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.

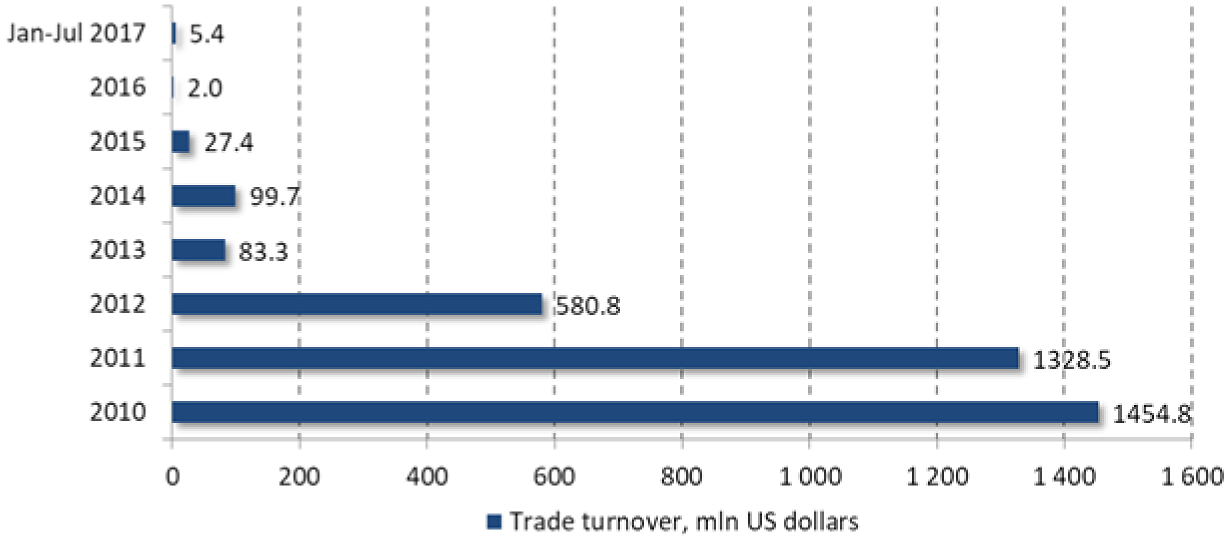

Figure 1. Trade turnover with Venezuela

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.

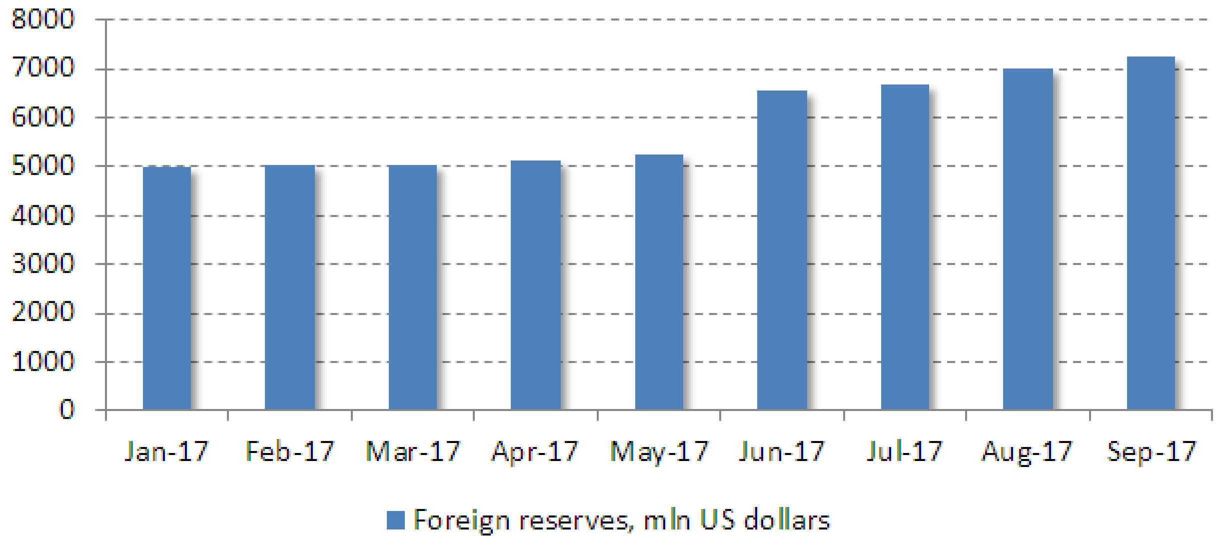

Figure 2. Foreign reserves of Belarus

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.

Aleh Mazol

Belarusian Economic Research and Outreach Center (BEROC)

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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).

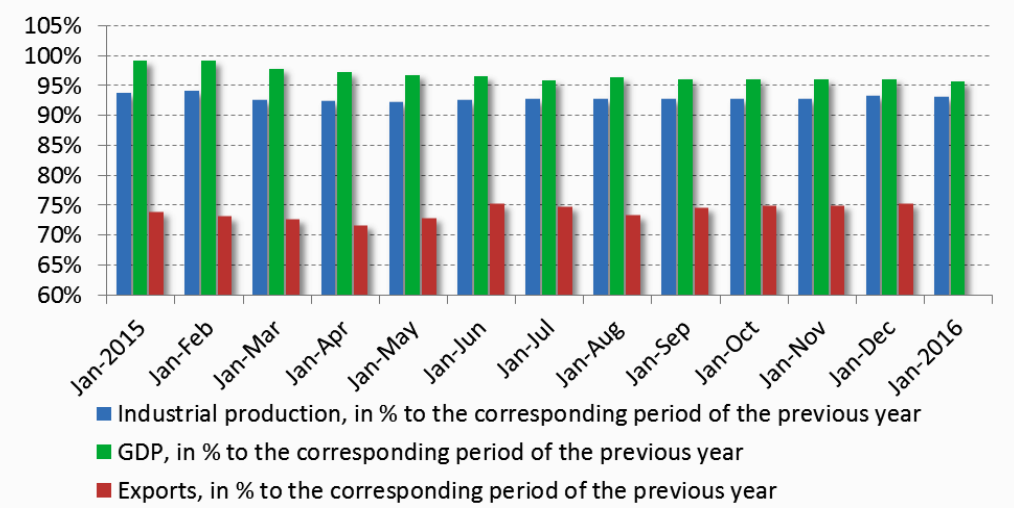

Figure 1. Economic indexes

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).

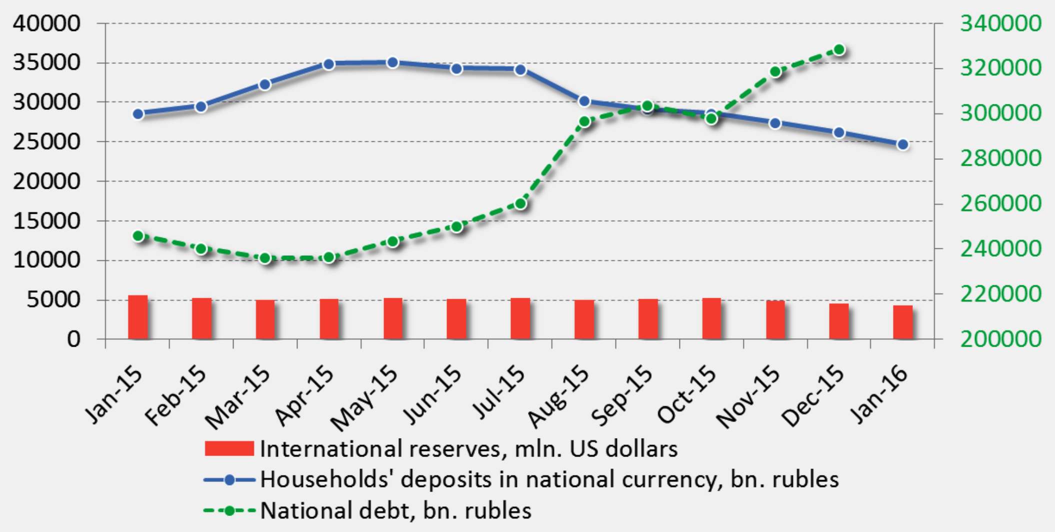

Figure 2. Reserves, deposits, debt

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.

Aleh Mazol, Belarusian Economic Research and Outreach Center (BEROC)

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Creeping Signs of the Approaching Crisis – Belarus Economy Digest

The first half of the year has shown clear evidence that the Belarusian economy needs better incentives to revive its industrial strengths.

In July the authorities announced their plans to provide financial assistance to several "giants" of industry. However, this decision has cast doubts over whether or not other taxpayers will ask the same from the state.

Also, this month the government carried on negotiations with the IMF and Eurasian Fund for Stabilisation and Development and are seeking to attract additional potential sources of loans. After their preliminary meetings all parties have decided to continue consultations showing striking unity on the necessity of economic reforms.

Economic Data: Spinning Down

Belarus' GDP fell 3.3 per cent in first half of the year, which raises questions about the government's official forecast growth rate of 0.7 per cent and fears that the country's efforts to bring a halt to the nation's current economic turmoil by the end of August may not be enough.

The hardest hit were mostly exporters to the Russian market

Belstat, the official state statistical body, released on 6 July its report on loss-making enterprises in Belarus for January-May 2015. Net losses for these enterprises hit around $0.8bn and more than doubled in comparison with the same period from last year. The hardest hit were mostly exporters to the Russian market, where shrinking demand was compounded by the further decline of the Russian ruble.

Yet in June, in comparison to May, industrial production rose by 3.8 per cent. Manufacturing seems to be in better shape, while the industrial activity of Russia continues to shrink by 4.8 per cent. If Russia's economy does not start seeing a recovery in the near future, things will get nastier for its strategic partner as well.

The problem of wage arrears presents a particular concern. According to Belstat, by the beginning of July 555 enterprises (mostly from the agriculture, hunting and forestry sectors) not paid 95,200 of their employees. The overall amount of overdue debt has increased from May by a considerable 37 per cent.

The numbers indicate that economic reforms are taking much too long. But where to begin? So far the government has failed to show a proactive approach to improve the situation.

State Support: Saving the "Giants"

Belarus’ economy needs new ways to kick-start economic growth. However for the moment the government is relying mostly on increasing public borrowing. On 1 July, the President signed several decrees in order to support and stabilise the financial and economic situation at MTZ and Gomselmash (see figure 1) – two manufacturing "giants" dragged down by low sales.

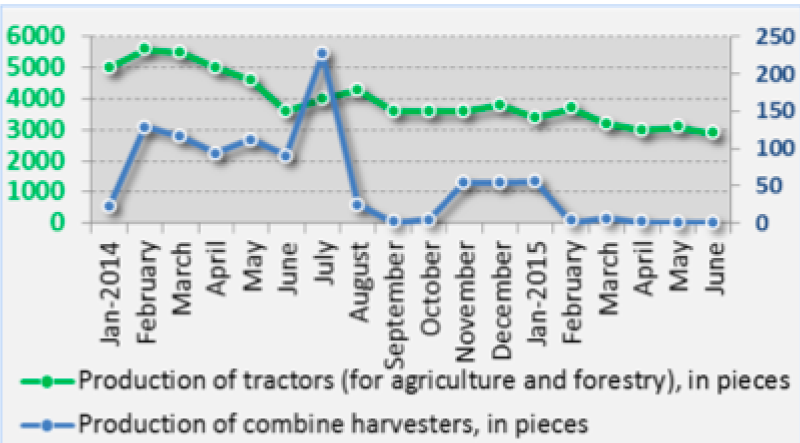

Figure 1 The dynamics of the production of tractors and combine harvesteres in Belarus

Given this grim picture, Belarus has clearly decided to bear the burden. The Ministry of Finance provides the main chunk of state financial assistance by issuing $425.8m in foreign currency bonds. This currency injection is supposed to act like a shot of adrenalin for Gomselmash – a leading manufacturer of combine harvesters and agricultural machines.

The MTZ, producer of a wide-range of tractors, is the second party to receive the states help, it will receive currency bonds worth around $150m underwritten by the company’s assets. Operations with these bonds are exempt from taxes, which in reality is a tax credit for those who will buy the bonds.

This mechanism, supposedly, aims to hide the prohibition of direct financing of the economy using the printing of the domestic currency in order to restructure the bad debts of the loss-making industrial "giants". Apparently, in terms of the current regime of monetary targeting a broad money supply, this will lead to its expansion, which strictly contradicts the IMF rules.

In light of this, the only way to get around the IMF’s tough stance on this issue is the gradual closing of the pipeline of state support for all of the other collapsing manufacturers, meaning the remaining "giants" will be slowly edging their way towards extinction. However, in order to avoid the worst scenario imaginable from unfolding, the government may decide to utilise a policy by which it would create artificial demand for "machines" by distributing them to other companies in the country and paying for them out of the national budget.

In any case, all of this unavoidably leads to more money printing, and, thus, creates the necessary conditions to jump start the next round of the familiar inflation-devaluation cycle.

New Credit Negotiations: the Long Way to Make a Deal

The IMF turned down Belarus’ preliminary agenda of economic reform. The snail's pace progress on freeing up the economy and implementing reforms has cast doubts on a new credit line of $3.5bn from IMF. The IMF calls for something more radical than just "formation of a legal framework" meaning the actual liberalisation of prices, a reduction in subsidies, the cancellation of mandatory plans for enterprises, and really carrying out privatisation.

In July Belarus tried to sell new promises of structural reforms to the Eurasian Fund for Stabilisation and Development

A deal with the IMF would help the country to pay for its imports and to refinance its previous debts. From the beginning of the year, Belarus' foreign-exchange reserves have shrank by 9 per cent from $5,059m to $4,620m, less than what is needed to pay for one month and a half of imports. Without a deal debt payments during the year will eat up more than half of the country's international reserves and leave it with less than one month's worth of imports.

In July Belarus also tried to reduce the tempo of their declining reserves by selling new promises of structural reforms to the Eurasian Fund for Stabilisation and Development, but they were also largely unsuccessful. However, the real obstacles of negotiating with the Fund have always been the political constraints implicit in working with it, particularly when it is taken into account that Russia holds the largest share of power in it.

Nevertheless, in order to not sink the economy of its strategic partner, the Russian authorities approved a loan of $760m for the repayment and servicing of Belarus' debts to Russia and the Eurasian Fund for Stabilisation and Development.

Aleh Mazol, Belarusian Economic Research and Outreach Center (BEROC)

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