BELARUSIAN MACROECONOMIC FORECAST

No. 1(8), June 2014

Growth is set to recover slowly, but external imbalances will remain

Executive summary

GDP: We expect that in 2014 and 2015 Belarus will display modest growth of output: 2.1% and 3.0%, respectively. This growth recovery will be due to cyclical factors: foreign demand is set to revive somewhat, while in the domestic economy investment demand is likely to expand gradually. This combination will secure some improvements in net exports in 2014, while in 2015 the problem of the external deficit will arise again. During both 2014 and 2015, output growth is conditioned on the access to affordable foreign borrowings. However, this path seems to be dangerous, as potential growth is still weak and structural weaknesses might deteriorate. Furthermore, there is a threat that the debt burden might become a problem for further development.

Monetary environment: The authorities intend to counter the problem of external imbalances by softening exchange rate policy. Through this we expect a gradual depreciation of the exchange rate in 2014 (up to 11 000 USD/BYR by the end of the year) and 2015 (up to 12 500 USD/BYR by the end of the year). This will allow preventing a further appreciation of the real effective exchange rate, although the gap between the actual rate and the equilibrium one is likely to sustain. The gradual depreciation will lead to additional pressure on prices. We expect annual average CPI inflation of 17.8% in 2014, and 13.2% in 2015.

Public finances: The consolidated budget is expected to run a deficit of 1.4% of GDP in 2014, as the stance of the economy emphasizes the need for some fiscal stimulation. However, the scale of stimulation will be small and limited to public investments growth, as inflation risks are high. An anticipated inflow of USD 1.5 bn of saved oil export duties in 2015 will significantly improve the situation in the public finance sector, generating a surplus of 0.3% of GDP.

Balance of payments: In 2014 the current account deficit will be around USD 7.4 bn, or 10% of GDP, about the same level as last year. In 2015 it will shrink slightly to USD 6.8 bn (8.9% GDP) due to a reduction of the negative balance of secondary incomes. We forecast that net FDI inflow will be around USD 1.9 bn in 2014 but will increase to USD 2.3 bn in 2015. We expect the capital and financial account balance to be in surplus at USD 7.6 bn in 2014 and at USD 7.7 bn in 2015.

Key forecast figures

	2011	2012	2013	2014F	2015F
Real GDP, % yoy	5.5	1.7	0.9	2.1	3.0
Consolidated budget balance, % of GDP*	2.1	0.5	0.2	-1.4	0.3
Current account balance, % of GDP**	-10.2	-3.3	-10.0	-10.0	-8.9
CPI, % yoy (aop)	52.3	59.2	18.3	17.8	13.2
Gross external debt, % of GDP**	68.5	53.6	53.8	60.5	67.0

* Social Security Fund is not included.
**Based on the average annual exchange rate in 2011 (5984 USD/BYR).
Sources: National Statistical Committee, NBB, Minfin, GET forecasts

Forecast calculations were completed in June 2014. Next revision is scheduled for December 2014.

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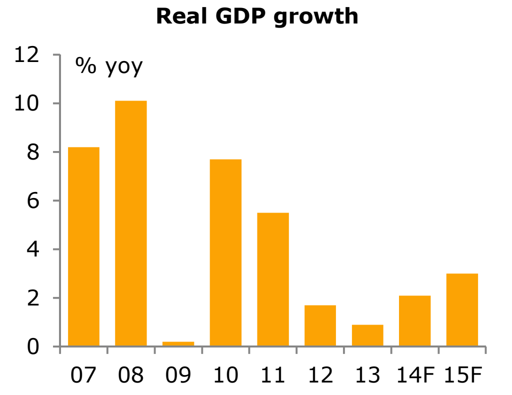
MACROECONOMY

Growth tends to recover, but remains weak

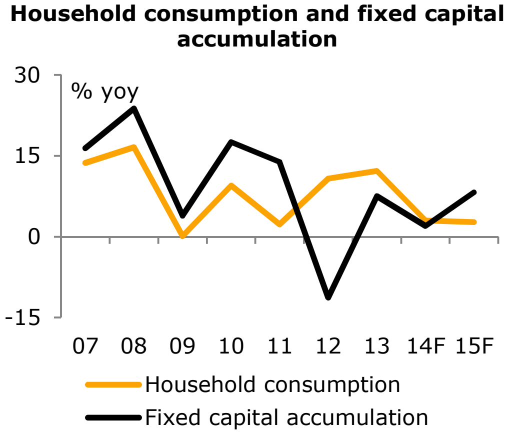
Disappointing results of 2013 have been a product of both structural weaknesses of the Belarusian economy and short-term challenges. Different approaches of the assessment of the potential output growth rate provide estimates between 1.5 and 4%. Given a cyclical phase of recession in 2013, the actual output growth rate has become lower than the potential one. The cyclical recession, in turn, stemmed from a number of channels. First, there were domestic ones consequent to the inheritance of the currency crisis in 2011. Since then, inflation and devaluation expectations have been pretty high and volatile, which determined high and volatile interest rates on the financial market. This caused a depression of capital investments, given the lack of accessible and affordable financial sources for them. Second, the government intended to secure high growth of real wages. On the one hand, it helped to expand consumer demand. But on the other hand, due to increasing costs on salaries and wages, Belarusian producers faced a loss in competitiveness, which resulted in shrinking foreign demand. Third, in some markets, foreign demand contracted given other exogenous shocks. For instance, the 'potash war' between Belaruskali and Uralkali led to a sharp contraction in exports of Belarusian potash fertilizers.

The prospects for 2014 are ambiguous in many senses. First, the structural weakness (and correspondingly low growth potential) is still a huge problem for Belarus. However, a long-term trend of declining potential growth rate seems to have been stopped, and the potential growth is likely to stabilize around current values. Furthermore, new initiatives by the government (enhancing more competitiveness between state-owned and private firms, less directed lending, etc.) may somehow strengthen growth potential (although such actions are still sporadic and far from a systematic structural reform approach of the economy). Second, some engines of cyclical recession are likely to have been (or will be) mitigated. For instance, there are certain improvements in respect to foreign demand: some foreign markets of capital goods demonstrate the signs of recovery in comparison to previous year (tractors, trucks); the supplies of potash fertilizers are expanding in physical volumes, given the market shutdown in the previous year. Moreover, in the first quarter of 2014 Belarus succeeded to restrict imports of non-energy intermediary goods considerably (although it is still not clear how sustainable this trend is and which factors are behind this trend), which further improves foreign demand on a net basis. In the domestic economy, although the environment in financial markets is still vulnerable, the authorities are somehow successful in reducing interest rates and enhancing more financial sources for capital investments. However, it should be admitted that the latter trend is gradual and there are no grounds for a sharp increase in capital investments, unless a significant portion of foreign investments will be secured. These trends in 2014 seem to secure a modest growth of GDP accompanied with slight improvements in net exports. Nevertheless, external imbalances are to remain a core challenge for the national economy, as their level is extremely high. As in previous years, foreign borrowing is to become 'a medicine', which is expected to secure growth accompanied by a huge foreign deficit.

Thus, for 2014 we expect a small growth of 2.1%. We expect that household consumption and net exports will be the core contributors to this growth, while the reduction of inventories is likely to contribute negatively.



Source: National Statistical Committee, GET forecasts 2014–2015.



Source: National Statistical Committee, GET forecasts 2014–2015.

Contributions to GDP Growth

	2013	2014F	2015F
GDP	**0.9**	**2.1**	**3.0**
Household consumption	7.1	2.0	1.8
Gross fixed capital formation	2.8	0.8	3.2
Net exports	-7.6	2.9	-0.3
Other components+ statistical discrepancy	-1.4	-3.5	-1.7

Note. Contribution to growth – in percentage points of GDP.

Source: National Statistical Committee, GET forecasts 2014–2015.

Given the lack of structural reforms, a similar picture of economic development is likely to sustain in 2015. The main distinction in comparison to 2014 might be a more active stimulation of wages and salaries, which is traditionally peculiar in election years. However, this time the scope of such expansionary policies is likely to be more modest, given the range of fragilities in the national economy. Given this background, we expect some further improvements in the growth rate in 2015, which however is again to be secured by a new portion of external borrowings. Furthermore, according to our projections, the trade deficit will keep on growing in 2015 (after its contraction in 2014), which will be mitigated by a new inflow of funds associated with the Belarusian part of oil duties (from 2015 onwards, Belarus and Russia announced a preliminary agreement to split oil duties between the countries, while previously all the duties were channeled to be Russian budget).

We expect a growth rate of 3.0% in 2015, which will be mainly secured by gross capital formation (capital investments) and household consumption. At the same time, net exports are going to be a leading negative contributor to GDP growth from the demand side.

The described path of the economy in 2014-2015 can hardly be characterized as sustainable development. Moreover, along this path a number of current 'troubles' might progress (adverse migration (i.e. accompanied with losses in human capital), loss of technological competitiveness, narrowing of export basket). Furthermore, this path is dangerous because of a potential debt burden, which might hamper growth in subsequent years.

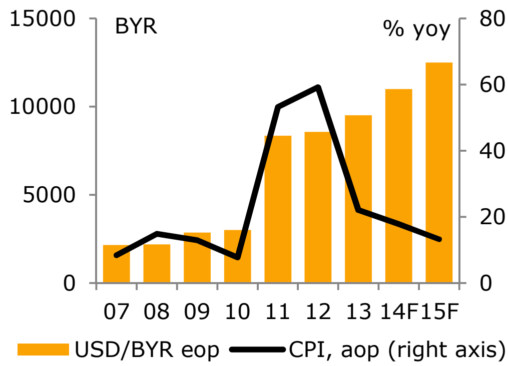
MONETARY ENVIRONMENT

Gradual depreciation and two-digit inflation

The traditional problem of high external imbalances has begun to be partially solved by exchange rate depreciation since early 2014. The authorities seem to struggle against the real appreciation of the Belarusian ruble. The contribution of the exchange rate to the reduction of the deficit is modest, and there is a considerable gap between the current level of exchange rate and its equilibrium. Hence, the authorities may intensify this tool in case of the lack of accessible (and affordable) external borrowing, and vice versa (i.e. artificially restrain the exchange rate in case of availability of funds). For our projections, we assume that the exchange rate vs. the US dollar by the end of 2014 will amount to 11 000 USD/BYR (10 255 annual average rate) and 12 500 USD/BYR by the end of 2015 (11 750 annual average rate). Such rate of depreciation will allow holding the real effective exchange rate roughly constant in 2014 (in comparison to 2013) and will provide for a small depreciation in 2015. However, these projections are conditioned on closing the gap in the financial account in order to balance the current account. Based on current projections with respect to FDI and portfolio investments, we suppose that this gap is to be closed by foreign loans. For 2014 we assess the amount needed (on a net basis) to be USD 5.7 bn, while in 2015 USD 5.1 bn.

Softer exchange rate policy will change monetary environment somehow: the exchange rate seems to contribute more to the dynamics of prices, supplementing price growth associated with expanding domestic demand and high inflation expectations. In 2014, the growth of consumer prices will also be due to adjustments in administratively regulated prices (utilities, transport, some food stuff, etc.). In case of absence of new domestic shocks in the money market, we expect that consumer prices will grow by 17.8% in 2014 and 13.2% in 2015 (annual average).

Exchange rate and prices



Source: NBB, GET forecasts 2014–2015.

PUBLIC FINANCES

Consolidated deficit might occur in 2014

The consolidated budget is expected to run deficit of 1.4% of GDP in 2014. Deterioration of the fiscal policy stance is related to the gloomy economic prospects. First, built-in stabilizers will contribute to the reduction of public revenues. Second, discretionary fiscal policy is expected to be aimed at sustaining economic growth via increasing expenditures on public investments. In 2015, the budget will benefit from the oil export agreements. However, further softening of fiscal policy is not expected as there is a risk of inflation acceleration, which will lead to the consolidated budget surplus of 0.3% of GDP.

Revenues of the consolidated budget are estimated at the level of 29% of GDP in 2014, which is slightly less than in 2013 (29.3% of GDP). The small negative effect is related to the fall in profit tax revenues caused by deteriorated financial stance of the real sector. Furthermore, a reduction of imports both in Belarus and Russia will lead to falling revenues from taxes on foreign trade. This fall will be partly offset by increase of excise revenues due to growing excise rates. Expected change in the regime of oil export taxation within CES in 2015 will significantly increase the consolidated budget revenues (up to 30.7% of GDP), as revenues form taxes on foreign trade will grow by 1.8% of GDP.

Consolidated budget expenditures are expected to grow in 2014–2015 up to 30.4% of GDP as a result of increased public expenditures on investments and growing expenses on debt servicing. Other expenditures are forecasted to remain stable, as soft fiscal policy is associated with inevitable inflation risks. Therefore, the government is expected to stick to the policy of fixing real wages in public sector to the level of 2013 both in 2014 and 2015.

Fiscal indicators, % of GDP

	2013	2014F	2015F
Consolidated revenues	29.3	29.0	30.7
Consolidated expenditures	29.1	30.4	30.4
Consolidated budget balance	0.2	-1.4	0.3

Source: Ministry of Finance, GET forecasts 2014–2015.

BALANCE OF PAYMENTS

High deficit of current account is likely to sustain

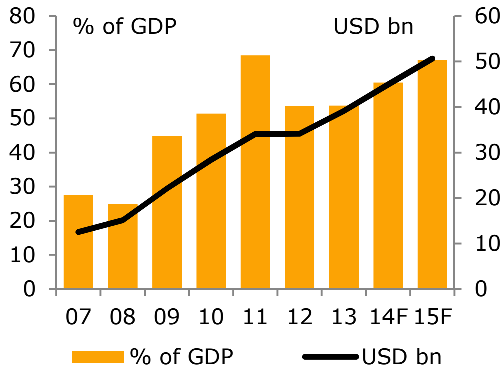
In 2013 the deficit of trade in goods and services constituted 2.7% of GDP. The current account deficit widen sharply to USD 7.3 bn (10.2% of GDP). We expect that the balance of trade in goods and services in 2014 will be negative; however it will shrink in comparison to the previous year and reach USD 1.6 bn (2.2 % GDP). The negative current account balance will be about the same as last year and amounted to USD 7.4 bn, or 10% of GDP. In 2015, due to a reduction of the deficit of secondary income, it will shrink slightly to USD 6.8 bn (8.9% GDP).

During 2013 merchandise exports contracted faster than imports (19.8% yoy and 8.7% in dollar terms, respectively) due to a decrease in supply of petroleum products to non-CIS countries and transport machinery products to Russia. For 2014 we expect a further drop in exports, and in imports, mainly owning to a decrease both in prices and volumes. Export contraction, as in the last year, will be attributed to the cutback of trade in petroleum products, potash fertilizers, and black metals with non-CIS countries. In addition Russia's economic stagnation shrinks the demand on this market, and decrease sales of Belarusians capital goods, i.e. machines and equipment (including products of automotive industry), as well as consumer goods to Russia. A reduction in imports will be triggered by a reduction of supply of investment and intermediate goods both from Russia and non-CIS countries due to a contraction of domestic demand. We expect that in 2014 the balance of merchandise trade will be negative and account for USD 4.3 bn. In 2015, the deficit of the balance of

Merchandise trade (growth rate in USD)

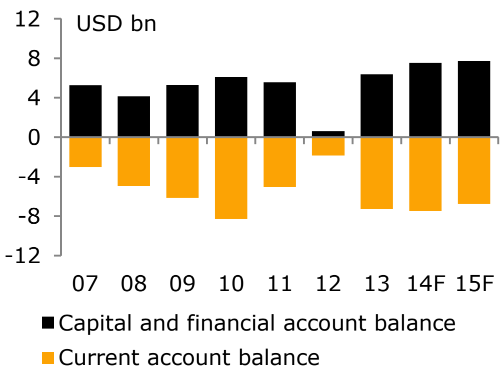
Source: National Statistical Committee, GET forecasts 2014–2015.

Gross external debt



Source: NBB, GET forecasts 2014–2015.

Balance of payments



Source: NBB, GET forecasts 2014–2015.

merchandise trade will expand further, and is expected to be at around USD 4.7 bn.

In 2014 and 2015, the balance of trade in services will be positive at around USD 2.6 bn in both years. The export growth will come from an increase in oil and gas transit and transportation services, while service import growth will expand almost at the same pace and will be supported by an expansion of transportation, construction, and travel services.

We expect that the balance of primary income will be negative in 2014 and 2015 as a consequence of the increase of interest payable under general government (including interest payments on the IMF loan and Eurobonds) and non-financial sector obligations, including payment on the loans of banking and nonfinancial sectors, and income payments on FDI. The balance of secondary income will be negative in 2014 and 2015 as well because of the transfer of export duties on Belarusian oil refinery products to the Russian budget. The transfer of these duties will significantly exceed the inflow of customs duties accrued according to the agreement between Russian, Belarus and Kazakhstan on the distribution of import customs duties within the Customs Union. However, it is expected that in 2015 the deficit of the secondary income balance will shrink almost twice, as Belarus and Russia reached an agreement about the gradual elimination of export duties. According to this agreement, Belarus will pay in 2015 only half of the sum of these duties.

Capital and financial account: The need in new borrowings

We expect that in 2014 the net FDI inflow will be USD 1.9 bn. The FDI inflow will be attributed to reinvested earnings and acquisition of equity capital in industry, banking and service sectors. In 2015 we forecast a slight increase in net FDI inflows to 2.3 bn. In 2014 and 2015 the necessity of repayment of debt under previously attracted loans (including the repayment of the principal amount of the IMF stand-by loan and 1st issuance of Eurobonds) and financing current account deficit will influence the balance of the other investment account, and will raise liabilities to non-residents as a result of foreign loans and credits attraction.

We forecast an inflow of portfolio investments only in 2015. These investments may reach USD 0.4 bn on a net basis due to Eurobonds issue, if market conditions allow.

Annex. Tables

		2011	2012	2013	2014F	2015F
Table 1. GDP						
Nominal GDP	BYR bn	297 158	530 356	645 669	762 605	887 624
	USD bn**	49.7	63.6	72.7	74.4	75.5
Real GDP	% yoy	5.5	1.7	0.9	2.1	3.0
Household consumption	% yoy	2.3	10.8	12.2	3.0	2.7
Public consumption	% yoy	-3.6	-1.0	-2.6	0.1	-1.6
Gross capital formation	% yoy	13.9	-11.3	7.5	2.0	8.2
Exports	% yoy	29.5	11.1	-17.4	4.8	4.4
Imports	% yoy	17.4	10.8	-4.9	-0.5	3.9
Table 2. Fiscal Indicators*						
Consolidated budget revenues	BYR bn	85 608	157 955	189 232	220 997	272 885
	% of GDP	28.8	29.8	29.3	29.0	30.7
EPT revenues	BYR bn	8 689	19 535	21 525	24 302	28 459
	% of GDP	2.9	3.7	3.3	3.2	3.2
VAT revenues	BYR bn	26 499	45 457	56 223	66 406	77 292
	% of GDP	8.9	8.6	8.7	8.7	8.7
PIT revenues	BYR bn	9 316	19 319	26 992	32 865	38 101
	% of GDP	3.1	3.6	4.2	4.3	4.3
Consolidated budget expenditures	BYR bn	79 428	155 169	187 751	231 642	270 052
	% of GDP	26.7	29.3	29.1	30.4	30.4
Current expenditures	% of GDP	21.5	22.8	22.6	23.4	23.2
Capital expenditures	% of GDP	5.1	6.4	6.9	7.0	7.2
Consolidated budget balance	% of GDP	2.1	0.5	0.2	-1.4	0.3
Table 3. Balance of Payments and External Debt						
Current account balance	USD bn	-5.1	-2.1	-7.3	-7.5	-6.8
	% of GDP**	-10.2	-3.3	-10.0	-10.0	-8.9
Export of goods	USD bn	40 928	45 574	36 571	35 053	34 146
Import of goods	USD bn	44 394	45 009	41 111	39 320	38 857
Balance of services	USD bn	2 258	2 292	2 581	2 636	2 601
Capital and financial account balance (analytical view)	USD bn	5 561	599	6 386	7 551	7 731
Foreign direct investments (FDI)	USD bn	3 877	1 308	2 060	1 892	2 266
Portfolio investments	USD bn	854	-191	-58	0	400
Gross external debt	% of GDP**	68.5	53.6	53.8	60.5	67.0
Table 4. Money, Inflation and Exchange Rate						
Base money	%, yoy eop	84.1	61.6	13.4	5.2	24.8
CPI	%, yoy aop	52.3	59.2	18.3	17.8	13.2
Exchange rate, USD/BYR	eop	8 350	8 570	9 510	11 000	12 500

*- Social Security Fund is not included into consolidated budget.
** - For 2011 this indicator is calculated based on the market exchange rate (for 2011 on average – 5984 USD/BYR).
Sources: National Statistical Committee, Ministry of Finance, NBB, GET forecasts 2014–2015.

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 97 per barrel on average in 2014 and USD 92 per barrel on average in 2015.
- Belarus will get 22 m t of crude oil from Russia in 2014 and 23 m t in 2015 on a duty-free basis.
- The prices of imported gas from Russia will be USD 165 per tcm (yearly average) in 2014 and 2015.
- In 2014 the government will obtain USD 1 bn in the form of privatization revenues and USD 1.5 bn in 2015; new public foreign borrowings will amount USD 1.5 bn annually in 2014 and 2015; in 2015 a new issuance of Eurobonds for USD 1.4 bn will take place.

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

Research products and publications of the project are available via the Internet at the web-sites of the IPM Research Center http://research.by/ and German Economic Team Belarus www.get-belarus.de.