Periodical Part

Economic outlook / Belaruski Ėkanamičny Dasledča-Adukacyjny Centr ; 2017

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Belarusian Economic Research
and Outreach Center

BEROC

Economic Outlook

First Quarter 2017

Recovery or surge?

- Output began growing, but the sustainability of recovery is doubtful

- The bottom in consumption is likely to have been passed

- Inflation is at historical lows

- Public debt is being refinanced forcedly

- External price conditions have stabilized

- Real wages grew, but labor market still depressive

GDP growth rate,% (seasonally adjusted, annualized)

Legend: q/q — 5 year average — FY average
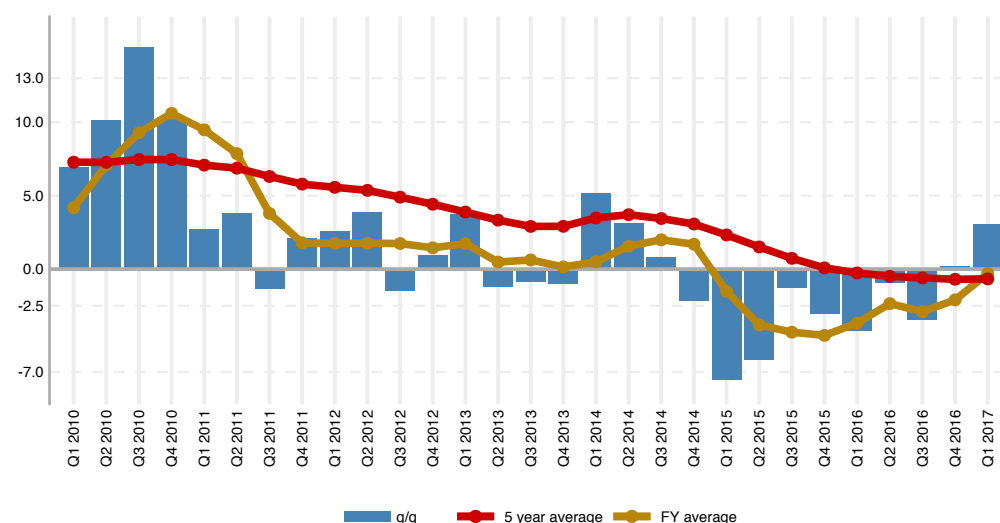
Decomposition of GDP growth: the contribution of structural and cyclical factors, percentage points

Legend: Structural factors contribution — Cyclical factors contribution — GDP growth rate, % (q/q annualized)

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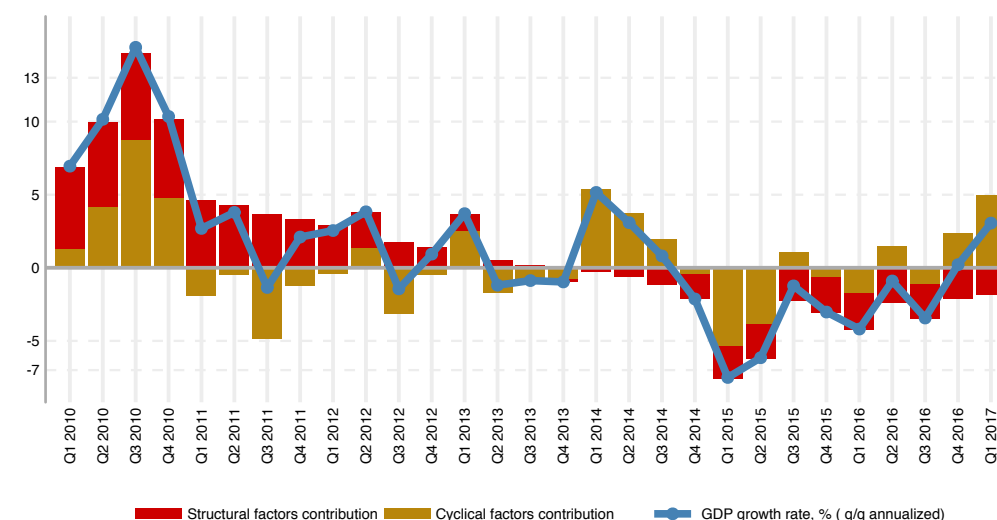
1. By default Belstat reports GDP growth rates (i) on accrual basis and (ii) vs. the same period of a previous year. The series of such growth rates turn out to be flat, but it 'hides' new signals in output dynamics. In internationally accepted practice series of the annualized growth rates between two consecutive quarters (with a seasonal adjustment) are more frequently employed. Such growth rates reflect the tendencies of the output with respect to a particular quarter (including the last one). The series of annual average growth rates (not on accrual basis) allow to avoid high volatility of previously mentioned indicator and embeds the information about the last quarter to the previous year context. Finally, average annualized growth for last 5 years (not on accrual basis) could be viewed as indicator characterizing the environment of the long-run growth.

2. Decomposition of GDP to structural and cyclical component is made by means of univariate Kalman and Hodrick-Prescott filters. Final decomposition is a result of averaging of these two approaches. In terms of growth rates, such decomposition demonstrates contribution of structural and cyclical factors to growth rates of the output. However, it doesn't focus on the current state of the trend (potential) output and output gap (corresponding estimates of levels may differ significantly (than estimates of growth rates) in comparison to estimates based on another decomposition techniques).

Main trends

Output began growing.
But structural weaknesses still overburden the
economy.

In 2017Q1 the economy grew modestly, which contradicted to the bulk of forecasts and expectations. In comparison to the 2016Q1 output grew by 0.3%, although domestic demand was still shrinking. It implies that an external demand was the key growth factor. Moreover, this relatively attractive performance was achieved against the background of restricted supplies of Russian oil. Adjustment to this factor would have mean even higher output growth rate in comparison to 2016Q1. In brief, such a picture postulates that a recovery that is likely to be natural and sustainable has begun in the national economy.

However, a comparison of output to the previous quarter (on a seasonally adjusted basis), and decomposition of growth by structural and cyclical factors draw a different picture. In comparison to the 2016Q4, growth strengthened substantially due to cyclical surge, and from the demand side it was driven mainly by household consumption. This view mainly assumes that the recovery is not sustainable. Given the negative trend growth, securing positive output growth requires substantial positive contribution of cyclical factors. However, the latter could not be large enough, otherwise causing resurgence of macroeconomic distortions. For instance, if the output pushed by artificially high incomes, this will

cause increase in unit labor cost, while the competitiveness of national producers is sensitive to it. Moreover, expanding domestic demand is still likely to cause growing demand on imports and pressure on consumer prices. Hence, growth of consumption in real terms will be modest, and its positive contribution to output growth will be offset by deteriorating net exports.

This view of the economic dynamics is more in line with a 'big picture' of the national economy. Business models of a large group of firms are totally inconsistent: they are not competitive without direct and indirect support of the state, artificial securing of demand for them, etc. Majority of such enterprises succeeded to improve their current performance and increased output due to palliative associated with the reduction of costs, and some improvements in external environment. However, the burden of accumulated debts suppresses them, while short-term improvements are not sufficient for solving the issue of excessive debt burden. Even tiny aggravation in external environment, increase in debt payments, etc., may cause rapid contraction of output by these firms turning into the decay of the recovery in the economy.

Informational background

Belarus clenched a new political bargain with Russia on economic issues

Since June 2016, Belarus-Russia relationships kept on being tense, because of contradictions in interpreting a fair gas price for Belarus. Russia used cuts in oil supply as an additional tool for pressure on Belarus, and also did it best to delay the tranche of EFSD credit to Belarus. In April 2017, the parties found a compromise. For Belarus, renewing the volume of oil supply has become a key achievement. As for the gas price, it remained unchanged for 2017 (about USD 130 per 1 tcm). But the parties agreed a discount to the price for 2018-2019, although its size and the mechanism of provision are still unclear. Further, Belarus gave up requiring the discount to the price of the gas that has already been supplied throughout 2016-2017, and transferred to Russia a correspondent payable in this case sum of about USD 0.7 bn. At the same time, the parties agreed that Russia will grant a bilateral loan to Belarus for a roughly similar sum. Provision of the loan tranche by the EFSD of about USD 0.3 bn (that should have been granted in autumn 2016 according to the schedule) has become an additional outcome of the bargain. Increased supply of Russian oil will cause short-term favorable impact on output, securing its positive growth rate in 2017Q2. However, other items of the bargain will roughly be neutral for the economy.

National bank tries to struggle against 'masking' the quality of banking assets

In 2017Q1, the NBB issued a regulation which introduces a definition of systemically important borrower into the banking practice. By this prudential novelty, the NBB has made granting loans to such borrowers less attractive for banks. Hence, this measure is expected to promote less concentration of loans among large and often (potentially) problematic borrowers. Such kind of loan concentration is a meaningful feature of the Belarusian case of low quality of banking assets.
The letter by the NBB to commercial banks dealing with the analysis of contraventions detected during the inspections has become one more important event for the banking agenda. In this letter the NBB states openly that banks practice some specific techniques directed at 'masking' real quality of assets. This step by the National bank may be interpreted as the intention to struggle against the issue and NPL challenge in a broader context.

Belarus placed new issuances of Eurobonds

In June Belarus placed two new issuances of sovereign Eurobonds: USD 0.8 bn until 2023 at 7.125% and USD 0.6 bn until 2027 at 7.625%. These funds will enable the country to redeem the previous issuance in January 2018 (USD 0.8 BN) relatively easily, while USD 0.6 bn are assumed to become a support to international reserves.

Output and demand

The bottom in consumption is likely to have been passed

In 2017Q1, some growth signs of household consumption have appeared. This happened for a first time since 2014Q4. Two reasons are behind this trend. First, savings rate has been reducing still. This means that plenty of households consider the reduction of their consumption during last couple of years as unacceptable and they are ready to adjust intertemporal preference in favor of current consumption, in order to prevent its further contraction. Second, real wages have displayed growth, which happened firstly since 2013Q3.

## Domestic demand recovery pushed the qualitative indicators of growth, but actualized risks

As the output growth rate has moved into the positive range, qualitative growth indicators have improved automatically. Alongside, domestic and foreign demand seem to be ex-changing their roles in contributing into GDP growth. Domestic demand is going to become a new 'leader' due to household consumption. This tends to deteriorate the stance of net exports (due to more demand on imports), and generates an impulse for pressure on prices and exchange rate. These trends will automatically restrict the room for output growth and will cause unsustainability of GDP growth indicator.

Contribution to output growth, percentage points

Legend: Personal Consumption Expenditures; Investments; Net exports and other components; GDP growth rate, %
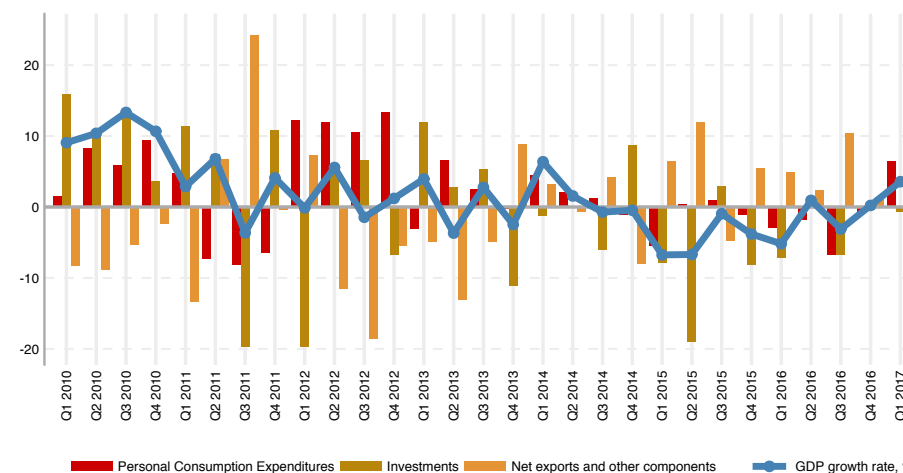
Note: The growth rate of GDP is provided on annualized quarter on quarter basis with a seasonal adjustment; GFCF – gross fixed capital formation.

Quality growth indicators

Legend: Labour productivity, 2013=100; Proxy of return on capital, % (right axis)
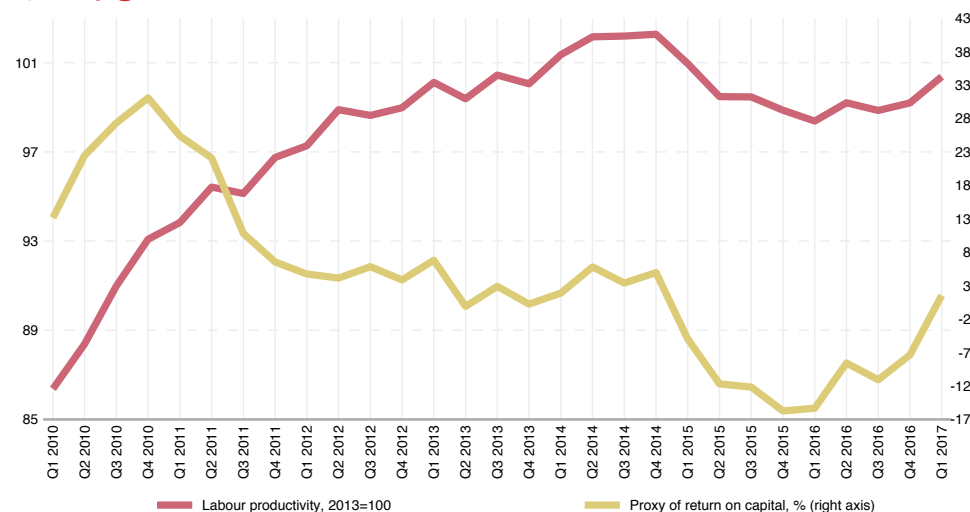
Note: The proxy for the return on capital is calculated as the relationship between annual average output growth and share of GFCF in GDP.
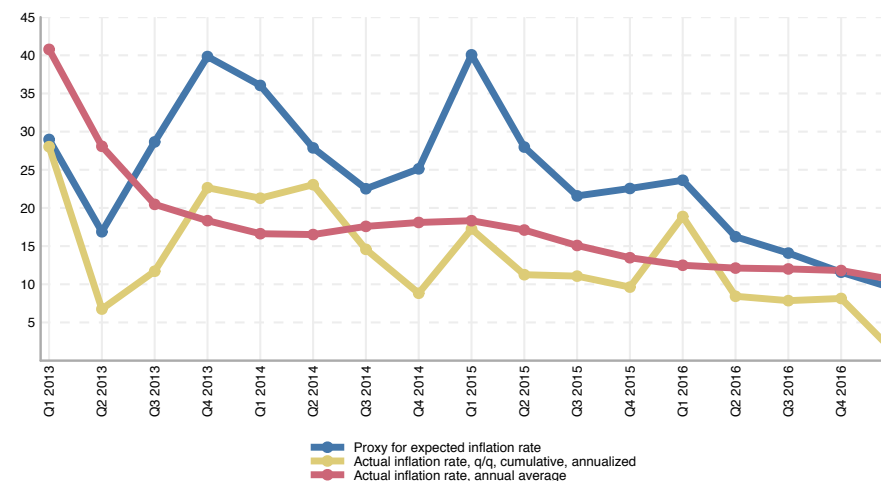
Monetary sector

Inflation is at historical lows

Inflation decreased to extraordinary low level in 2017Q1 (based on Belarusian benchmark). For instance, seasonally adjusted annual level of inflation in 2017Q1 is below 3%. Key factors of such a low level are: protracted depression of domestic demand before 2017Q1, decline in inflation expectations, strengthening of BYN and relatively tight monetary policy of the National Bank. This trend has a twofold interpretation: on the one hand, this could be a successful implementation of the National Bank monetary policy measures, on the other hand, it reflects a depressive state of domestic demand.

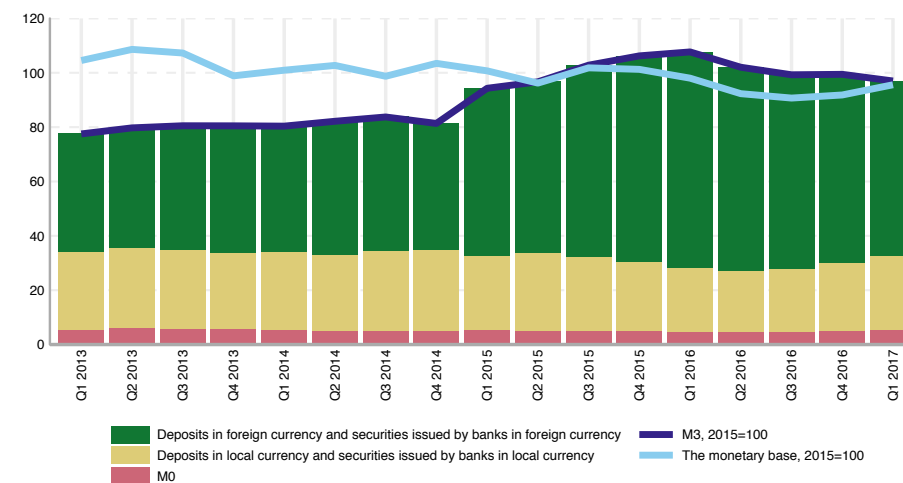## National Bank decreased its policy rate, but market real rates remain high

As a reaction to a low inflation National Bank of Belarus decreased its interest rate by 3 percentage points down to 15% in 2017Q1. However these actions did not secure a similar reduction of market rates in real terms. First, despite large liquidity commercial banks did not decrease loan interest rates at a pace the National bank did. Second, decrease of inflation for some market segments was way bigger then decrease of nominal interest rates. These trends reflect inability of monetary policy to fight against structural weaknesses of national economy.

Inflation and inflation expectations %

— Proxy for expected inflation rate
— Actual inflation rate, q/q, cumulative, annualized
— Actual inflation rate, annual average

Note: Inflation expectation proxy is calculated as difference between interest rates of new savings deposits and call deposits for individuals.

Monetary aggregates

■ Deposits in foreign currency and securities issued by banks in foreign currency
■ Deposits in local currency and securities issued by banks in local currency
■ M0
— M3, 2015=100
— The monetary base, 2015=100

Note: The components of Broad money (M3) correspond to the scale M3 in 2015=100. All the components are seasonally adjusted.

Fiscal sector

Balancing between fiscal stability and poverty reduction

Consolidated budget has still performed a surplus that was used for repayment of public debt principal. However, securing the surplus tends to become more challenging. Consolidated revenues from foreign trade have been decreasing steadily but were offset by other sources of revenue that cause relative stability of total consolidated revenues (as the share of GDP). Alongside, steady growth in social transfers from the expenditure side took place, as this is a major instrument being used by the government to provide certain level of social protection and limit poverty level in the country.

## Public debt burden is the main threat to financial stability

Belarus have to pay in medium-term considerable sums nominated mostly in foreign currency in order to service its debt. For instance, USD 3.4 billion or about 20% of consolidated budget expected revenues has to be paid in 2017. At the same time, part of the budget revenues in foreign currency is significantly lower and comes to about USD 1.5 billion. Hence a permanent refinancing of the public debt is required. Resolving such a debt burden is not likely in near future and this causes a crucial threat to financial stability.

Consolidated budget performance, % GDP
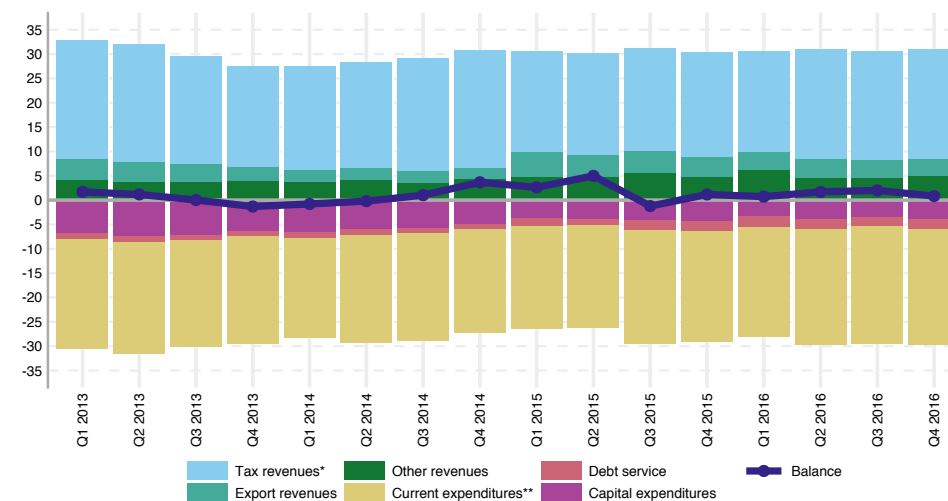
Note: * - without taxes on foreign trade; ** - without debt service. % GDP values are seasonally adjusted.

Public debt, %GDP
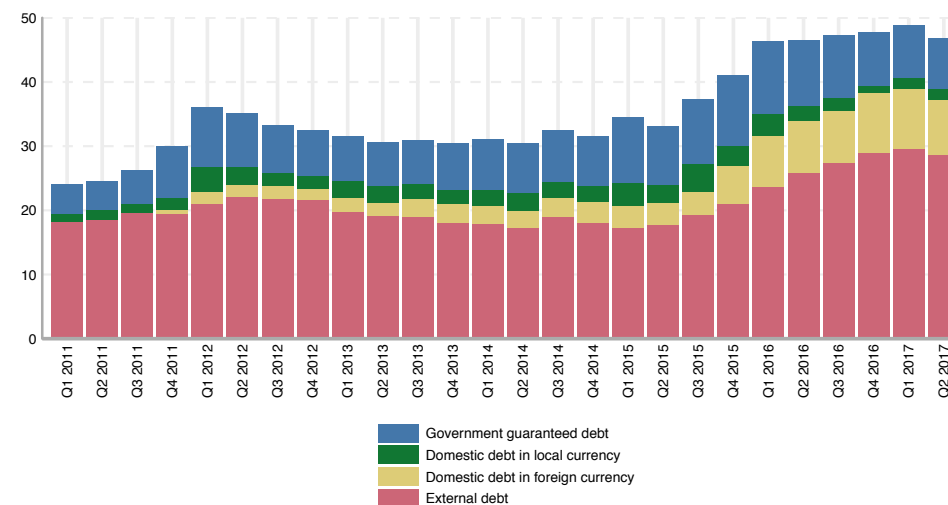
Note: as of the beginning of the quarter.

External sector

External conditions stabilized

In the past 3 quarters prices of Belarusian exports and imports followed identical trend. It is likely that sufficiently stable relative prices depict a new steady-state of foreign markets. For Belarus it means that foreign trade conditions and price competitiveness are not likely to change substantially in upcoming time. Therefore, exports and imports will be determined by non-price factors of competitiveness and trade balance will depend on relation of their physical volumes.

## Global economy growth remains slow, but optimism is rising

In 2017Q1 major world economies showed different trends. In the US, output growth rate slowed down from annual 2.1% in 2016Q4 to 0.7% in 2017Q1. Level of this indicator has not changed in the EU and speeded up slightly in China from 6.7% to 6.9% respectively. Weakening growth in the US may cause concerns, but considered together with other economic indicators the US economy is more likely to strengthen growth in the medium term. This understanding ensured optimism in the global economy that resulted in heavy growth of the world financial markets at a rate of 4.5 – 12 % in the last quarter. The US Fed increased its rate by 0.25% that is now as high as 0.75 – 1%.

External price competitiveness indices, 2013 = 100
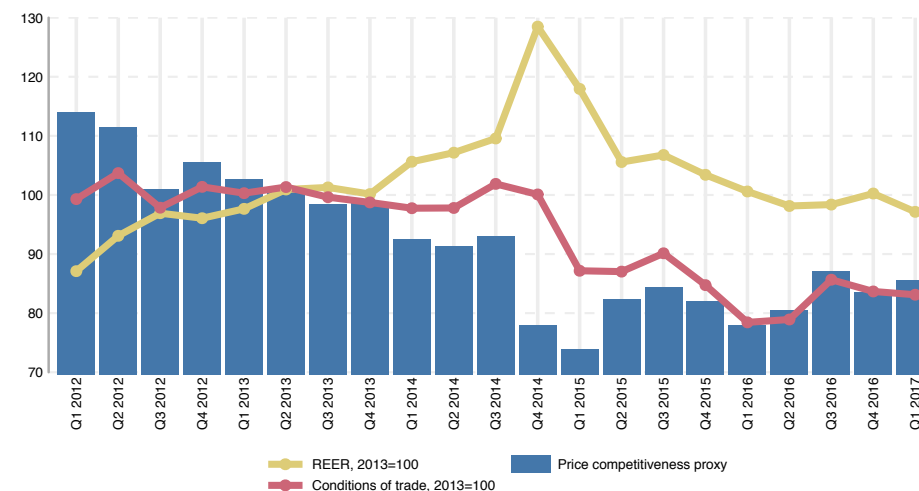
Note: Price competitiveness index is calculated as the product of trade conditions index and reversed REER index multiplied by 100.

Global economic indicators, 2013=100
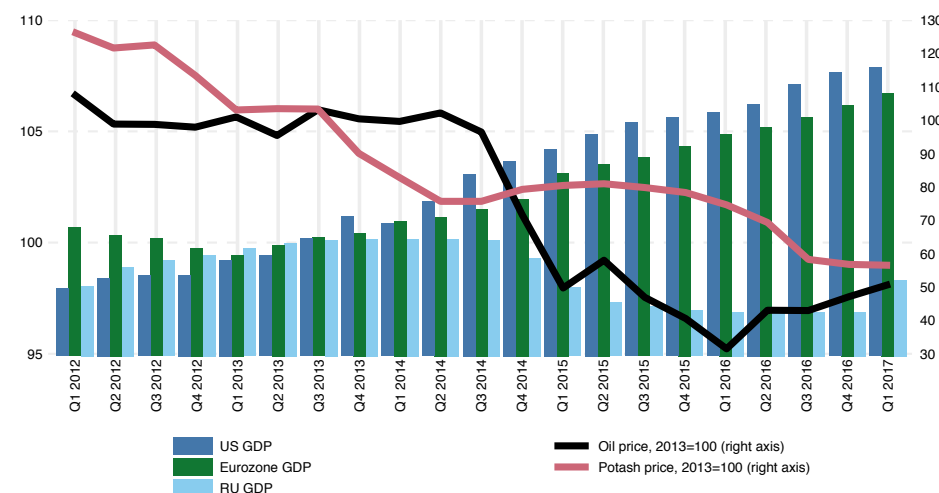
Note: All GDP indicators are seasonally adjusted. Potash and oil price indices are calculated based on corresponding data in the IMF IFS database.

External operations

Physical volumes of imports returned to pre-recession level

Cutting physical volumes of imports was one of the most important part of eliminating of macroeconomic imbalances in the national economy. This approach helped to restore external balance, but was painful because it was associated with decline in the output. Since 2016Q3 physical volumes of imports started to increase and in 2017Q1 it exceeded the pre-crises level of 2013-2014. On the one hand, this fact may be considered as a positive trend meaning the end of recession in Belarus. But on the other hand, such a sharp growth of imports may reflect redundant increase of domestic demand and therefore, unstable recovery.

## Market conditions for foreign borrowing are favorable

Gross external debt (as the share of GDP) reached its historical maximum in 2017Q1. The reason for this was sluggish decrease of level of GDP expressed in the US dollars. Nevertheless, strengthened BYN to USD in 2017Q1 will cause decline of the indicator in 2017Q2. In light of these processes along with a positive trend in the output growth rate sovereign bonds market conditions were favorable for new loans. This favored for the Ministry of finance to issue Eurobonds for USD 800m maturing in 2023 with a 7.125% coupon and for USD 600m maturing in 2027 with a 7.625% coupon.

Prices and volume of international trade, 2013=100
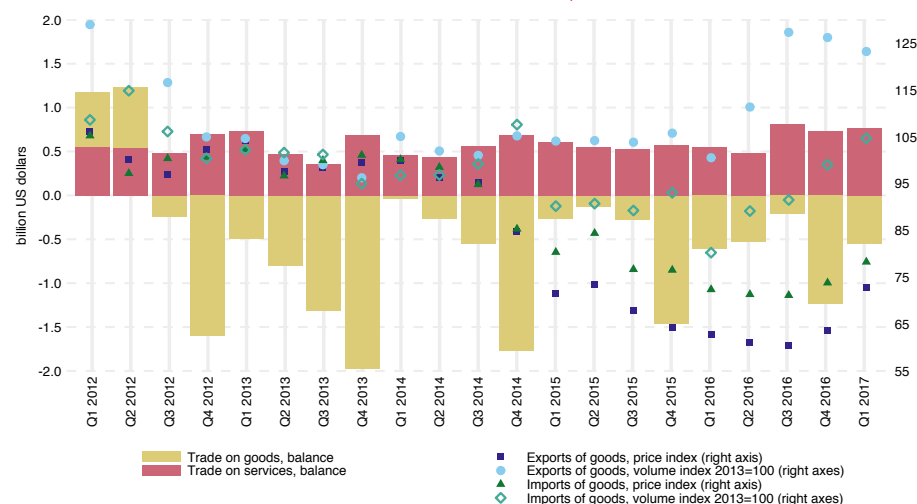
Note: PI – price index; PVI – physical volume index. Indices are seasonally adjusted. Balance of trade in goods and services are not.

The volume and price of foreign borrowings
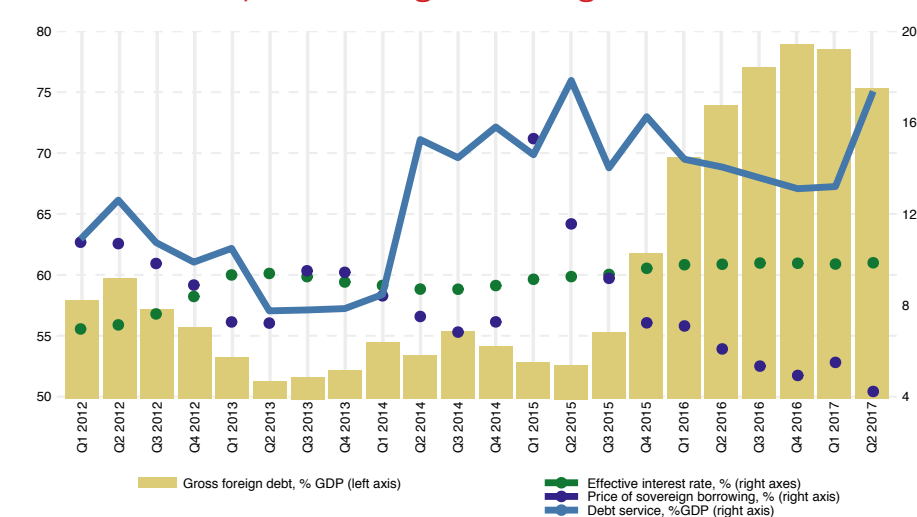
Note: debt service includes interest and principal payments. Effective interest rate is calculated as a ratio of interest paid during past 4 quarters and average amount of debt in this period. Price of sovereign borrowing - an estimate of the yield to maturity on Belarusian Eurobonds 2018.

Social sphere

Labour market is still depressed

Despite discontinuation of output decline in 2017Q1 labor market continues to fall. Number of people employed still surpasses those dismissed. Government's intention to defeat unemployment by May 1 and to increase salary up to BYN 1 000 (approx. USD 500) were not reflected in corresponding trends in statistical data for 2017Q1. Labor market problems along with street protests pushed Government to terminate Presidential Decree #3 (2015), dubbed "the decree against social parasites", which introduced an unemployment tax for those who officially work fewer than 183 days per year.

## Dilemma: to fight against raising poverty level or support macroeconomic stability

Real average wage grew in 2017Q1. Nevertheless instability of economic recovery in conjunction with sensitivity of competitiveness of businesses towards salary growth mean that increase of average real salary in the 1st quarter will not organically mutate into sustainable growth. At the same time, securing steady growth of real wages is considered as crucial by authorities in order to to mitigate social tensions. For instance, the country is experiencing a tendency towards raise of poverty level: in 2017Q1 it raised to 6.0% (from 5.4% a year earlier). The highest poverty levels were traditionally detected in Brest and Gomel regions, 8.7 and 8.1% respectively. Taking into account significant gap between rural and urban population it is likely to expect poverty level in rural parts of these regions being 15-20%.

Employment and new working places

Employment level, 2013=100
New work places created, 2013=100 (right axis)
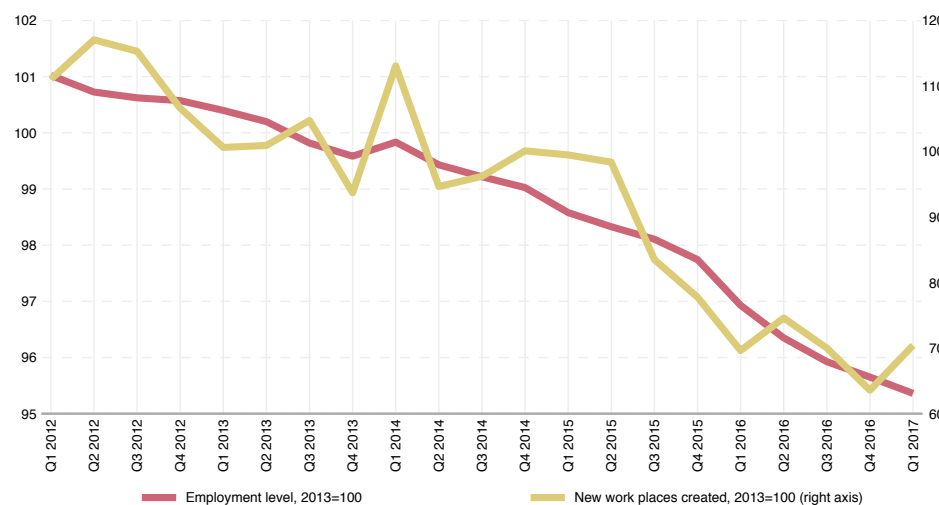
Note: Indices are seasonally adjusted

First category tariff rate and households income

First category tariff rate, q/q, % (left axis)
Real pension (right axis), 2013=100
Real wages (right axis), 2013=100
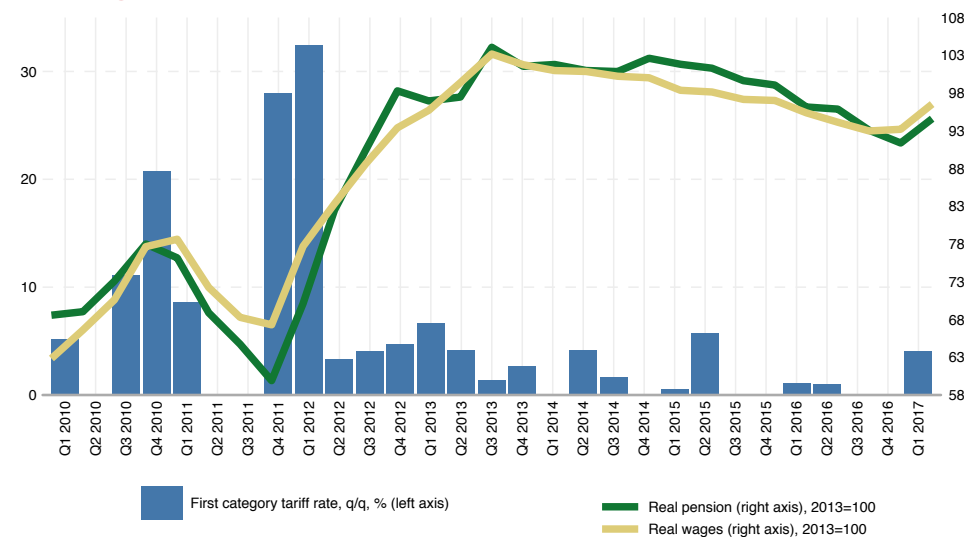
Note: Indices are seasonally adjusted

Technical forecast

Output growth, quarter on quarter, % (annualized)

Technical forecast ▬▬ BEROC experts forecasts, annual average

Inflation rate, annual average, %
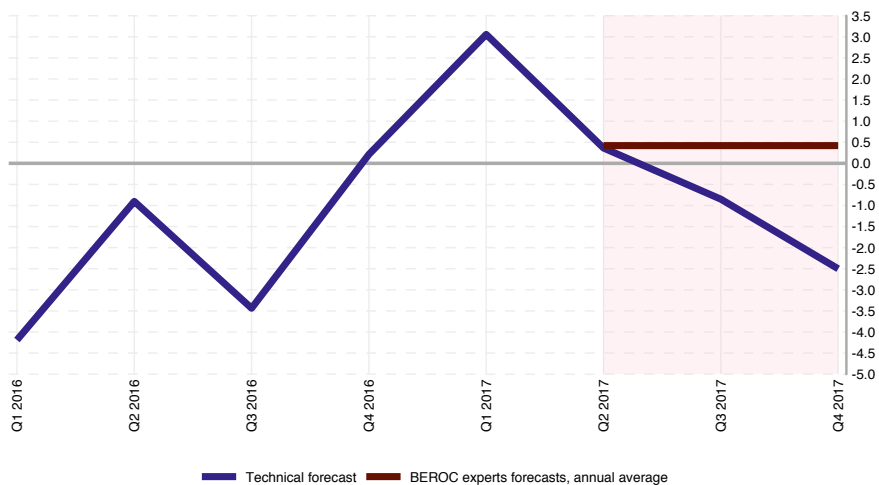
Technical forecast ▬▬ BEROC experts forecasts, annual average

Real wages, 2013 =100

Technical forecast ▬▬ BEROC experts forecasts, annual average
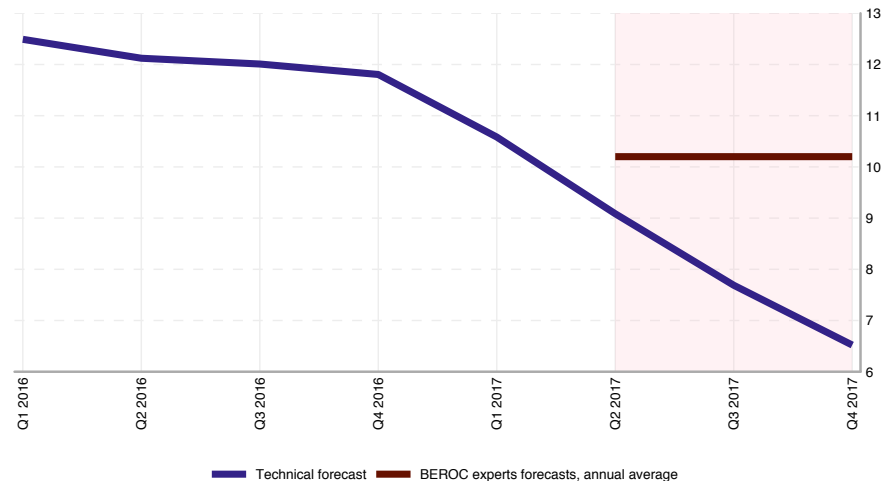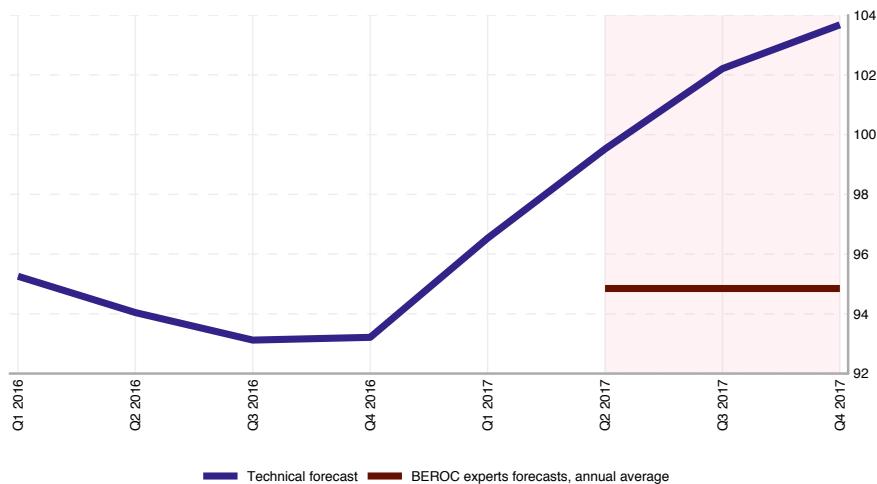
Employment, 2013 = 100

Technical forecast ▬▬ BEROC experts forecasts, annual average
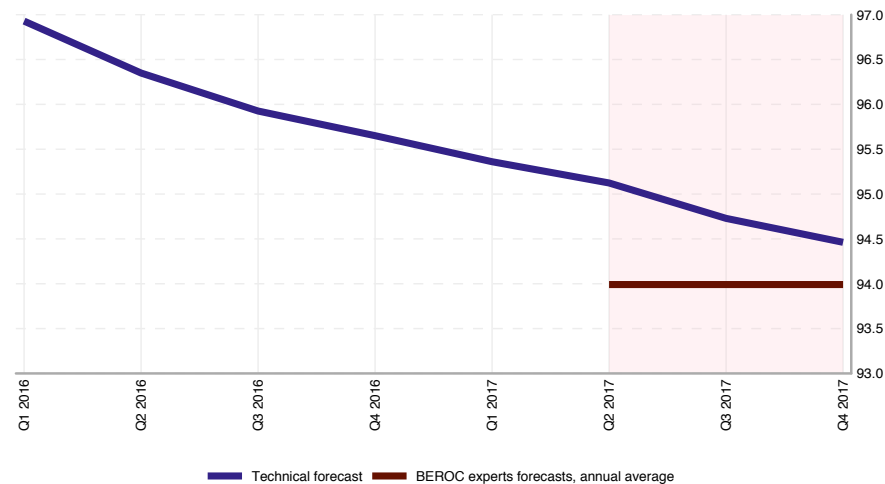
Technical forecast is an automated procedure that selects the best specification of ARIMA model for certain dataset based on Akaike information criterion (AIC) and employs this model for forecasting for 4 upcoming quarters. ARIMA-based forecast just takes into account past trends of selected indicator and doesn't consider other factors, neither in the past nor in the future. "Technical" forecast means that it doesn't include any linkages between economic indicators and is fully based on statistical methods. To correctly interpret this type of forecast one should use it as an answer to the following question: "what would happen with a particular indicator in a short-run period provided that inertial scenario is applied. That is, in case fundamental parameters of economic environment don't change, exogenous factors don't impact the environment and fiscal and monetary policies don't change either".

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International Monetary Fund (**www.imf.org**)

R Core Team (2016). R: A language and environment for statistical computing. R Foundation for Statistical Computing, Vienna, Austria. URL **https://www.R-project.org/**.

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