BELARUSIAN MACROECONOMIC FORECAST

No. 2(13), November 2016

Macroeconomic adjustment leads to a prolonged recession

Executive summary

GDP: We expect the recession to continue in 2016 and 2017; real output will shrink by 2.8 and 0.9%, respectively. From a longer term view, this scenario implies huge economic costs: In comparison to 2014, output will drop by 2017 by more than 7%. However, there are still a number of downside risks even to this rather pessimistic scenario: High NPLs might become a challenge to financial stability, and the high debt burden poses further risks.

Monetary environment: Under the baseline scenario, we expect the maintenance of relative financial stability. Inflation will be about 10-12% in 2016-2017, with a similar adjustment of the exchange rate. However, high NPLs (non-performing loans) and high debt pressure (both for firms and the government) may lead to a different scenario, and create new turbulence in the domestic financial market.

Public finances: The general government budget (according to the national definition) is expected to run a surplus of 0.2% of GDP in 2016, which is going to turn into a deficit of 0.7% of GDP in 2017. This dynamics is explained by a fall in revenues caused by the contraction of the real sector and a fall in export duties on oil products. Reduced fiscal space promotes the revision of public expenditures from support to the real sector to social policy financing.

Balance of payments: We expect that in 2016 the current account deficit will worsen in comparison to 2015, mainly due to unfavorable dynamics of export and import prices. Hence, we project that the current account deficit will amount to USD 2.6 bn, or 5.7% of GDP. The level of the current account deficit might be roughly constant in both absolute and relative terms in 2017. With respect to the financial account, we project a net inflow of about USD 2.8 and 3.3 bn in 2016 and 2017, correspondingly.

Key forecast figures

	2013	2014	2015	2016E	2017F
Real GDP, % yoy	1.0	1.7	-3.9	-2.8	-0.9
General government balance, % of GDP*	0.1	1.1	1.4	0.2	-0.7
Current account balance, % of GDP	-10.3	-6.7	-3.8	-5.7	-5.7
CPI, % yoy (aop)	18.3	18.1	13.5	11.8	10.5
Gross external debt, % of GDP**	54.2	52.6	72.5	89.2	95.0

* Including Social Security Fund
** Gross external debt at the end of the period in relation to annual GDP in US dollars
Sources: National Statistical Committee, NBB, GET estimates and forecasts 2016–2017.

Forecast calculations were completed in November 2016. Next revision is scheduled for May 2017.

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MACROECONOMY

Macroeconomic adjustment meets structural weaknesses

Over the course of the year 2016, the consensus view on the performance of the Belarusian economy has significantly changed. At the beginning of the year, the expected recession was treated as somehow inevitable and the lesser evil (say, in comparison to financial turmoil given financial fragility). From an economic policy perspective, the expected recession could be considered as a combination of (i) a cyclical slowdown due to restrictive policies oriented at enhancing financial stability and (ii) some structural reasons that reflects poor fundamentals and a worsened external environment. However, the cyclical component seemed to be the main cause of the 2016 recession. Hence, one was expecting that once the necessity of restrictive policy measures disappears (say, due to some financial stabilization), the cyclical slowdown will automatically turn into expansion, causing the end of the recession. Moreover, this view assumed that enhancing trust in financial stability will not require much time.

However, there are more and more signs that the economy has taken a different turn than previously expected. First (and most important), apart from strengthening financial stability, restrictive measures have simultaneously caused a structural reduction of the national economy. For instance, fewer obligations to grant directed loans have actually become beneficial for banks and facilitated financial stability. But the other side of the coin, which is felt in the real sector, was not only a temporary fall in investments (that were previously financed by such loans). Many enterprises (mainly state-owned) found themselves totally inviable without such forms of support. In the end, such tightening measures in economic policy caused not only a cyclical slowdown, but also a structural slowdown at the same time. The latter means that some firms not just shrink their production but close it down altogether. Hence, the recession is going to be driven more and more by structural factors, rather than by cyclical ones. Thus, the most important challenge for today's agenda is how deep such structural adjustment may be, and how long it may take.

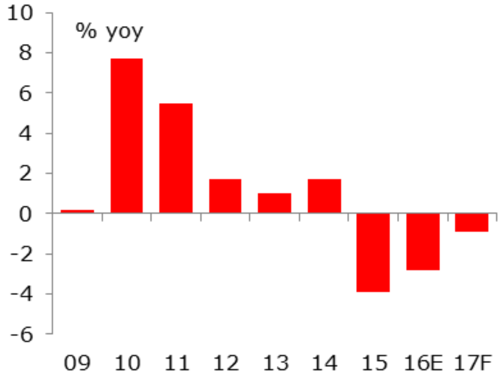
Second, the hope for a rapid boost due to a loosening of financial conditions seems to have failed. Although the NBB tries to lower nominal interest rates, their real level remains definitely high. Hence, economic policies are rather tight, which means that the exit from the cyclical slowdown is going on slower than it could be.

Third, a long period of recession itself generates new challenges, which can finally form a kind of vicious circle. For instance, the recessionary environment leads to deteriorating asset quality (both public and private). The latter, in turn, puts a limit on new lending, which creates a new impulse for a slowdown.

These trends are likely to carry the recessionary environment well into 2017, even though the magnitude of the GDP fall is becoming smaller. The recession that was expected to be not so deep and long is indeed becoming deeper and longer.

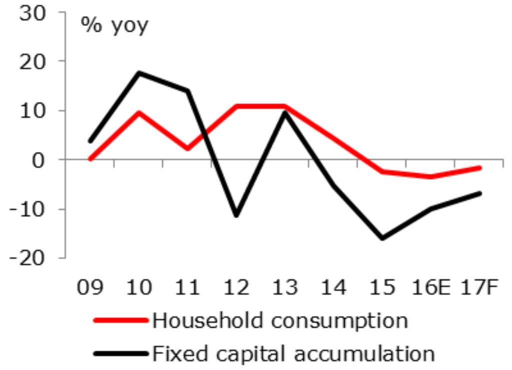
From the demand side, the trends depicted above are going to be reflected in a reduction of roughly all components, but with a major role of capital investments. The firms are reluctant to invest, having in mind the poor growth potential and low expected returns on investments even in case of an improving external environment. From this view, depressed investments may be treated as the reflection of structural weaknesses and lack of growth engines. Furthermore, the reluctance to invest is strengthened by a high level of real interest rates, which have to be maintained by the authorities in order to secure relative

Real GDP growth



Source: National Statistical Committee, GET estimates and forecasts 2016–2017.

Household consumption and fixed capital accumulation



Source: National Statistical Committee, GET estimates and forecasts 2016–2017.

Contributions to GDP Growth

	2015	2016E	2017F
GDP	**-3.9**	**-2.8**	**-0.9**
Household consumption	-1.6	-2.3	-1.1
Gross fixed capital formation	-5.9	-3.3	-2.1
Net exports	5.3	3.1	2.2
Other components+ statistical discrepancy	-1.7	-0.3	0.1

Note: Contribution to growth – in percentage points of GDP

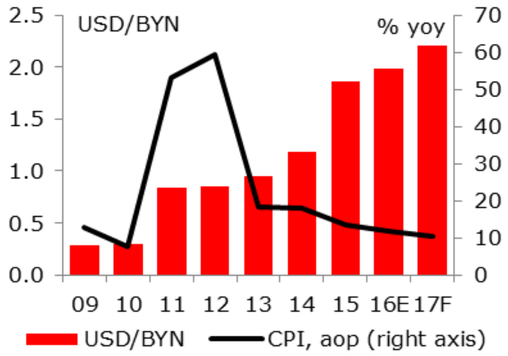
Source: National Statistical Committee, GET estimates and forecasts 2016–2017 price and financial stability. In 2016, we expect that gross capital formation will decrease by 10.1% (after roughly 20% reduction throughout 2014-2015), causing a negative contribution to GDP by 3.3 percentage points. The same trend is going to be maintained in 2017 as well: We expect gross capital formation to shrink by 7.0%. From a long-term view, this trend is going to facilitate the adjustment of the capital stock to a more reasonable level, given excessive and unproductive building of capital in previous years.

Expenditures for household consumption adjusted somehow throughout 2016. But this adjustment was mitigated by the rapidly increasing share of consumption in income (and a correspondingly lower savings ratio). In other words, in 2016 households seem to smooth their consumption, hoping for income recovering in the near future. However, a continuation of wage contraction in 2017 is likely to be accepted as a 'new reality', which is to cause further adjustments in household consumption. Thus, we expect that in 2016 household consumption will contract by 3.5%, followed by another 1.6% in 2017.

In foreign trade, an accomplishment of adjustments to a 'new normality' is going to occur throughout 2016-2017. The bulk of such adjustments have already happened, due to a floating exchange rate regime and the low level of oil prices. The mechanism of such adjustment – lower foreign demand for Belarusian goods, lower export prices, and less domestic demand, delivering a more than proportional cuts in imports – will persist. However, its focus will be shifted to the relationship between domestic demand and demand for imported goods. Due to these mechanisms, we project net exports to provide a positive contribution to GDP dynamics in 2016 (3.1 percentage points), followed by another 2.2 percentage points in 2017.

The described scenario for the dynamics of demand components implies that the recession will continue in 2016 and 2017: Real GDP is going to fall by 2.8% and 0.9% correspondingly. From a longer term view, this scenario means a long (3 year) recession, causing a rather severe output drop (by 7.5%, 2017 vs. 2014) and a corresponding deterioration of well-being.

Exchange rate and prices



Source: NBB, GET estimates and forecasts 2016–2017

MONETARY ENVIRONMENT

Public and private debts are prior issues of concern

As a baseline scenario in the monetary sphere, we expect a continuation of rather tight policies embodied in restricting monetary aggregates. The constrained growth of broad money along with the 'autonomous' part of demand contraction will secure the maintenance of the disinflation trend. However, due to adjustments of regulated prices and tariffs, the absolute level of inflation will still be relatively high. On an annual average basis, we expect that CPI inflation will amount to 11.8% and 10.5% in 2016 and 2017, correspondingly. At the same time, we project a certain adjustment to the exchange rate of Belarusian ruble, which will follow closely the dynamics of inflation.

However, we emphasize a number of risks that may lead to financial instability and might cause a much higher inflation. First, this is the issue of NPLs. Although there is some institutional progress in this respect (e.g. the establishment of a special Agency for agricultural NPLs, the initiative of the National Bank to endow more powers to creditors, etc.), there is still no systemic response to this major challenge. Hence, the issue of NPLs may be treated as a trigger for a new domestic money market shock and/or for changes in the monetary policy (for instance, the National Bank might activate an option of considerable injections of liquidity into troubled banks, given the lack of other feasible solutions). Second, the increasing public debt burden (while this debt is mainly nominated in foreign currency) and the lack of stable hard currency revenues of the government may also cause shocks for the domestic financial market.

PUBLIC FINANCES

Continued challenges to fiscal policy

The contraction of the economy automatically leads to a reduction of the tax base. In order to sustain the level of consolidated budget revenues, the government revised the system of tax privileges. In 2016, the most significant changes have occurred in legislation on VAT, as utilities are no longer exempted from this tax. This measure is expected to compensate for a reduction in VAT revenues that occurred in 2015 (by 0.6% of GDP). An increase of excises is another measure aimed at restoring the pre-crisis level of related revenues. First of all, a reduction of oil prices provides space for an increase of excises on fuel. An increase in revenues from excises on beverages is expected only in 2017, as the financial stance of the sector is rather weak. These measures will allow avoiding a reduction of consolidated budget revenues in 2016–2017. Furthermore, a fall of revenues from petroleum export duties (to around USD 0.75 bn) will not statistically affect the budget in relative terms, due to falling GDP in USD terms.

Despite some facilitating trends in revenue dynamics, the fiscal authorities have to be definitely more conservative in respect to expenditures, given a higher and further increasing debt burden. A lower nominal GDP (especially in dollar terms) makes servicing public debt more challenging for the fiscal position of the government. For principal repayments, the authorities have to secure a consolidated budget surplus if refinancing options are limited. Hence, we project a reduction of the expenditure lines that are related to the public support to the economy, including the housing and utilities sector. However, the scale of this reduction is limited, as it entails financial stress to the sector of state-owned enterprises and the banking sector in the short-run. Social expenditures, on the contrary, will remain at the level of 2015, as the state is expected to increase support to socially vulnerable groups affected by crisis.

BALANCE OF PAYMENTS

Increase in the current account deficit

We expect that in 2016 both goods exports and imports will contract at approximately the same rate, which will result in a higher merchandize deficit of USD 3.0 bn. It is the result of a continued contraction of Russia's economy, which leads to decreasing sales of Belarusian capital goods, i.e. machines and equipment, as well as consumer goods. The fall in exports to non-CIS countries will be caused by the cutback of trade in petroleum products and potash fertilizers due to falling prices. The fall in imports will stem from a reduction of the supply of capital, intermediate, and consumer goods both from Russia and non-CIS countries due to a shrinking of domestic demand. In 2017, we forecast that both exports and imports will decrease modestly in nominal terms (about 1% each) and the deficit of the balance of merchandise trade will shrink down to USD 2.9 bn.

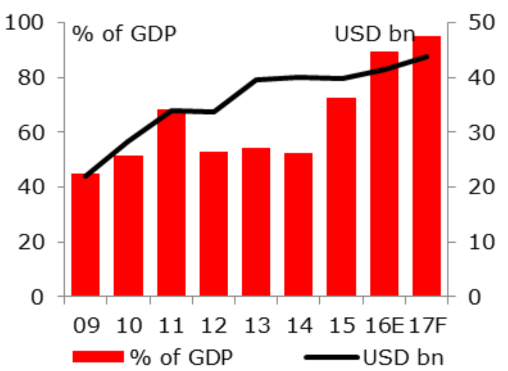
In 2016 and 2017, the balance of trade in services will be positive at around USD 2.4 bn and 2.5 bn, respectively.

Fiscal indicators, % of GDP

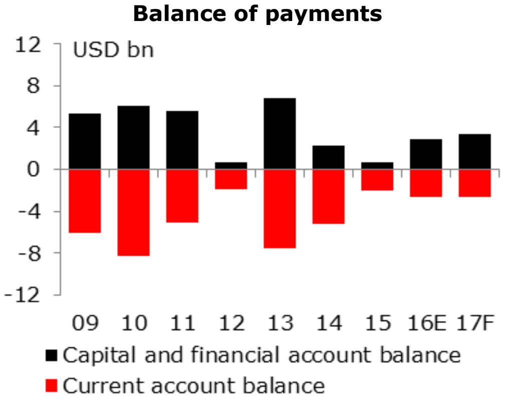
	2015	2016E	2017F
Consolidated revenues	30.6	30.6	30.5
Consolidated expenditures	28.8	29.8	30.4
Consolidated budget balance	1.8	0.8	0.1
Social Security Fund balance	-0.4	-0.6	-0.8
General Government balance	1.4	0.2	-0.7

Source: Ministry of Finance, GET estimates and forecasts 2016–2017

Note: Growth in USD
Source: National Statistical Committee, GET estimates and forecasts 2016–2017



Source: NBB, National Statistical Committee, GET estimates and forecasts 2016–2017



Source: NBB, National Statistical Committee, GET estimates and forecasts 2016–2017

The service export growth will come from an increase in oil and gas transit and transportation services, while service import growth will be supported by an expansion of construction, financial services, and royalties. We expect that the balance of trade in goods and services will be slightly negative, amounting to USD -0.5 bn in 2017 and -0.3 bn in 2017.

We expect that the balance of primary incomes will be negative in 2016 and 2017 as a consequence of the increase of interest payable under general government and non-financial sector obligations, including debt service in the banking and nonfinancial sectors, and income payments on FDI. The balance of secondary income will turn positive in 2016 and 2017, because the inflow of customs duties accrued according to the agreement between Russian, Belarus and Kazakhstan on the distribution of import customs duties exceeds the amount transferred to the account of the authorized agency in the Eurasian Economic Union.

We expect that in 2016 the negative current account balance will widen to USD 2.6 bn, or 5.7% of GDP, mainly due to worsened terms of trade. In 2017, we expect roughly the same figures in both absolute and relative terms.

Capital and financial account: Repayments stay in focus

We expect that in both 2016 and 2017, the net FDI inflow will be approximately at the same level as in 2015 (USD 1.4 bn in 2016 and USD 1.3 bn in 2017). The FDI inflow will be mainly attributed to reinvested earnings, and less to acquisition of equity capital in industry, banking and service sectors.

In 2017, the necessity of principal repayment of external debt under previously attracted loans will influence the balance of the other investment account, and will raise liabilities to non-residents due to new borrowings. For instance, we expect that the government will manage to almost fully refinance its FX debt due in 2017 (both external and domestic), either due to a possible loan from the IMF, or through other options if the IMF funds will not be available. In the latter case, a new issuance of Eurobonds might take place as a kind of finance of last resort; the Ministry of Finance argued recently that they consider the option of a new issuance in 2017.

Annex. Tables

		2013	2014	2015	2016E	2017F
Table 1. GDP						
Nominal GDP	BYR bn	649 111	778 095	869 702	892 407	965 477
	USD bn	73.1	76.2	54.8	46.5	46.2
Real GDP	% yoy	1.0	1.7	-3.9	-2.8	-0.9
Household consumption	% yoy	10.9	4.3	-2.4	-3.5	-1.6
Public consumption	% yoy	-2.1	-2.0	-0.4	-1.2	2.6
Gross fixed capital formation	% yoy	9.6	-5.3	-15.9	-10.1	-7.0
Exports	% yoy	-17.4	14.7	1.0	3.5	1.6
Imports	% yoy	-6.1	9.4	-6.3	-1.2	-1.5
Table 2. Fiscal Indicators*						
Consolidated budget revenues	BYR bn	189 232	219 281	266 321	273 315	294 212
	% of GDP	29.2	28.2	30.6	30.6	30.5
EPT revenues	BYR bn	21 525	19 994	21 819	20 999	22 353
	% of GDP	3.3	2.6	2.5	2.4	2.3
VAT revenues	BYR bn	56 223	69 829	72 670	78 669	85 111
	% of GDP	8.7	9.0	8.4	8.8	8.8
PIT revenues	BYR bn	26 992	32 092	37 009	39 639	43 323
	% of GDP	4.2	4.1	4.3	4.4	4.5
Consolidated budget expenditures	BYR bn	187 751	211 154	250 377	266 173	293 401
	% of GDP	28.9	27.1	28.8	29.8	30.4
Current expenditures	% of GDP	22.5	21.8	23.8	25.8	27.0
Capital expenditures	% of GDP	6.8	5.5	4.2	4.1	3.4
Consolidated budget balance	% of GDP	0.2	1.0	1.8	0.8	0.1
Social Security Fund balance	% of GDP	-0.1	0.0	-0.4	-0.6	-0.8
General government balance	% of GDP	0.1	1.1	1.4	0.2	-0.7
Table 3. Balance of Payments and External Debt						
Current account balance	USD m	-7567	-5 222	-2 074	-2630	-2617
	% of GDP	-10.3	-6.9	-3.8	-5.7	-5.7
Export of goods	USD m	36 540	35 423	26 190	24 423	24 210
Import of goods	USD m	41 134	38 059	28 327	27 381	27 072
Balance of services	USD m	2 253	2 153	2 312	2 425	2 542
Financial account balance (analytical view)	USD m	6 755	2 260	678	2 836	3 331
Foreign direct investments (FDI), net	USD m	1 984	1 789	1 466	1 450	1 337
Portfolio investments	USD m	-20	-968	0	0	0
Gross external debt	% of GDP	54.2	52.6	72.5	89.23	95.0
Table 4. Money, Inflation and Exchange Rate						
Base money	%, yoy eop	13.4	13.8	14.9	13.4	2.2
CPI	%, yoy aop	18.3	18.1	13.5	11.8	10.5
Exchange rate, USD/BYR (USD/BYN)*	aop	8 876	10 216	15 865	1.98	2.20

* - Since 2016, the exchange rate is presented as USD/BYN instead of USD/BYR, i.e. in respect to a denominated (new) Belarusian ruble (10.000 BYR = 1 BYN)

Sources: National Statistical Committee, Ministry of Finance, NBB, GET estimates and forecasts 2016-2017.

Notes:

aop	average of period	NBB	National Bank of Belarus
avg	average	p.a.	per annum
bn	billion	PIT	personal income tax
eop	end of period	VAT	value added tax
EPT	enterprise profit tax	yoy	year-on-year
m	million	ytd	year-to-date

Annex. Assumptions of the forecast

- World prices for crude oil (oil basket) will be USD 48 per barrel on average in 2016 and USD 50 in 2017.
- Belarus will get 22 m t of crude oil from Russia in 2016 and 23 m t in 2017.
- The actual prices of imported gas from Russia will be USD 105 and 100 per tcm (annual average) in 2016 and 2017, correspondingly.
- In 2016 and 2017 the government will obtain about USD 1.0 and 0.9 bn of oil duties correspondingly, and will attract about USD 3.0 and 2.5 of new borrowings on a gross basis.
- Russian real GDP will decrease by 0.9% yoy in 2016 and will display 0.5% growth in 2017.

About the German Economic Team Belarus (GET Belarus)

The main purpose of GET Belarus is to conduct a dialogue on economic policy issues with the government, civil society, and international organizations. Experts of German Economic Team have experience in policy advice in several transition economies, including Ukraine, Russia, and Moldova. In Belarus the IPM Research Center and the German Economic Team provide information and analytical support to the Council of Ministers, the National Bank, the Ministry of Foreign Affairs, the Ministry of Economy and other institutions involved in the process of formation and implementation of economic policy.

About the IPM Research Center

The IPM Research Center was established in 1999 within the mutual project of the Institute for Privatization and Management (Minsk, Belarus) and CASE - Center for Social and Economic Research Foundation (Warsaw, Poland). It is a member of the CASE research network, William Davidson Institute NGO Alliance, and Economic Policy Institutes Network (project of the UNDP's Regional Bureau for Europe and the CIS). The IPM Research Center actively cooperates with the German Economic Team Belarus (GET Belarus). Within this cooperation the IPM Research Center provides independent policy advice on economic issues to the different official agencies, namely to the Council of Ministers, National Bank, Ministry of Economy, Ministry of Finance and other organizations involved in the process of formation and implementation of economic policy.

The Mission of the IPM Research Center is to enhance national competitiveness through elaboration of the research-based economic policy recommendation and the promotion of professional dialogue on the urgent issues related to economic performance.

Activities

- Regular analysis of the economy of Belarus;
- Monitoring of main sectors of the economy;
- Promotion of professional dialogue between Belarusian and German experts on important issues for the economic development of Belarus.

Analytical materials

Current research products and publications of the project are available via the Internet:

http://research.by/get and www.get-belarus.de