

Output Grows, but Inflation Hurting Macroeconomic Stability – Digest of Belarusian Economy

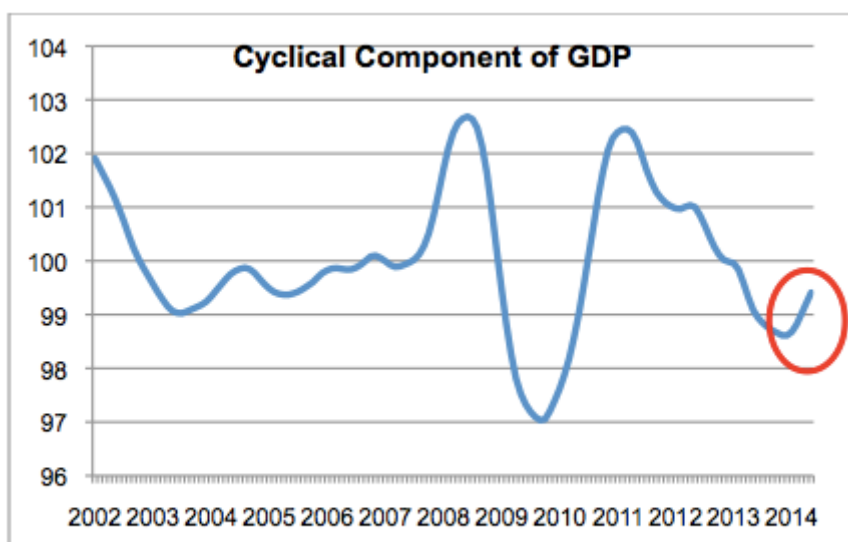
The economy of Belarus is showing signs of rising levels of output with most industries increasing their overall output figures throughout May. At the same time foreign and domestic investment demand are exhibiting signs of recovery.

However, this recovery does not itself necessarily signal a return to high output growth. The growth rate is likely to remain weak in the coming months and a new challenge – climbing inflation – might hurt the economy.

Output: Growth is Reviving, but Remains Poor

The Belarusian economy has entered a period of recovery (see Figure 1). Belstat reported that in January-May output grew by 1.5% (0.5% in the 1st quarter, and 1.1% in January-April). Indeed, broad positive trends in output have become more systematic and noticeable.

On the production side, major industries displayed gradual output growth across different sectors (trade, manufacturing, agriculture, electric power production) in May. Only construction and a number of manufacturing sub-industries (mainly machinery and equipment manufacturing) seem to be exceptions to this general trend.



Note: The cyclical component is extracted through Hodrick-Prescott filter. The level of 100 corresponds to potential level of output.

On the demand side, an increase in investment activity and on external markets set the stage for recovery. External factors have also played an important role in Belarus' economic revival through May. In particular increased potash fertiliser exports, having recovered after demand was driven down in 2013, has become one of the most notable changes. Consumer activity remained strong, although its growth is likely to weaken in the near future due to real wages stagnating.

Despite a number of encouraging trends in the real economy, in general the overall economy's prospects have not significantly improved. Several factors are hampering its growth. First, its poor growth potential remains one of Belarus' core issues. Even according to the most optimistic forecasts for 2014, the GDP's growth rate will remain extremely modest (up to 3% by the end of the year).

Second, financial markets and the monetary environment continue to be in a very fragile state. The authorities achieved some success in making them more stable and reducing interest rates over the past couple of months. However, they will hardly succeed in sustaining it if another shockwave ripples through the economy, especially if they fail to find a way get access new foreign loans.

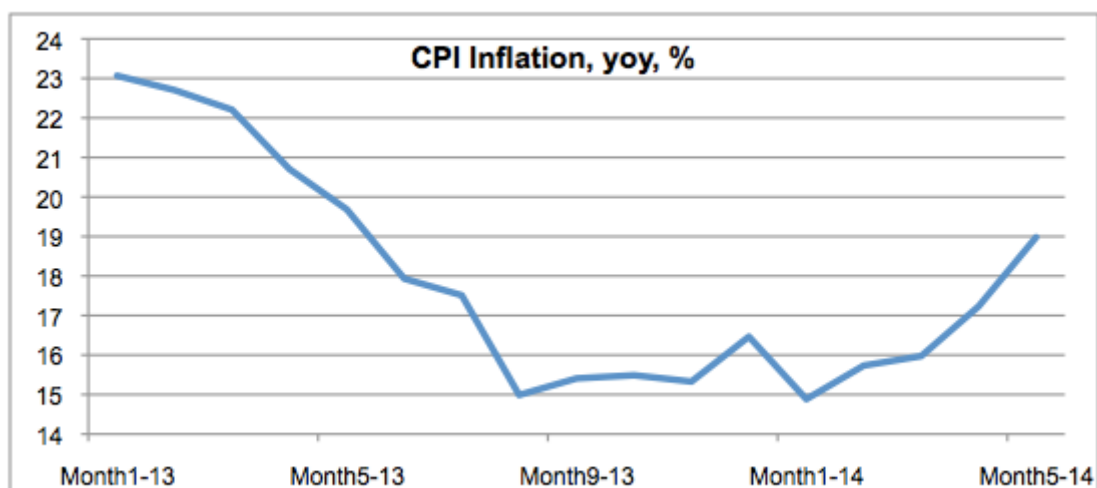
Should things start to fall apart, the authorities will have to tighten their interest rate policy against a backdrop of growing inflation. However, if they are able to continue to build momentum for sustained domestic investment, which has been successful thus far thanks to reduced interest rates and increased liquidity in the banking system, they might be able to reverse this negative trend.

Third, a contraction the volume of intermediary imports has had an enormous impact on improving the environment of the nation's net exports. However, there are doubts about the origins of this shift (i.e. was it driven by the preferences of firms or was it the outcome of an administrative restriction being placed on imports) and its sustainability (i.e. can firms maintain their current levels of production if they receive fewer imported intermediate inputs).

Monetary Environment: The Threat of a New Inflation Spike

In 2013, the inflation rate steadily fell, reflecting a gradual shift in inflation forecasts (which, nevertheless, remained high and volatile), contracting domestic demand for investment and a relatively strict economic policy. Growing inflation appeared to be relatively consistent in 2014, as the majority of the factors that contribute to it persisting in the economy.

However, recently the situation appears to have changed. Since the beginning of the year the rate of inflation has begun to gain momentum with the annual CPI (consumer price index) inflation rate reaching 19% (see Figure 2) in May.



Administratively regulated prices for services are the main culprit. Since the beginning of the year the tariffs on utilities and transportation have grown considerably (by 20.6% and 15.5% correspondingly). In reality, raising these tariffs is sound policy, and despite the opaqueness of how the new rates were reached, it was necessary to adjust them to a more fiscally responsible and economically reasonable level.

Another contributing factor has been the government's decision to dealing with the Belarusian rubles exchange rate. Given its lack of access to external financing, along with a huge deficit of current account, they could not avoid employing this tool for mitigating the nation's currency deficit. A more rapid pace for depreciation also contributed to prices going up.

There was also a significant spike in foodstuff prices in 2014 (up 12% since the beginning of the year). Meat prices (particularly pork prices) lead the pack in terms of growth. Prices for meat and poultry grew by 25.3% from January-May, with pork jumping 51.0%.

A substantial reduction in the nation's pig stock (due to an outbreak of African hog cholera in 2013) the primary driver behind this trend. Still, trying to explain the sharp jump in foodstuff prices in terms of African hog cholera alone seems to be misleading.

In 2014, agriculture's growth rate of costs has been considerable, making it among the leading industries of the economy. In the 1st quarter, expenses in this sector grew 25.4%, while the average rate of expenses throughout the economy was just 10.6%.

Such a pronounced growth in costs cannot be explained away by African hog cholera. The low levels of efficiency witnessed throughout agricultural sector as a result of large direct and indirect subsidies to it may provide a better explanation, or at least an alternative one, for rising costs and the subsequent price adjustments.

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A new round of inflation rate hikes has developed into a serious potential threat for the national economy. Accelerating inflation may drive up expectations about its future direction. Alternatively, increased inflation expectations may lead to a new wave of deposits being tied to dollars. If this is the case, the authorities will have to enforce a strict interest rate policy in order to cease deposits being done in dollars, which would result in additional output losses.

Furthermore, a sharp spike in prices for a small group of goods and services (especially intermediate goods like fuel and utilities) may distort the structure of relative prices and correspondingly cause adjustments in other prices to eliminate these distortions.

Finally, increasing prices will lead to less a lower level of competitiveness for the Belarus' producers and manufacturers. In battling to fend it off, it may become clear that a rapid pace of depreciation will become necessary. However, given the closer relationship between exchange rates and prices, the

threat of a new inflation-depreciation downward spiral may arise alongside output losses.

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