive employment in state enterprises and the propping-up of inefficient enterprises, limits the potential for monetary policy to stabilize inflation and further to solve the issue of repaying of foreign debts.

Overall, the current positive macroeconomic situation cannot last long. Each production cycle does not bring substantial profits for the majority of Belarusian enterprises. Indeed, in many cases the cycles generate losses. The more they produce, the more they get bogged down in losses, which in turn leads to the growth of foreign debts.

An expert from BIPART (the Belarusian Institute for Public Administration Reform and Transformation), Vladimir Kovalkin, compares the general situation in the Belarusian economy to "walking on very thin ice that might crack at any moment and fall in." In Particular, the Belarusian budget possesses insufficient funds to pay both foreign debts and the interest building upon them.

As a result, according to experts, any problem or any differences in foreign economic relations may first prevent the refinancing of foreign debts from previous years, and then eventually lead to a default.

In sum, while the Belarusian economy gradually recovers, it still suffers from long-standing structural problems. Failure to resolve these problems may not only reduce economic growth, but also lay the groundwork for a new type of crisis for Belarus—a debt crisis.

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State debt and weak trade policy test Belarus recovery – digest of the Belarusian economy

On 5 September 2017, Belarusian president Alexander Lukashenka once again declared the need to accelerate the government's efforts to improve legislation concerning economic embezzlement and other abuses that are slowing down the economic development of the country.

Meanwhile, export are recovering briskly, although mostly due to goods based on raw materials. What's more, the debt burden on the economy is rising, reaching a historical maximum. This is now the most significant risk to the national economy.

Trade Policy: exporting to the European Union

In the first half of the year, Belarus increased its export of goods, although this is primarily due to the price factor and goods based on raw materials. The dominant exports include fuel, meat, milk and other food products, chemical products (especially potash fertilizers), and metals.

Thus, the main export items comprise goods with relatively low value added. Meanwhile, on 11 July 2017, Lukashenka officially demanded that export partners be diversified, first of all to the EU market. According to him, all Belarusian economic authorities and enterprises need to ‘bite’ into the European market, given its status as the most most effective and technologically advanced.

However, in the first half of the year, the share of EU countries accounted for only about a quarter of Belarusian exports. This is in stark contrast to the early 2000s, when Belarus delivered almost half of its exports to Europe.

In 2012, Belarusian exports to EU countries reached a record of $17bn, primarily due to the export of petroleum products produced from duty-free Russian oil. Afterwards, disputes with Russia concerning the price of supplied oil and the redistribution of duties from oil products, along with a decline in world oil prices, has resulted in a drop of export to EU countries of approximately 67% in 2014-2016 (see Figure 1).

Nevertheless, the share of raw materials in exports to the EU remains huge – approximately 80 per cent of Belarusian sales still consist of fuel, wood, chemical products, and metals. Therefore, it is evident that an increase in exports of high-tech products remains a very important task for the economy as a whole.

According to the President of the Mises Scientific Research Centre, Jaroslav Romanchuk, Belarus's economy still lacks the prerequisites for increasing and diversifying its exports in the Western direction. On the contrary, economic self-isolation threatens Belarus, as competitors displace Belarusian exporters even on the Russian market.

State debt: increasing pressure

The debt burden on the economy is on the rise. The national debt relative to GDP has reached 40.4 per cent – a historical maximum. As a result, continuing with existing growth dynamics creates serious challenges for the economic development of the country.

According to Doug Constable, in 1997-2006, the debt burden on the Belarusian economy remained at very low levels – external and internal debt were less than 10% of GDP. Low energy prices from Russia and the growing Russian market allowed the Belarusian economy to grow rapidly in the early 2000s without the need for additional borrowing.

In 2007, however, Russia revised energy prices on oil and gas for Belarus. As a result, in order to ensure a high rate of economic growth and the stability of the exchange rate of the Belarusian Ruble, the government became actively involved in external borrowing.

Thus, starting in 2007, the debt burden on the economy began to rise. From 2007 to 2012, the national debt relative to GDP increased by more than four times. Moreover, due to the devaluation of the Belarusian Ruble and the economic recession of the last two years, by the beginning of this year the national debt has grown by almost half, reaching 39.4 per cent.

As a result, today the debt service costs alone for the national budget make up approximately 10 per cent of its expenditures; to repay the main part of its debt, Belarus needs keep borrowing.

According to the Honorary Chairman of the Business Union of Entrepreneurs and Employers, Georgiy Badei, such dynamics will remain negative until Belarus has an acceptable rate of economic growth: to pay the debt, the economy needs to generate growth. If the economy grows, the budget revenues will increase and we Belarus can begin to repay accumulated debts.

At the same time, the reduction of investment in fixed capital over the past several years (such as plant machinery and equipment) does not lead to optimism regarding acceleration of growth of output and employment. Therefore, the only significant steps to be taken to liberalise the economy include reducing taxes on enterprises. This could will stimulate economic activity and help to repay accumulated debts.

The budget: balancing fiscal stability

Meanwhile, the consolidated budget in Belarus has boasted a surplus since 2011, which is used for repayment of state debt (see Figure 2). The structure of revenues and expenditures of the budget has remained stable over the last eight years.

However, securing a surplus is posing more and more of a challenge. In real terms, budget revenues shrank in 2015-2016 because of a recession (although revenues remain relatively stable as a share of GDP), becoming the reason for expenditure restraint from the government.

In recent years, capital expenditures have decreased the most. As a result, fiscal policy has become persistently procyclical. What’s more, steady growth in social transfers has become a major instrument of the government to provide a certain level of social protection and limit the poverty level in the country.

Taking together, the physical volumes of foreign trade have led to strong growth, thus helping the government fulfil budget obligations. However, debt sustainability is becoming the largest risk for the national economy.

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The end of a long-lasting recession? – Digest of the

Belarusian economy

On 17 May 2017, Belstat, Belarus's official statistical body, announced that Belarus's economy is growing for the second straight month.

Thus, on 24 May, Deputy Prime Minister Vladimir Semashka declared new investment plans for the industrial sector assuming further economic recovery.

Nevertheless, the economic environment remains complex and the debt burden of enterprises is high, threatening the stability of the banking system.

Economic growth: good prospects for the future

On 17 May, Belstat announced that in January-April, GDP increased by 0.5 per cent in comparison with the corresponding period of the previous year, thus extending March's positive dynamics (see Figure 1).

The main contributor to the recent economic growth remains export. Figures for the first quarter of the year indicate that export of goods has increased by 20 per cent, thanks to the steady recovery of the Russian economy and increase in consumer demand for Belarusian food products.

Another key factor is that the export of oil refinery products has risen from the ashes after the upward correction of world oil prices and a long-awaited deal with Russian authorities on oil import. This will mostly add up in the second half of the year.

According to economist Vyacheslav Yaroshevich, the Russia-Belarus oil deal will encourage the entire economy, thus resulting in 30 per cent year-on-year export growth and an additional 0.7 per cent GDP growth by the end of May.

Furthermore, in the second half of the year, industrial production will also start contributing to overall GDP growth. According to Vyacheslav Yaroshevich, the industry shows signs not only of growth in production volumes, but also improvements in the financial situation, including increase in revenues, efficiency of sales, and net profits.

The financial sector: disappearing savings

According to data from the National Bank of Belarus, as of 1 May 2017 the amount of foreign currency deposits in banks amounted to $6.8bn – the lowest since December 2013. This trend of constant decline in foreign-currency savings has been observable since November 2015. As a result, after 18 months, savings declined by almost $1bn.

Three factors explain this trend. First is the the constant decrease in the profitability of deposits for Belarusians both in foreign and national currency.

For many years, the deposit rates on bank savings nominated in Belarusian rubles exceeded two-digit numbers. Even during periods when the Belarusian ruble was stable (the 2000s – a period of generous oil subsidies), their yield came to more than 10 per cent per year. Only in the summer of 2006, due to declining inflation, did the average deposit rate fall to 9.7 per cent.

Over the next decade, it was always expressed in double figures due to the high inflation rate. It even exceeded 50 per cent per annum during the 2011 and 2014 financial crises. However, in 2015-2017, after the National Bank of Belarus committed to reduce inflation, these rates dropped to the historically low level of 8.4 per cent. They will supposedly continue to decrease (see Figure 2).

The second factor is that there are very few profitable investment projects for banks to finance. Moreover, on 1 May, the share of bad assets (generated by current operations of enterprises) in Belarusian banks reached 14.2 per cent.

According to the Senior Director of the Moscow office of Fitch Ratings, Olga Ignatieva, the quality of assets in banks will continue to deteriorate, as the economic environment is complex and the debt burden of enterprises remains high. Thus, banks have less motivation to attract new deposits.

Finally, Belarusians, who are facing a decline in their real incomes, try to maintain the same level of consumption at the expense of their savings.

Manufacturing sector: modernization 2.0

On 24 May, Deputy Prime Minister Vladimir Semashka announced plans to invest $500mln in the modernization of MAZ (the largest manufacturer of trucks in Belarus), $800-850mln in the development of BMZ (a large metallurgical plant), and commit additional financial resources to the modernization of refineries.

According to Vladimir Semashka, MAZ struggles with production volumes. Three years ago, the enterprise produced 24,000 trucks per year, whereas by the end of 2017 it was producing no more than than 11,000. The refineries performed better, but endured financial losses due to the drop in world oil prices and the decrease in oil suppliers from Russia in 2016.

However, in light of the absence of internal financial resources, the government has only two options if it wants to fulfil its plans for modernization and foreign direct investments.

According to the opinion of economists from the investment company UNITER, Belarus must increase the annual inflow of foreign direct investments (FDI) to $3-4bn if it wants to increase economic development. However, data for 2013-2016 shows that the volume of FDI has stabilised at $1.3-1.5bn per year without significant changes in recent years.

The second option is obtaining loans from international financial organisations. Once again, negotiations with the IMF remain incomplete (nobody knows for how long), and the Eurasian Development Bank still requires more profound reforms in the Belarusian state sector (including privatisation).

Thus, in May, Belarus's economy showed its first signs of recovery – the rise in export and industrial production point to positive prospects for the second half of the year. However, problems in the financial system, which have accumulated over the previous years, have not disappeared. This threatens the sustainability of the economy.

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Privatization: one step forward, two steps back – digest of the Belarus economy

On 4 May 2017 Belarusian president Alexander Lukashenka declared that Belarus plans to gain approximately $50bn in exports off goods produced in the Great Stone industrial park.

Meanwhile, on 3 April 2017, Moscow and Minsk resolved all their disputes in the oil and gas sector.

On 18 April 2017, Belarusian prime minister Andrey Kobyakov announced that the Belarusian economy has avoided recession, with 0.3 per cent GDP growth in the first quarter of the year.

Privatisation: standby mode

On 21 April 2017, the authorities once again announced that state-owned enterprises (SOEs) would not be privatised in the near future.

However, for the IMF, privatisation of major SOEs is a key condition if Belarus wants to receive a new credit line (worth approximately $3bn). More precisely, the IMF wants Belarus to prepare approximately 10 SOEs for pre-sale. The government has so far failed to begin any stage of this process.

Although the official list of state enterprises up for sale in 2017 includes 38 joint-stock companies, almost nothing has been transferred into private hands – neither auctions nor tenders of sale for the SOEs have been declared so far. The Belarusian government insists that this is due to lack of interest from potential investors.

This is unsurprising, as many SOEs are in a difficult financial position due to high credit indebtedness (see Figure 1). According to the National Bank of Belarus, at the beginning of 2017 the debt load of the real sector exceeded its monthly revenue by 3.2 times. These SOEs, suffering from chronic debt and a failed business model, have proved impossible to sell as whole business entities.

As a result, on 21 April 2017, Lukashenka stated that privatisation is unrealistic, essentially ending discussion about the fate of the largest SOEs.

Instead, the Belarusian authorities want to attract foreign investment. Each regional governor has been ordered by the president to bring in no less than $100m in investment each year. However, the Belarusian economy remains unattractive to foreign investors, which is reflected in the reduction of foreign direct investment in 2015 and 2016.

The oil and gas dispute: finally resolved

On 3 April 2017, Belarus and Russia resolved their longstanding oil and gas dispute and signed the corresponding documents on 13 April 2017.

As a result, Russia agreed to increase oil supplies to Belarus to up to 24m tonnes and sell gas to Belarus at a discount. Over the next year, the price of Russian gas for Belarus will fall to $129; in 2019 the price will decrease even more. Nevertheless, experts are dubious that the pursuit of a unified gas market by 2025 will encourage Russia to supply Belarus with gas at domestic prices.

According to the Scientific Director of the IPM Research

Center, Irina Tochitskaya, if Belarus paid Russian gas prices, all other countries in the Eurasian Economic Union would insist on similar discounts. This would be a significant loss of income for Russia.

In turn, the Deputy Chairman of the Belarusian Scientific and Industrial Association, Georgy Grits, admitted that according to the agreement, independent gas operators would be able to sell gas to Belarus, not just Gazprom. However, if this were the case, the stock market would determine the price of gas, precluding preferential conditions for Belarus.

What's more, he also noted that the gas transportation system in Belarus belongs to Gazprom. Therefore, it would be difficult to deliver gas from independent operators without agreements with Russian authorities.

Thus, the dependence of Belarus on Russian gas supplies will only increase, guaranteeing new tensions in the oil-gas sector in the near future.

Economic growth: first time in 24 months

For the first time in two years, the Belarusian GDP has grown. According to the National Statistical Committee of Belarus, in January-March 2017 GDP growth reached 0.3 per cent year on year (see Figure 2).

On 18 April 2017, Belarusian Prime Minister Andrey Kobyakov stated that the economy was gradually recovering from an economic downturn and is on track for its forecasted targets, which include 1.7 per cent GDP growth. However, the authorities' optimistic forecasts are largely dependent on growth of oil refining and export of petroleum products.

Meanwhile, the IMF and the World Bank still predict that the recession in Belarus will continue. The Russian bank Sberbank has stated that given sluggish economic growth, the recession in Belarus will end only in 2018.

The considerable volume of foreign debt payments for the current year, the prolonged reduction in real household income, the limited effectiveness of monetary policy (due to high level of dollarisation in the economy), and the lack of significant resources for the state budget to finance its investment programmes all constrain possibilities for further growth.

Independent experts maintain a similar position, adding that the Belarusian GDP needs to improve by 7 per cent just to return to its 2014 level (in Belarusian constant prices).

According to the head of the analytical centre Strategy, Leonid Zaiko, if we compare dollar equivalents, the GDP must grow by nearly 40 per cent (from $47bn up to $76bn). Thus, he concludes that even with a 4 per cent growth per year, the economy will need more than ten years to return to its 2014 level.

All in all, it seems that the past two years of recession have not shaken the official economic policy of the last two decades. The authorities still rely on the public sector and oil revenues. Meanwhile, the lack of progress in privatisation limits Belarus's investment appeal and hinders further prospects for sustainable long-term growth.

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Under pressure from Eurasian Economic Integration – digest of the Belarusian economy

As of 26 December 2016, the oil and gas dispute between Belarus and Russia remains unresolved.

Moreover, Russia persistently rejects any tradeoffs: this deprives Belarus of a substantial part its foreign exchange earnings from petroleum product sales, thus aggravating the economic recession in Belarus.

In turn, the growth of state debt points to the formation of stable insolvency for most state-owned enterprises and increases the risk of a banking crisis in the economy.

The energy sector: losing ground

The current oil and gas dispute between Russia and Belarus has deteriorated since the beginning of the year. Minsk has decided to pay its own gas price of $73 (a fair price which conforms to the agreement on the transition to equal-income prices between countries). However, the contract claims that the price should be $132.

As a result, according to the Russian gas monopoly Gazprom, Belarus owes approximately $340m for gas deliveries from January to September.

In response to this debt, Russia decided in the middle of the year to nearly halve the quantity of oil supplies to Belarusian refineries: from 5.3m to 3.5m tonnes in the third quarter of the year, and to only 3m tonnes in the fourth quarter. Moreover, on 23 December 2016 Deputy Prime Minister of Russia Arkady Dvorkovich announced the court proceedings on the gas dispute.

Meanwhile, after some improvement at the end of last year and in the first quarter of this year, the country's economic growth has worsened again. One of the main reasons for this is the reduction in the amount of Russian oil processed.

According to Prime Minister of Belarus Andrei Kobyakov, the loss of 1.6m tonnes of oil in the third quarter has led to a chain reduction in industrial production and wholesale trade resulting in a 0.3 per cent GDP drop. By the end of 2016, this drop could reach 0.5 per cent (see Figure 1).

In turn, this reduces the real income of the population and effective demand within the country, thus creating preconditions for the formation of deeper systemic problems in the economy. For example, the number of foreign companies to close has overtaken the number of newly registered ones in Belarus in 2016.

Economic integration: a time of tough decisions

The main Belarusian argument in the energy dispute is grounded in the process of Eurasian integration, which implies four key economic freedoms for the participants in the Eurasian Economic Union (EAEU): free movement of goods, services, capital and labour.

However, this integration project includes various exemptions and limitations. In particular, the plans for the formation of a single energy market has been delayed until 2025.

At the same time, the creation of a common electricity market for the EAEU is scheduled for mid-2019. However, Russia and Belarus must first reach a compromise. Since Belarus produces electricity mainly from gas, the country urgently needs equal prices with the Russian regions by 2019.

However, Russia has so far shown few signs of willingness to radically amend its position (by transitioning to equal-income prices); it is offering to compensate only $300m a year for the difference in gas prices and only through resale abroad of part of the Russian oil supplied to Belarusian refineries.

This scheme thus reduces the oil flow to Belarus, as well as the amount of petroleum products produced from it, further decreasing its foreign exchange earnings. Moreover, Russia wishes to determine the volumes of oil supplies to Belarus on a quarterly basis, increasing Belarus's economic dependence even further.

In addition, Russia may insist on other tough conditions, including a requirement to redirect the export of oil products from Baltic to Russian ports and to sell the Minsk Wheel Tractor Plant – a very important asset for the Russian defence industry.

State debt: missing the target

The problems in the energy sector put pressure on the internal and external debt of Belarus. In particular, in 2017 Belarus may have to return approximately $3.5bn to its creditors.

At the same time, the economic slowdown in Russia (the main trading partner of Belarus) has led to the weakening of external demand for Belarusian products. As a result, export earnings have decreased and a substantial part of enterprises transfer from profitable to unprofitable, further limiting the ability of Belarusian enterprises to finance their debt obligations.

On 15 December 2016 Alisher Mirzoyev, the Director of the project group on financial loans of the Eurasian Fund for Stabilisation and Development, stated that the decrease in efficiency of state-owned enterprises (SOEs) and the low efficiency of long-term projects financed primarily through directed lending have formed a significant part of the debt burden in Belarus.

The directed lending has created large imbalances in the economy. For example, interest rates on preferential loans in 2015 reached only 9 per cent versus market rates of around 35 per cent. Therefore, according to the Deputy Minister of Economy of Belarus Dmitry Krutoy, in 2016 the volume of directed lending has decreased almost by half (from $20bn) in comparison with 2015.

However, risks of insolvency of SOEs still lead to loss of revenue for the country's budget. Moreover, deterioration of the financial conditions of SOEs lead to an increase in problem assets of the banking system and exacerbate the problem by creating an additional crisis in this sector of the economy.

For example, since the beginning of this year the share of problem assets of Belarusian banks has increased by 2.2 times. If at the beginning of January they constituted only 6.8 per cent of risk assets, in November they reached 14.9 per cent (see Figure 2).

Thus, the problems in the energy sector aggravate the economic recession in Belarus further, affecting the capabilities of profitable enterprises to repay their debts and harming the overall investment attractiveness of the country.

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Oil pessimism and manufacturing optimism – digest of the Belarusian economy

On 26 November Belarusian Deputy Prime Minister Vladimir Semashko announced that the recession in the Belarusian manufacturing sector has ended.

However, Belarusian banks strongly disagree with this statement. They yearn for more financially stable corporate borrowers, especially in the industrial sector.

Meantime, oil refining – currently the mainstay of Belarusian manufacturing – is under threat as Russia reduces the volume of oil it supplies to Belarus for processing. This is likely to impede Belarus's recovery from the economic recession even further.

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Industrial production: an optimistic view

On 26 November, Vladimir Semashko announced that all indicators point to the fact that the manufacturing crisis has stopped – the growth rate reported by the Ministry of Industry has already reached 3 per cent; it is predicted to rise to more than 11 per cent next year.

However, such an extraordinarily positive appraisal of economic performance in the industrial sector seems slightly premature. There are several reasons to think so. First of all, in 2015 the manufacturing sector received financial assistance from the state (in the form of of foreign currency bonds) totaling more than $500m. This sum has yet to be repaid.

Secondly, due to a lack of free financial resources, the repayment of these debts will fall on the shoulders of ordinary Belarusians. The average wage in Belarus remains at historically low levels – despite several months of growth it has fallen once again and now constitutes only $379.

Finally, even though growth dynamics have reversed when it comes to several industrial product items, the overall picture in manufacturing remains disappointing (see Figure 1). In October industrial production increased by 3.6 per cent compared with September – this was slightly better than expected but hardly surprising.

The banking system: endangered risk takers

Meanwhile, the demand for loans from Belarusian enterprises remains low due to the high cost of borrowing (18 per cent on average). If the credit market were in a different condition, banks could channel unused funds into the economy in order to break the recession.

Theoretically, banks could increase their loan portfolio – they do have the money. However, the situation five years ago, when banks’ credit portfolios grew by dozens of percentage points a year, seems unlikely to repeat itself in the coming years.

Belarusian Development Bank analysis shows that the economic downturn and deteriorating financial conditions of enterprises has led to changes in the internal instructions of the Belarusian banks prohibiting to increase loan portfolio if they do not first improve their quality. Belarusian banks do not trust corporate borrowers to repay their debts in the future, as most potential borrowers are classified as ‘low-quality’.

For example, in January-September 2016 the number of problem loans in the banking sector increased from 6.8 per cent of the total at the beginning of the year to 14.3 per cent on 1 October. This rise in banks’ problem loans coincides with the deteriorating financial conditions of enterprises.

The current economic downturn has several repercussions. First, it increases the risk for those banks who wish to raise their loan portfolio. Second, it discourages others from further risk taking. As a result, according to the National Bank, the volume of corporate loans in national and foreign currency decreased by 3.9 per cent and by 5.2 per cent in

January-September respectively.

Oil negotiations: waiting for refunds

Belarusian authorities are trying to find new ways to increase the financial base of budget profits. On 25 November 2016, Igor Demin, an official representative of the Russian company Transneft, confirmed that two Belarusian oil transport companies had stated their intention to increase the cost of transit for Russian oil from 1 January 2017 by 20.5 per cent.

In October, Belarusian authorities had already threatened Moscow with a sharp increase (50 per cent) of the oil transportation tariff. Transneft representative Igor Demin responded that such changes would require a corresponding agreement with Transneft and the Russian government.

At the moment, a 2010 intergovernmental agreement regulates the calculation of the growth rate for transit tariffs. It takes into account the preliminary predetermined volume of oil transit, which remains unknown until February 2017. According to these arrangements, Belarus has the right to increase the transit tariff unilaterally only to adjust for average annual inflation.

However, the main reason behind the growth of the transit tariff remains the volume of oil reaching Belarusian oil refineries. From 2016 until 2024, Russia agreed to supply 24m tonnes of oil annually. But starting in the second half of the year, Moscow reduced the oil stream first to 3.5m tonnes (approximately 40 per cent) per quarter, and starting in October to only 3m tonnes (see Figure 2).

The main reason behind these harsh measures is the Belarusian gas debt, which has already reached $281m. In turn, authorities in Minsk are demanding that gas prices be reduced and set according to their own calculations ($73 instead of $132). Belarus has promised to close this gap by 20 October in exchange for the resumption of oil supplies, but the invoice nevertheless remains unpaid.

The decrease in the oil supply and the corresponding decline in petroleum product production have led to an additional 0.3 per cent GDP drop. Officials in Minsk urgently need a new bargaining chip for their oil manoeuvres to succeed. They are now relying on alternative oil streams from Azerbaijan.

Thus, the authorities have decided to raise the stakes in the energy dispute once again. Although such a controversial move may possibly help resolve the issue of discounted gas, it will surely not help attract new foreign investors, especially into the manufacturing sector, suffering as it is from a lack of cheap capital.

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This article is a part of a joint project between Belarus Digest and Belarusian Economic Research and Outreach Center (BEROC)

Autumn of tough economic decisions – digest of the

Belarusian economy

On 17 October 2016, new macroeconomic data from Belstat, Belarus's national statistical committee, indicated that this year's economic decline seems to have finally halted. The GDP stopped falling and foreign trade saw a slight revival.

However, on 21 September the IMF warned the Belarusian authorities about new threats to macroeconomic stability, namely the high level of bad assets in the banking sector and the sustainability of state debt.

Meantime, the tight embrace of the Russian economy continues to squeeze Belarus – this time because of petroleum product transportation.

Economic growth: waiting for recovery

On 17 October 2016, Belstat announced that the downturn the GDP experienced in January to September reached 2.9 per cent year-on-year against 3.0 per cent year-on-year in January to August (see Figure 1). In other words, after entering a new slowdown phase in June, the economy is showing some signs of recovery.

However, household consumption, which accounts for approximately half of Belarus's GDP, is still failing to contribute to growth, unlike in previous years. For example, in September retail turnover (as a proxy for household consumption) dropped by 4.4 per cent year-on-year.

Thus, Belarusians continue to reduce their spending, expecting the economic recession to take a further toll on their financial resources. An important reason for this relates to the government's aim to link the growth of real wages with productivity improvements.

As a result, due to the weakening economy and a deteriorating external environment, in September real wages dropped by 2.4 per cent, coming to only $377. Moreover, according to Belstat the real disposable income of Belarusians in January-August decreased by 7.1 per cent year-on-year.

Another major component of GDP – capital investments – has also exhibited downward dynamics. After some recovery in the second quarter of the year, capital investment has become much weaker in recent months. In January-September it dropped by 19.5 per cent year-on-year.

Net exports, on the other hand, have stopped deteriorating. By the end of August, the trade deficit from the first half of the year had reverted to a trade surplus.

The financial sector: exposing hidden threats

Meanwhile, according to IMF reports published on 21 September 2016, there are two important new threats to the Belarusian economy. The first threat is the high level of bad assets in the banking sector (see Figure 2), resulting from the common practise of prolonging loans and changing their agreement conditions (mainly in order to restructure them).

Moreover, IMF experts have stated that the accumulated nonpayment risks in the banking sector are rapidly approaching the "red zone", which could trigger a new wave of financial instability. In order to prevent such a situation, the banking sector urgently needs to take new stabilising measures. This could mean the creation of a special body with powers to privatise debtors to address the issue of bad loans.

The second threat has to do with the sustainability of state debt, which according to IMF estimates will continue to worsen. Moreover, the state debt consists mainly of loans denominated in foreign currency. Thus, in coming years the debt's servicing and repayment to creditors will become one of the largest problems for the state budget due to the loans' sensitivity to shock from the exchange rate.

The only way for the government to alleviate budget pressure in the current economic climate is by repaying old debts with new ones. However, as a result this money will not actually boost the Belarusian economy but merely increase the state debt even more.

The right decision would be to introduce structural and institutional reforms. This sort of twin strategy could stimulate productivity growth and establish a basis for sustainable long-term economic growth.

The transport sector: the road less travelled

On 10 October 2016 it appeared that Belarus and Russia had almost resolved the oil and gas conflict. However, it seems that Belarus overpaid for this deal. In order to continue to receive duty-free oil, Russia may insist on "freezing" the transport routes of Belarusian petroleum products through nearby Baltic ports in favour of Russian carriage bays.

In order to displace the Baltic States (Latvia and Lithuania) the JSC "Russian Railways" (the main operator of railways in Russia) is offering an unprecedented 25 per cent discount on the transportation of Belarusian petroleum products to Russian ports.

Extraordinary discounts from Russia come with substantial pitfalls

The discount will be valid until 31 December 2018 and makes the Russian Railway's tariffs for Belarus comparable with the transportation tariffs at the Latvian port of Ventspils or the Lithuanian port of Klaipeda. However, as is usually the case when it comes to relations with Russia, such an extraordinary discount comes with substantial pitfalls.

In order to force Belarus's hand, Moscow is attempting to include commitments to export certain predetermined volumes of petroleum products via Russian ports into an intergovernmental agreement. The agreement regulates the duty-free supply of Russian oil for processing at Belarusian oil refineries.

However, such a set-up does not provide much economic incentive to Belarus. The Lithuanian port of Klaipeda and the Latvian port of Ventspils operate most of the transportation of Belarusian goods by sea and offer better conditions.

First of all, the Baltic ports are much closer to Belarus. For example, the distance between Mozyr (the second largest refinery centre in Belarus) and Klaipeda amounts to 783 km, while the distance between Mozyr and St. Petersburg comes to 1031 km. Secondly, Lithuanian and Latvian railways offer better services. Thirdly, such a re-orientation would involve additional logistical expenses.

Unfortunately, Russia is still playing a hard geopolitical game, and it will be difficult for Belarus not to get entangled in its eastern neighbour's ambitions. Therefore, the only remaining question is what toll these impending economic decisions will take on the Belarusian economy.

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This article is a part of a joint project between Belarus Digest and Belarusian Economic Research and Outreach Center (BEROC)

Russian oil blackout – digest of Belarus economy

On 14 September 2016 First Deputy Prime Minister of Belarus Vladimir Semashka announced that negotiations on oil and gas relations between the Belarusian authorities and Russia's main economic players had failed.

Meanwhile, the oil crisis has cast further uncertainty on how long Belarus' economic recession will continue and whether the execution of the state budget for 2017 will be successful.

The only way left for the government to rectify the economic situation is to hope for help from the IMF, which started its mission on 19 September 2016.

Refinery industry: forget the oil

The Belarusian authorities had planned to resolve their problems with Russia in the energy sector on 13-14 September 2016, but negotiations between the governments failed to yield results.

According to the 2011 Belarusian-Russian intergovernmental agreement, the gas contract price for Belarus is pegged to the tariff payable by Russian consumers with the addition of transportation and storage costs, equivalent to $132 for 1,000 cubic meters.

The Belarusian authorities consider a fair charge for Russian gas to be $73, calculated as the cost of gas on the German market minus transportation costs and export duty of 30 per cent.

However, the Russians are insisting that the already signed energy contract is valid for the 2015-2016 period, which includes a predetermined price formula. Thus, there is no possibility that the contract price can be changed. The establishing of equal gas prices will only be possible by the end of 2025 after creating a common gas market within the Eurasian Economic Union.

Meanwhile, the total amount of Belarusian debt for gas supplies has already reached $300m. As a result, on 16 September 2016 Russian Deputy Prime Minister Arkady Dvorkovich announced that the supply of crude oil to Belarus would be reduced by 5m tonnes (or 25 per cent of total supplies) in the second half of the year (see Figure 1).

However, the intergovernmental agreement between Belarus and Russia in the energy sector signed on 29 May 2014 clearly states that Russia has no right to restrict the supply of oil. The document specifies that for each calendar year the parties will jointly develop and approve the volume of oil and petroleum products supplied.

There is provision to vary supply volumes, but not by more than 2 per cent. Therefore, the total variation in oil supply may not exceed about 480 tonnes for the whole year, far from the 5m tonnes threatened by Russia.

Economic growth: diminishing

expectations

Initially, the Belarusian authorities forecasted 0.3 per cent economic growth in 2016, but later amended their predictions to a decline in GDP of 2 per cent. However, this year the refining of oil is set to be one of the core brakes on the economy. If the supply of the so-called "black gold" does not double, economic growth in the next year would seem miraculous.

The official forecast for 2017 assumes that Belarus will obtain 24m tonnes of oil. As a result, the recession would end and GDP growth would amount to not less than 0.2 per cent (assuming the average world oil price of $35 per barrel) or 1.5 per cent (assuming an oil price of $45).

However, the official economic plans for the next year do not account for a decline in the volume of Russian oil supplies to the country. On 23 September 2016 Prime Minister of Belarus Andrei Kobyakov announced that the total losses from oil shortages to Belarus's economy had already accounted for 0.3 per cent of GDP.

The latest Belstat data shows that the GDP of Belarus in January-August decreased by 3 per cent on the previous year and had outperformed the January-June GDP data by 0.5 per cent (see Figure 2).

There are other core factors which affect the government's macroeconomic predictions. One of these is investment activity. This year it has been highly unstable. Even agriculture is slowing down. Due to decreasing prices on the Russian market Belarus is unable to benefit from increasing volumes of trade (see Figure 2).

Budget policy: debt manoeuvres

However, another important factor in the oil drought is a decreasing level of income within the Belarusian budget.

In 2016 the government planned to use more than $1.1bn in revenues from export duties on petroleum products and oil to repay foreign debts. In the first half of the year because of lower oil prices and supply cuts from Russia, Belarus received only about $390m or just one-third of the money it had anticipated.

The price of oil has fallen and the country does not have enough money to settle with its main creditors

Meanwhile, the core project of the 2017 budget will involve making payments on external debt and arranging its refinancing. In particular, fees from the sale of petroleum products will go directly towards the repayment of foreign debts. The price of oil has fallen and the country does not have enough money to settle with its main creditors, namely Russia and the Eurasian Fund for Stabilisation and Development (EFSR).

Even if the price of oil does exceed $35 and Belarus receives a new tranche of the $700m loan from the EFSR, it will not help to repay the external debt of $3.2bn in 2017. The budget is still short of $1bn.

Therefore, taking into account all the possible social and economic risks, Belarus urgently needs new credit from the IMF. Belarus has been trying to test the waters during negotiations with the international organisation between 19-30 September 2016. Moreover, the decision from the IMF is being eagerly awaited by the end of the year by the authorities, who hope to receive several tranches as early as 2017.

In conclusion, the longer the Belarusian authorities wait for the introduction of painful structural reforms, the worse the economic situation in the country will become. The time will come when neither financial aid from the West, nor dwindling oil streams from the East will be sufficient to help to revive the crumbling economy.

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Testing the Limits of Investment Crisis – Belarus Economy Digest

On 25 August 2016 the National Statistic Committee of Belarus (Belstat) publicised new macroeconomic data for July, which showed that the economy is suffering from a lack of investment flows.

Meanwhile, according to the National Bank of Belarus the continuing decline of companies' profits threatens the financial stability of the country.

Finally, the CEO of "Great Stone" Hu Zheng tries to convince authorities of the profitability of the "Great Stone" industrial park, teaching Belarusians about high-level commercial science.

Economic Recession: Investment Drought

In January-July 2016 investment in fixed capital in Belarus has dropped by a fifth since the same period last year. Belarus has not witnessed such a decline in investment activity since the 1990s, a period of investment disaster in the economy.

2016 has brought a third straight year of investment drought, bringing the total amount of years of drought up to four over the last five years. Moreover, the process of investment "deforestation" is speeding up: from -5.9 per cent in 2014 up to 20.6 per cent right now (see Figure 1).

The main explanation lies in the economic structure of the Belarusian economy – the greatest "stake" still belongs to the state. It thus continues to play the leading role in the investment scenario. As a result, the decline in investment expenditures of public industries has pulled down the whole investment activity in the country.

The second reason concerns foreign investors: they spend money mainly on sectors with high domestic demand – finance, communications, retail trade, restaurants, and so on. With the reduction of the "life-giving" source of superprofits the additional commercial investments have also greatly diminished.

Finally, in order to help the National Bank reduce inflation, the government has committed itself to cut funding of state programmes by approximately BYN28tn this year and by BYN20tn the next one.

Therefore, given the significant dependence of investment programmes of state enterprises on state funding, the government’s hopes for an investment recovery in the following years seem dubious.

The Financial System: Destabilising Loss-Makers

According to Belarus's statistical agency Belstat, the profits of enterprises have decreased by a fifth in the first half of the year, while the number of loss-making companies has increased by a quarter compared to the same period last year. On 1 July 2016 the number of loss-makers reached 1,738 (or 22.8 per cent in total) and outperformed the corresponding figures of the previous year by 24.8 per cent.

On 28 July 2016 representatives of the National Bank said that the situation with loss-makers is even more complicated, as over the last several years, in order to expand production, a large share of enterprises took out more loans without an adequate assessment of their ability to pay them back.

Correspondingly, in the first half of the year the amount of troubled assets in Belarusian banks doubled, thus increasing the risk of financial instability in the country.

Moreover, according to the National Bank, due to the devaluation of the national currency the debt burden (formed mostly by foreign currency liabilities) of the enterprises has increased significantly over the past two years.

As a result, the positive effect of the devaluation on price competitiveness of Belarusian exporters has been cancelled out. In January-July 2016 exports fell by more than a fifth in comparison with the same period last year.

Trade Policy: Low-ball from the Great Wall

On 5 June 2012 President Aliaksandr Lukashenka signed a decree on the creation of the Belarusian-Chinese industrial park "Great Stone," aimed at attracting over 100 companies from China and Europe. However, to this day only eight residents have agreed to participate, and only two of them have started the building process.

On 19 August 2016 the CEO of "Great Stone" Hu Zheng tried to dispel any uncertainty about the future of the project by claiming that the conditions for entering the project are too restrictive (the size of the company and its business area: electronics, pharmaceutics, R&D, engineering, biotechnology, fine chemistry, new materials, warehouse logistics), which restrains investors.

Hu Zheng has suggested that the criteria for residents must initially be relaxed and their areas of activity expanded. He gave several examples, including firms engaged in processing of raw materials on a tolling basis (for example, processing of stone or metal).

However, such "extraordinarily helpful" advice may turn the innovative project into a simple excuse to transfer the above mentioned enterprises with low added value (which are also potentially harmful to the environment) from China to Belarus.

Due to prohibitive tax benefits (10 years of "all inclusive" tax vacation plus a subsequent 10 years of half-priced tax bills) for the investors, acting on such advice could undermine the competitiveness of Belarusian enterprises, contribute to additional job losses of Belarusians and lead to even more severe budget problems.

In Belarus this is an unpopular position: the first Deputy

General Director of the "Company for the development of the industrial park" Kirill Koroteyev has admitted that the primary aim of "Great Stone" is to attract only high-tech companies.

Thus, the government is still searching for additional sources of economic growth, preferring to bet on foreigners and forgetting about the entrepreneurial abilities of their own citizens. Meanwhile, investments continue to evaporate and additional fiscal risks threaten the financial stability of the country.

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The Midterm Exam for the Economy: Digest of Belarus Economy

On 19 July 2016 the National Statistic Committee of Belarus (Belstat) has announced the macroeconomic results of the first half of the year. The figures disappoint – economic growth still in the red zone.

Moreover, the Eurasian Development Bank has warned that the Republican budget requires additional cuts in order to sustain the acceptable level of state debt.

Finally, on 27 July 2016 the new round of Belarusian-Russian negotiations on gas prices and gas debt payment was held in Moscow.

Economic Growth: Leaving Plans for Christmas

In the first half of the year, the government planned to withdraw the economy from recession. However, actual results still dissatisfy. According to Belstat for the first half of 2016 GDP of Belarus has decreased in comparison with the previous year by 2.5 per cent and once again missed the official forecast this time by 2.6 per cent.

Such a reduction of economic growth still took place together with the weak domestic demand and demand from Belarus's major trade partners – the exports of goods dropped almost by fifth part accompanied by a significant slowdown in the growth of the physical volume of industrial production (see figure 1).

Meantime, Belarus' officials still have an optimistic view on the assessment of current macroeconomic situation. On 26 July 2016 the Prime Minister Andrei Kobyakov has announced that in the first quarter of 2016 the plan for creation of new jobs was exceeded by almost 2 times.

However, according to Belstat the number of work places in Belarus continues its reduction eight month in a row. In the first half of the year 341 thousands of Belarusians lost their jobs and outperform the number of employed by 81 thousands.

Additionally, the attraction of foreign investments in Belarus show little progress. For example, the number of new residents in the widely boosted Chinese-Belarusian industrial park "Great stone" still has not increased.

For two previous years the "Great stone" has attracted only eight residents and in the first half of the 2016 – zero. Moreover, only few currently registered residents began to implement the announced projects.

One of the main reasons that restrict the flow of foreign investments in Belarus tried to explain the British Ambassador in Belarus Fionna Gibb. She thinks that the Belarusian authorities do very little to overcome such situation. According to her, British companies avoid investment, because our country remains quite a closed country and business is not ready to take big risks.

State Debt: Resetting the Race

By the end of June the international reserves of Belarus increased by 7.3 per cent in comparison with first month of the year and amounted to $4.8bn (see figure 2). This number has already outperformed the official forecast for the whole year by $24m indicating the success of monetary policy realized by NBB in recent month.

However, this amount of international reserves remains at one of the lowest levels in recent years, which indicates that Belarus still possesses inadequate resources needed for the maintenance of its economy, and makes the problem of attracting additional capital not only from Russia still very difficult.

On the same time after two month of decline the state debt of Belarus has resumed its growth increasing by 7.4 per cent in comparison with the start of the year. The main source of growth falls on its external part taking into account the first $500m tranche of credit from the Eurasian Fund of Stabilization and Development.

However, in the second half of the year the internal part also will add up some additional pain. According to NBB since the beginning of year the volume of problem assets in banking system has increased by two times and reached 13.4 per cent growing already for eight months in a row – a historical maximum for the Belarus.

This situation occurred due to substantial granting of loans on preferential terms for mostly loss-making enterprises. In order to solve this problem the government will be forced to increase borrowings in the internal market.

Energy Sector: Monetizing the Negotiations

Meantime, on 27 July 2016 the new round Belarusian-Russian negotiations on gas prices and gas debt payment was held in Moscow. According to Russian side the debt of Belarus for gas has reached $270m since the beginning of the year.

Belarus' authorities believe that the price should be lower since energy prices are getting cheaper on the world market. Besides that Russia itself has lowered price for some consumers, for example, Armenia, but unwell to reduce price for Belarus.

Price for 1 thousand cubic meters of gas for Belarus is $132. While Belarus considers a fair price equal to $73. The main argument of Minsk stays the intergovernmental agreement in which it is written that for Belarus should be applied equal prices (export price minus transportation).

Meantime, in order to force the decision Russia has reduced oil supply to Belarusian refineries by 37 per cent. Due to such a sudden strike estimated losses of Belarus may rich additional $200m per quarter significantly outperforming the amount that Belarus saves on the price of gas.

Furthermore, the negotiations were complicated due to extra conditions that Russia put forward, namely to revive the previously announced privatization projects (MAZ, Grodno-Azot and other enterprises).

Summing up, the government still waits playing with gas bargaining and new coins arrived after denomination occurred on 1 July 2016. While it helps to avoid painful structural reforms and spend some time in the shuffle, it still little contributes to restore the shrinking economy.

Moreover, such situation may additionally transform into even harder problems in the next year – slowing down economy driving at a first gear cannot easily switch to higher one without improvements in labour productivity, innovation and entrepreneurship.

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Waiting for a Miracle: Digest of Belarus Economy

On 28 March 2016 the Council of the Eurasian Fund for Stabilisation and Development (EFSD) approved the provision of a new loan to Belarus.

In the meantime, the export and real estate market established new numbers of their record fall, questioning the limits of slowdown in Belarus.

In such a situation the government tries to secure state financial support – President Alexander Lukashenka has signed a new decree that grants funding only for profitable strategic investment projects.

Exports: Reaching the Bottom

According to new data announced on 21 March 2016 by Belstat, Belarus' exports in January has decreased by more than 20 per cent (in dollar terms) in comparison with the same month last year to just $1.6bn – the lowest level for one month since 2009 (see figure 1).

Moreover, exports declined for 16 straight months in a row. This happened mainly for three reasons. First of all, approximately half of Belarus' exports go to Russia, where growth has been under pressure since 2014.

Second, Belarus' main exports are positioned to markets outside the Eurasian Economic Union; this includes potash fertilizers and oil products. In January, the delivery of these items to foreign markets fell by more than a third in dollar value compared to the same period of the previous year.

However, according to the General Director of Belarusian Potash Company Elena Kudryavets, the company (Belaruskali) increases its share in the world exports and focuses on the real needs of the market while responding to changes in demand.

Next reason concerns refinery. Belarus exports about 14-15mln tones of oil products produced mainly from Russian crude oil and purchased at a reduced price. Therefore, the drop of world oil prices adversely affected the interests of Belarus – the lower world price, the lower the margin between the world and price for Russian oil.

Additionally, export prices for oil products has fallen more in comparison with world oil prices. As a result, foreign exchange earnings of Belarus from the sale of oil products in 2015 fell by 28 per cent compared with 2014.

Real Estate: Repeating the Bubble

Deep recession and big financial rescues for inefficient Belarus' state-owned enterprises led to the downfall of households' incomes (nearly by half). However, right now the next wave of economic problems has reached the shores of Belarus' main private companies.

Starting in 2001, the rising oil prices marked the beginning of the "golden age" for real estate investments in Belarus. Sensing the smell of "easy money" local major entrepreneurs have started to turn into real estate bosses. As a result, the average house prices in Belarus almost tripled by the end of 2013 (see figure 2).

However, since 2014 house prices dropped by more than 28 per cent – the nightmare for Belarus' real estate market.

The bubble occurred generally due to three motives: the overconfidence in stability of oil prices and the Russian market; steady growth of incomes of Belarusians subsidised by loose monetary policy of the National Bank of Belarus (NBB);

and lack of other possibilities for profitable investment.

Moreover, Belarusian companies helped to ignite the fire of problems by themselves leading to the rising debts of their operations including real estate transactions.

Additionally, this situation plays both as a consequence of the economic crisis and a big reason for its continuance causing subsequent problems in the banking sector. According to the NBB, in February 2016 the amount of troubled assets of Belarus' banks increased once again and reached 10 per cent share of their whole assets.

State Governance: Swapping the Rules

Step by step the state machine begins to change its main driving economic mechanisms. On 21 March 2016, a new Presidential decree, No.106, changed the system of formation of state programmes and the provision of state support to economic entities.

The main adjustments suppose the transition from an individual towards a programme approach for the granting of state financial support. It cancels the possibility of direct requests of the enterprise for additional financial resources in case of permanent economic troubles.

For now, the government provides financial resources only according to the strategic investment priorities of the economy and the possibility of the fulfillment of strict requirements for achieving efficiency targets.

As a result of such a daring decision, the EFSD, on 28 March 2016, approved the provision of $2bn loan to Belarus in order to support the economic policy measures and structural reforms proposed by the government and the National Bank of Belarus.

According to EFSD's press centre, Belarusian authorities agreed to insure the control over the monetary policy, through implementation of flexible exchange rate policies and the achievement of a balanced budget. Moreover, structural reforms assume substantial increase in the share of compensated utilities by the population – up to 70 per cent by the end of 2017.

All these should add up to reduction in cross-subsidies and direct lending, playing an important role in the increase of competitiveness in the economy.

However, according to former NBB's Chairman Stanislau Bahdankevich, the economy, right now, is experiencing substantial difficulties with repayment of previously obtained loans ($3.3bn only in 2016). The inability to accomplish such transactions means default for the economy; Bahdankevich believes that the new EFSD's loan is needed only to avoid such a negative scenario.

Belarus' economy still suffers from recession, stacked in debts enterprises, free falling exports and a declining real estate market. However, it seems that state authorities finally got some insight into the economic troubles and have started the process of finding a way out.

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The Moment of Truth: Digest of Belarus Economy

On 16 February 2016, President Alexander Lukashenka announced zero tolerance for structural reforms being proposed by the government.

Meanwhile, since the beginning of 2015 state debt has increased by more than half and real wages in dollar equivalent have fallen to a ten year low.

Belarus's government is still trying to find a simple way out of the crisis by releasing new development plans while waiting for credit from the IMF and Russia.

Economic crisis: approaching phase two

On 18 January 2016 Minister of Economy Vladimir Zinovskii predicted a tough 2016, and said it would influence Belarus’s economic performance in the next five years. The World Bank believes Belarus' GDP will contract this year by 0.5 per cent.

Taking into account these forecasts, experts speak morosely of a "new reality", admitting that previous methods of dealing with the country's economic problems have been exhausted. According to representative of the National Academy of Sciences of Belarus Georgy Grits, the economy has entered a prolonged recession and unpopular measures are needed to find a way out of it.

Economic data published on 20 February 2016 indicates that the country has started the new year by repeating the acute problems that began in 2015. GDP has dropped by 4.3 per cent and industrial production has shrunk by 6.8 per cent (see Figure 1).

However, in contrast to 2015 the budget for 2016 is based on much more shaky ground. The state finances for 2016 assumed an average oil price of $50 a barrel and a small budget deficit. But turbulence in the oil market in January, when the price of oil dropped to $30 per barrel, has put hopes for such a scenario to rest. The government has announced that it will introduce deep spending cuts and tax increases.

All this adds up to trouble and a declining economy. Belarusian families will face a fundamental degradation in their quality of life. The process has just begun.

Last year real wages in dollar equivalent fell by more than 12 per cent. Additionally, on 1 January 2016 the government increased tariffs for heating and hot water by one third, and plan to cut back subsidies to increase the consumer payment level for utilities to 80 per cent.

So, the first phase of Belarus’s crisis in 2015 has revealed all its consequences for enterprises. But for ordinary Belarusians, phase two is only just starting, and looks to be much worse.

State debt: the warning signs of trouble

In previous years the bullish case for Belarus depended on the belief that the state machine could always combat a slowdown by repeating its well-known trick – printing roubles. As a result, with higher spending from people and increased industrial production, economic growth engaged its second gear.

But today’s situation differs. Without extra money from oil and new contracts with Russia, such a policy will increase prices and decrease the ruble exchange rate, further reducing income for Belarusian families. Add here increasing debts and drawing down of national reserves, mix the ingredients and you will get a toxic combination (see Figure 2).

The warning signs are there that despite a more flexible exchange rate, reserves are steadily evaporating. The only way to replenish them remains external borrowing. Thanks to the gods, Russia has decided to spare its neighbour and has announced that it will dispense a $2bn loan to Belarus in the near future.

Additionally, the weakening currency and the National Bank of Belarus’s (NBB) new policy for deposits are prompting savers to scrape up their money from the banks. According to the NBB, in the last seven months ruble deposits have declined by almost 30 per cent. The problem lies in people’s expectation of a further devaluation, creating a self-fulfilling reduction in savers' confidence.

However, the biggest trouble concerns state debt. Since the beginning of 2015 it has increased by 66.4 per cent and is approaching the threshold value for economic security. It has reached 22.7 per cent of GDP with a threshold value of 25 per cent.

Further, excessive government borrowing that is used to finance a sharply increasing budget deficit has caused a crowding-out effect in the economy. When the state becomes a borrower it pushes out competition from the private sector, leaving only crumbs on the investment market and thus decreasing the market's efficiency.

It is easy to say, but Belarus should have cleaned up its financial system and freed its exchange rate several years ago. Now the economy has slowed, debt has piled up and the dollar earnings from oil refining have been drained, leaving almost no painless way out.

Economic reforms: resting in peace

So far Belarus's rescuers have focused too much on raising taxes and cutting spending, and too little on reforming the state and freeing up the economy. The economic downturn has seen wages fall considerably, and the country remains chronically uncompetitive.

It will be essential to broaden and deepen Belarus's economy before its biggest advantage, a cheap workforce, is spent. However, the government proposed to begin with budgetary reform and anti-crisis plan.

Next, the Ministry of Foreign Affairs declared its program for export development. State-owned enterprises are apparently uncertain of how to diversify the supply of products.

Meanwhile, on 18 February 2016 the Minister of Economy of Belarus Uladzimir Zinouski made the most significant proposal yet. He suggested carrying out government optimisation by reducing the number of ministries, thus increasing the efficiency of decision making.

However, experts have pointed out that on the whole these measures hardly count as game-changing reforms.

According to Belarusian economist Sergei Chaly, the authorities still have an ongoing dispute about the key problem in the economy: some senior officials propose to reform the public sector by privatising state-owned enterprises, while others argue that the biggest problem concerns the monetary policy that led to the high cost of loans and inefficiency of state companies.

If Belarus’s authorities still show exceptional resistance to implementing real reforms, decreasing reserves, increasing state debt and evaporating savings are transforming into an incurable disease for a slowing-down economy.

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New Policies on Deposits, Waiting for Foreign Money – Digest of Belarus Economy

On 20 November 2015 Belstat, the official statistical body, released the updated macro-economic statistics. Disappointing figures on exports and manufacturing suggest that the economic downturn in Belarus continues.

However, on 11 November 2015 the National Bank of Belarus announced reforms on the deposit market. The bank tries to replenish the deposit’s term structure hoping that it can boost cheap investment in the economy.

Meanwhile, rising debt among individual companies raises the question of how much worse things can get. Loss-making state-owned enterprises dragged down by overdue debts are hoping that a good order can guarantee them potential further credit.

Economic Depression: Approaching the Bottom

According to Belstat by November 2015 GDP had dropped by 3.9 per cent year-on-year. The economy has lost its August "miracle" returning to the most negative forecast figures. After a half-point positive adjustment in August, GDP decreased twice by 0.2 percentage points in September and October. Exports have weakened further, falling to their lowest levels in the last decade (see figure 1). The Prime-Minister Andrej Kabiakoŭ, on 24 November 2015 admitted that the government's measures which were introduced in order to increase exports and find new markets were still not enough.

Nevertheless, the authorities hope to override the so-called "external-factors" in the economic crisis by significantly increasing the volume of loans granted to enterprises to boost their economic activity. They expect that these measures coupled wit old-fashioned Soviet style manual controls will bring economic salvation.

However, according to the National Bank of Belarus in the first nine months of the current year Belarusian banks decreased the volume of lending using the national currency by 6.5 per cent. The volume of new credits granted in foreign currency also declined by nearly $2.5bn.

Thus, to reverse such a negative tendency Belarus urgently needs new credit lines from the Eurasian Development Bank and the International Monetary Fund (IMF). However, on 20 November 2015 the National Bank of Belarus announced that the Belarusian authorities failed to conform with an IMF three-year programme of reforms supported by a new loan of $3bn.

Although that will spare the economy further short-term pain, the disease will remain. Loans that should have gone to vibrant companies with promising new ideas go instead to state "zombies". Hence, to sustain economic growth the economy needs increasing credits.

Deposit Market: Dreaming about Long-term Structure

Taking into account tough and long run negotiations about new loans with the Eurasian Development Bank and the IMF the only way to replenish the financial resources of the banking system is to attract additional deposits. However, by 1 November 2015 in comparison with May deposits in Belarusian rubles shrank by 22.7 per cent (see figure 2).

In this light on 11 November 2015 the National Bank of Belarus declared new rules for the deposit market in Belarus, which was adopted within the government's program of macro-economic stabilisation.

The changes include the addition of an irrevocable type of deposits, not allowing early withdrawal of invested funds, and a 13% tax on income from interest on short-term deposits, less than 2 years for foreign currency deposits and less than 1 year for deposits in Belarusian rubles.

The National Bank of Belarus aims to build a long-term resource base for banks, and create a more efficient use of financing, including the availability of long-term loans for economic entities and the population. However, several pitfalls still exist before results will be achieved.

First of all, under the conditions of the current economic crisis, low competitiveness of Belarusian enterprises on external markets (primarily in Russia) decreases their investment attractiveness and leads free cash funds to continue to concentrate where they can bring the highest profit with the lowest risk and costs. This is on short-term deposits in Belarusian banks.

Secondly, repeated financial crises, the lack of tax stability and the protection of owners' rights, have changed the preferences of Belarusians. For them it is better to have more cash in their hands today than make investments in long-term deposits.

Thirdly, the decrease in the level of the population's income will lead to a further reduction in savings and, hence, to an additional drop of deposits in Belarusian banks. According to Belstat, the real disposable cash income of the population in January – August of 2015 decreased by 5.3 per cent in comparison to the same period of the previous year. In dollar terms this decline amounted to about a third.

Companies' Debts: Losing Ground

But dig deeper and the situation looks even less promising. The increase in accounts payable in recent months indicates that companies, including state-owned enterprises, repay loans slower than banks issue new ones (see figure 3).

Moreover, persistently harsh external macro-economic conditions suggest that state "giants" will compete harder for additional financial resources provided under another extensively used state policy that of direct preferential lending.

However, the use of the direct lending policy means that state-controlled banks lose the ability to perform the key function of financial mediation. They can no longer select effective credit projects.

Taking into account the tough prospects of obtaining new loans from the IMF and Eurasian Development Bank, coupled with the National Bank of Belarus's new policy of monetary targeting, government bonds remain as the key instrument for the implementation of such lending.

In July 2015 Belarusian large state enterprises like the Minsk Tractor Works (MTZ) and Gomselmash received such help. The timber industry hopes for the same after the authorities' decided on 22 October 2015 to transfer their problem assets to the control of the Development Bank of Belarus.

Trying to avoid the acceleration of inflation, the government issues new bonds and turns and therefore turns into a formidable competitor for private companies. A distorted economic environment reduces the incentives for enterprises to increase their efficiency and leads to a decline in Belarus's economic development.

Summing up, all this puts pressure on the National Bank's new economic policy. If the authorities decide to switch on the printing machines it could lead to a financial crisis once again.

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This article is a part of a joint project between Belarus Digest and Belarusian Economic Research and Outreach Center (BEROC)