



## Energy Shocks and Macroeconomic Management: Policy Options for Belarus

### Summary

Energy import prices for Belarus have strongly increased at the beginning of 2007 and will continue to do so in the future. From a balance of payments perspective, this energy shock induces higher nominal imports and a higher demand for foreign currency on the foreign exchange market. In order to rebalance the foreign exchange market under the current fix exchange rate peg, policy measures are needed to simultaneously reduce the demand for foreign exchange and to increase its supply.

The most obvious direction for reducing the demand for foreign exchange is to decrease energy consumption. There is much room to save energy in Belarus, as can be seen by its low level of energy efficiency. But the necessary investment in energy saving technologies will only materialise, if these investments yield a decent rate of return. For this to happen domestic energy prices have to rise and the energy sector has to be reformed. Furthermore, in order to contain aggregate demand and thus imports, a slowdown of the current high growth of credit expansion -which fuels demand-, seems necessary.

The supply of foreign exchange should be increased by attracting foreign capital. Loans from multilateral and bilateral financial institutions for financing investment in energy saving projects are readily available at favourable conditions. But also private financing could enter the country to conduct joint implementations projects in the context of the Kyoto Protocol. Furthermore, there is a wide scope for attracting FDI, including the selling of state enterprises to foreign investors. Finally, Belarus could borrow from non-residents, preferably in local currency.

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## 1. Introduction

Belarus has little own energy resources. Despite this fact, energy plays a crucial role in the Belarusian economy and especially in its foreign trade. In 2006, energy exports accounted for 38.3% of total exports; the corresponding figure for imports was 32.8%. As can be seen in Table 1, these shares are rather high in international comparison.

**Table 1: Share of energy products in foreign trade, selected countries**

	Share of energy in exports (%)		Share of energy in imports (%)	
	2005	2006	2005	2006
Belarus	34.8	38.3	33.0	32.8
Czech Rep.	3.0	--	6.6	--
Hungary	2.6	--	6.5	--
Poland	5.1	--	11.4	--
Russia	49.0	48.7	1.5	1.2
Slovakia	7.2	--	13.8	--
Ukraine	9.8	6.7	29.5	28.2

Source: COMTRADE.

In January 2007, the price for gas imports from Russia more than doubled and will continue to increase significantly in the coming years. Furthermore, the conditions for processing Russian oil have also worsened since January 2007. Given the importance of the energy sector and the magnitude of the price changes, it is adequate to state that the Belarusian economy is currently facing an energy shock, which will continue for some years to come. In Part 2 of this paper, we provide an overview of the facts related to this energy shock and quantify its effect on the trade balance.

The existence of an energy shock raises two immediate and crucial questions. First, what will be the macroeconomic implications of the shock? And second, how should the macroeconomic management of the country react to this shock, in order to lessen its negative consequences?

Part 3 analyses the macroeconomic implications of the energy shock. We focus on the impact of the shock on the balance of payments, assuming a continuation of the current fix exchange rate policy of the National Bank of Belarus (NBB). This pragmatic approach is highly suitable for economic policy consultancy. The line of argumentation is easy to grasp and the main policy options can be derived in a consistent manner.

Parts 4 and 5 discuss possible policy reactions to the energy shock. Part 4 examines different policy options to absorb the shock by increasing the supply of foreign currency. In Part 5, policy measures are discussed which would contribute to reduce demand for foreign currency and thus contribute to re-balance the foreign exchange market. In Part 6 we provide our policy recommendations.

## 2. The energy shock on Belarus in 2007: overview of facts

The energy shock on Belarus consists of two parts, a gas and an oil shock. We will look first at the changes regarding gas imports and quantify the impact of these changes on the trade balance of Belarus. Afterwards, the corresponding analysis will be conducted for oil imports. Finally, both impacts are combined.

In 2006, Belarus paid USD 46.68 per  $\text{tm}^3$  of Russian gas. For 2007, Belarus and Russia have agreed on a price of USD 100 per  $\text{tm}^3$ . But following an agreement the price will continue to rise according to a dynamic correction coefficient, until it reaches the world market level in 2011. Table 2 shows the new gas import prices for Belarus.

The impact of the new gas import prices on the trade balance is shown in Table 3. In the Table, we also included the relatively minor, but positive effect of higher gas transit tariffs, on which Belarus and Russia also agreed.

**Table 2: New gas import prices for Belarus, 2007-2011**

	2007	2008	2009	2010	2011
Market price*, USD/tm <sup>3</sup>	246	242	234	228	223
Correction coefficient**	--	0.67	0.8	0.9	1.0
Import price for Belarus, USD/tm <sup>3</sup>	100	162	187	205	223

\* Estimation of market prices for Germany based on IMF forecast (excluding transit cost).

\*\* According to the bilateral agreement between Gazprom and Beltransgaz.

Source: IPM Research Center.

**Table 3: Impact of gas shock on the trade balance, 2007-2011**

	2007	2008	2009	2010	2011
Import price, USD/tm <sup>3</sup>	100	162	187	205	223
Import price increase*, USD/tm <sup>3</sup>	53	115	141	158	176
Import volume, m tm <sup>3</sup>	21	21	21	21	21
Impact gas import on trade balance, USD m	-1120	-2418	-2951	-3321	-3703
Impact gas transit on trade balance, USD m	73	97	106	54**	58**
<b>Net impact gas on trade balance, USD m</b>	<b>-1047</b>	<b>-2321</b>	<b>-2845</b>	<b>-3267</b>	<b>-3645</b>

\* Compared to the gas import price in 2006.

\*\* This assumes that gas transit revenues decrease with the start of the North Stream pipeline.

Source: IPM Research Center.

As regards external trade in oil-related products, the agreement with Russia foresees that crude oil imports from Russia will be subject to a special export duty, while oil products refined in Belarus for further export are also subject to export duties equal to Russian ones. We forecast the world market price of Russian crude oil and Belarusian oil products according to IMF forecasts and the rates of duties according to the Russian formulas of export duties. Under these conditions, we find that Belarus is likely to keep the physical volumes of crude oil imports and oil product exports unchanged. The consequences of the new agreement for external trade in oil-related products are provided in Table 4.

**Table 4: Impact of oil shock on the trade balance, 2007-2011**

	2007	2008	2009	2010	2011
Import price*, USD/t	316	320	317	311	306
Import price increase**, USD/t	89	93	90	84	79
Import volume, m t	21	21	21	21	21
Impact oil import on trade balance, USD m	-1860	-1944	-1881	-1756	-1651
Export price***, USD/t	466	458	446	434	427
Export price increase**, USD/t	81	73	61	49	42
Export volume, m t	15	15	15	15	15
Impact oil export on trade balance, USD m	1199	1080	903	725	622
<b>Net impact oil on trade balance, USD m</b>	<b>-661</b>	<b>-863</b>	<b>-978</b>	<b>-1030</b>	<b>-1030</b>

\* Projected import price of crude oil including special duty and excluding VAT.

\*\* Compared to prices in 2006.

\*\*\* Projected export price of refined oil excluding VAT.

Source: IPM Research Center.

Putting Tables 3 and 4 together, we arrive at the combined net impact of the gas and oil shocks on the trade balance, which is shown in Table 5.

**Table 5: Impact of energy shock on the trade balance, 2007-2011**

	2007	2008	2009	2010	2011
Net impact gas on trade balance, USD m	-1047	-2321	-2845	-3267	-3645
Net impact oil on trade balance, USD m	-661	-863	-978	-1030	-1030
<b>Net impact gas and oil on trade balance, USD m</b>	<b>-1709</b>	<b>-3184</b>	<b>-3823</b>	<b>-4297</b>	<b>-4674</b>

Source: IPM Research Center.

### 3. The macroeconomic impact of the energy shock: A foreign exchange market approach

Our following analysis of the macroeconomic effects of the shock is build upon the foreign exchange market in Belarus. As became clear in the last chapter, the new energy reality with energy import prices converging to world market levels has serious consequences for the balance of payments development. These dynamics will at the same

time affect the market for foreign exchange and cause disequilibrium between demand and supply, putting downward pressure on the exchange rate.

There are two basic ways how the market can be brought back to equilibrium. In a flexible exchange rate system, or a system with an easily adjustable peg, the nominal exchange rate reacts and re-balances demand and supply. However, in the current situation, and in accordance with past policy, we think that the NBB and the authorities in general will try to avoid a (significant) devaluation of the national currency.

There are good reasons for this assumption. The cornerstone of the past policy of the NBB since 2004 is the de-facto peg to the US dollar, which can be considered an important anchor of monetary and financial stability in the country. Giving up this anchor under the current circumstances would in several ways be harmful to the economy. First, the traditional high pass-through effect of exchange-rate movements on inflation would increase the latter and could start a devaluation-price spiral. Second, since the financial dollarisation of the economy is still relatively high, a devaluation would increase the risks to financial stability. If the public shows a loss of confidence in the national currency and further depreciation expectations materialise, this would further jeopardise stability. Third, the continuation of the official policy of implicitly targeting wages in US dollar makes a devaluation unlikely.

Since a devaluation scenario can be excluded due to its low probability, the key policy question is how to absorb the effects of the energy shock on the foreign exchange market. How can the equilibrium between demand and supply be restored and the external value of the Belarusian ruble with reference to the de-facto target kept at a constant level? Since the stability of the exchange rate played and continues to play a key role in the policy strategy of the Belarusian authorities, measures to reach stability need to be identified. In general, these measures can be subdivided into two groups: either by increasing supply or by reducing demand for foreign currency on the foreign exchange market.

#### **4. Macroeconomic policy options: How to increase supply of foreign exchange**

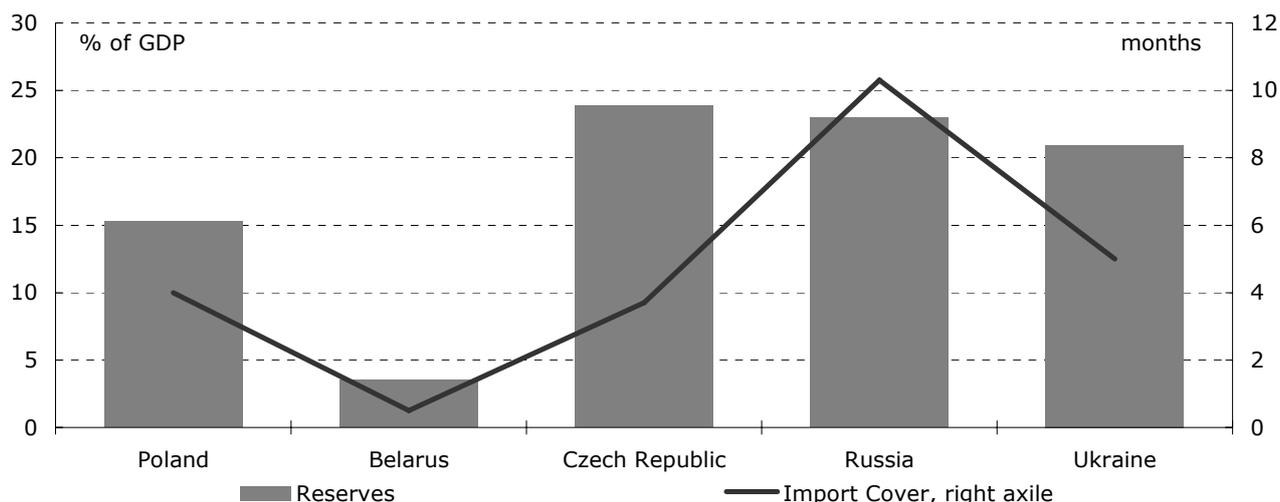
In principle, there are a number of policy responses to increase supply on the foreign exchange market and thus bring the market back to equilibrium at an unchanged exchange rate.

##### *4.1 Monetary policy response (Selling of official foreign reserves)*

The typical response for a central bank that targets the exchange rate in case of adverse shocks is exchange market intervention. By selling official foreign reserves, the NBB can increase the supply of foreign exchange in the market, thereby shifting the supply curve in such a way that the new equilibrium is reached at an unchanged exchange rate.

While it is common practice among exchange rate targeting countries to follow such intervention procedure, some concerns for its application in the current situation arise. The first concern deals with the source of the underlying shock. Normally, interventions are undertaken in both directions (i.e. buying and selling foreign exchange) to stabilise the exchange rate in the presence of different shocks. In case of Belarus, the energy shock is a fundamental and long-lasting one-sided shock, which makes an increase in supply in the long term necessary. Selling reserves would be a very short term approach, which does not solve the fundamental problem. Second, in order to intervene in one direction only, the NBB needs to have enough reserves at hand to conduct such a policy. Regarding the level of foreign reserves, the following Figure 1 shows that their respective level is quite low in Belarus as opposed to other transition countries:

**Figure 1: Foreign exchange reserves for selected countries, 2006**



Note. Data for Russia are for 2005.  
Source: EBRD.

It is obvious that the current level of foreign reserves does not allow a full absorption of the shock only by foreign exchange market intervention. This would only waste the limited amount of reserves and further endanger stability.

An indirect support of the currency in times of depreciation pressure can come through interest rate increases. Normally, in case that reserves need to be sold to defend the domestic currency, the monetary base shrinks and domestic rates go up. This is the situation that Belarus has experienced in the beginning of this year, providing indirect support to the currency. However, also this option has certain limits and is only adequate in the short run. In the long run, interest rate increases hurt the domestic economy and therefore cannot be sustained over longer periods.

#### 4.2 Foreign borrowing

A second option to increase supply is by attracting capital inflows in the form of foreign debt<sup>1</sup>. This would also shift the supply curve in the foreign exchange market outwards, assuming that the borrower (the Finance Ministry or state-owned banks as the second most likely group of borrowers) exchanges the foreign currency proceeds from the bond or loan<sup>2</sup> into local currency. The issuance of (public or private) foreign debt is therefore also positive for the supply of foreign exchange.

As in the case of the previous section, some problems arise with such a strategy. Issuing a foreign debt title means a commitment to regular payments of interest and an ultimate repayment of the principal. Even taking into account that the current high level of global liquidity makes foreign borrowing relatively cheap, Belarus has no sovereign rating and no prior experience in international bond markets. Therefore, the interest rates that need to be offered to investors will be relatively high to compensate for this risk, at least in the beginning. Foreign borrowing, i.e. external indebtedness can therefore not be considered a fundamental solution to the problem, but rather a short-term answer to allow adjustment in other parts of the economy. Moreover, issuing in foreign currency exposes the issuer to substantial exchange rate risk. If the exchange rate moves adversely over the maturity of the bond or loan, interest and principal

<sup>1</sup> While foreign debt can be defined in different ways regarding currency, residence of creditor, etc., for the purpose of this paper we use the definition of "debt due to non residents, which is denominated in foreign currency", since we are concerned with the supply of foreign exchange.

<sup>2</sup> Belarus requested a stabilization loan of USD 1.5 bn from the Russian government on 22 February 2007, which is currently being reviewed by the Russian authorities.

payments in foreign currency can become more expensive when expressed in domestic currency. This can dramatically increase the cost of debt servicing.

#### *4.3 Local borrowing*

Another possible way to attract foreign exchange inflows is an increase in local borrowing. While borrowing on local markets in local currency does not per se increase the supply of foreign exchange, it can indirectly do so if the lender is a non resident<sup>3</sup>. In such a case, the non-resident investor needs first to transfer foreign currency to Belarus, exchange it into domestic currency on the foreign exchange market, and can then buy local debt titles with the proceeds<sup>4</sup>.

As in the case of foreign debt issuance, local debt does not offer a fundamental solution to the energy shock since it is an interest-bearing liability for a limited amount of time only. As such, it can be only considered a short-term response to the shock. However, comparing the different forms of borrowing there are some clear advantages over foreign borrowing.

First, and most obvious, is that there is no direct exchange rate risk for the debtor involved<sup>5</sup>. Second, this local issuance might contribute to the further development of capital markets in Belarus as liquidity increases. This would be also an important step and prerequisite for additional local borrowing by banks and enterprises. A liquid sovereign debt market fulfils crucial benchmarking<sup>6</sup> purposes for such corporate bonds, which could be also bought by non-residents. This would increase the supply of foreign exchange further.

However, these benefits of local bond issues instead of foreign borrowing need to be compared to their respective costs. First, the nominal interest rates in domestic currency will likely be higher than foreign currency rates. Even though this fact in itself is not necessarily a cost (both interest rates cannot be directly compared, since also the foreign exchange risk needs to be taken into account), the Ministry of Finance might consider to issue in the currency which looks "cheaper". Second, domestic markets offer normally in comparison to foreign ones besides higher yields also lower maturities, exposing the issuer to roll-over risk. Furthermore, the risk of reversal of foreign exchange flows (in times of crisis) is higher when foreign investor participation is high. This has policy implications for the NBB, making its job to defend the currency in such situations more difficult and creating an indirect exchange rate risk.

#### *4.4 Attraction of FDI and privatisation*

The last policy option discussed consists of FDI and the privatisation of state companies: provided these enterprises are sold to non residents, the result will be an increase of supply of foreign currency on the foreign exchange market, similar to the previous scenarios.

At first glance, however, the privatisation of state companies does not offer a permanent solution to the problem. Conceptionally similar to the case of foreign exchange reserves, there is only a limited amount of assets to be sold. However, this view neglects two important facts. First, from a qualitative point of view, privatisation as a rule also goes along with increases in the efficiency of companies and their competi-

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<sup>3</sup> This assumes that foreign participation in domestic markets is not subject to capital controls or similar currency regulations. If this is not the case, respective legislation changes need to be made to allow foreign investors the access to domestic markets.

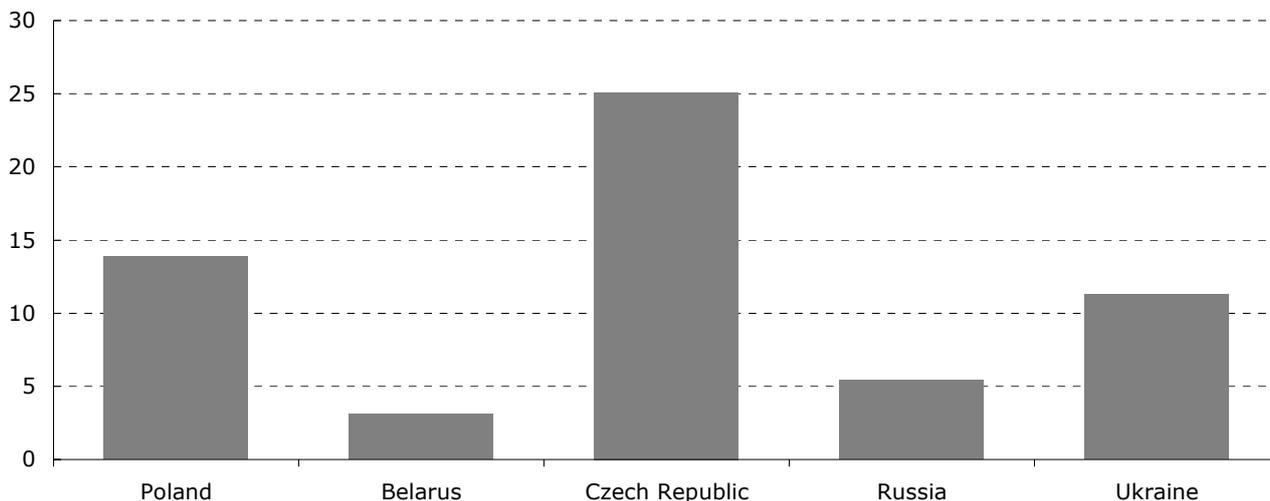
<sup>4</sup> This has been widely observed in Ukraine in 2005, when foreign investors became major players in the domestic bond market, pushing down local yields and increasing foreign reserves of the central bank.

<sup>5</sup> This risk is taken on by investors instead, which are being compensated by a respective premium.

<sup>6</sup> This benchmarking property means that prices of other (private) instruments will be determined in relation to the sovereign (the benchmark).

tiveness. As far as the external dimension of competitiveness is concerned, this can bring an important contribution to exports (if the relevant companies belong to export-oriented industry/service sectors) and subsequently to the supply of foreign exchange. Second, looking at the quantitative dimension, there is much room for privatisation in Belarus since the efforts in the past were quite limited and the majority of the capital stock in the economy is still in state hands. Figure 2 provides a comparison with transition peer countries:

**Figure 2: Privatisation revenues in transition countries, cum. % of GDP, 2005\***



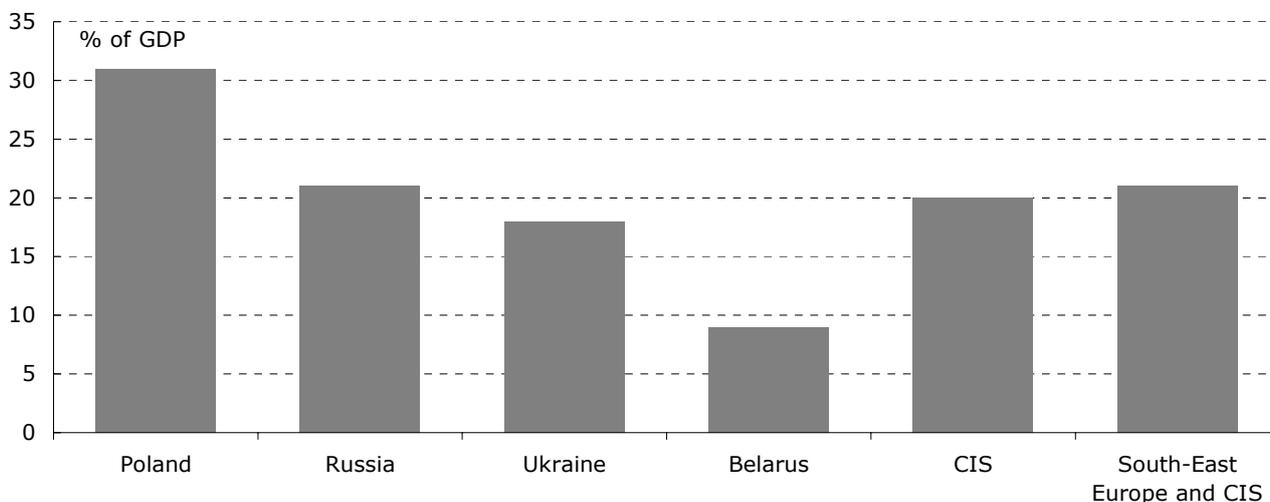
*Note.* Privatisation proceeds are in principle to finance fiscal deficits only. The part saved in the Special Privatisation Accounts is not included.

\*Data for Russia are for 2003.

*Source:* EBRD.

A second, closely related source of foreign exchange inflows is the attraction of foreign direct investment (FDI). This form of investment from above also implies an initial increase in the supply curve of foreign exchange when non residents acquire or establish domestic firms. Even though a subsequent outflow of foreign exchange can be recorded, when capacity-increasing capital goods from abroad are being imported, there should be a positive long run impact on productivity, competitiveness and export performance, as long as these investments are directed at the tradable sector. This would imply an overall positive net effect on the supply of foreign exchange.

**Figure 3: FDI inward stocks in transition countries in 2005, % of GDP**



*Source:* UNCTAD, World Investment Report 2006.

While the previously discussed issue of privatisation is naturally limited by the supply of assets in state hands, foreign direct investment is not subject to such limits. As long as the domestic economy is attractive from the point of view of a foreign investor, there are practically unlimited possibilities for such projects with an associated inflow (supply) of foreign exchange. However, Belarus has a relatively poor record in attracting FDI. The cumulative inflows of FDI, i.e. the stock of inward FDI stood at less than 10% of GDP. This figure is very low in international comparison with peer transition countries, as Figure 3 demonstrates.

Regarding concrete projects, Table 6 shows some major investments conducted by foreign companies in Belarus. The sectoral composition is relatively diversified:

**Table 6: Major foreign direct investments as of 2006**

Company	Foreign Investor	Sector
Brewery Siabar	Detroit Belarus Brewing Company	Alcoholic beverages
JV Mobilnaja tsyvrovaja svyaz	SB Telecom	Telecommunications
MTC	Mobile Telesystems	Telecommunications
Glass factory Elisovo	ATEC Holding GmbH	Glass
JV Bakko Bisov	Bahco Group	Light industry
MAZ-MAN	MAN	Trucks
JV Santa Impex Brest	Alfa-Mar-Seafood Import-Export	Food
Coca-Cola Beverages Belarus	Coca-Cola	Non-alcoholic beverages
B&B Insurance	-	Insurance
Merck Medical	Merck	Pharma
Zeiss BelOMO	Zeiss	Optical systems
Mozyrskiy NPZ	Slavneft	Oil
Priorbank	RZB Raiffeisenbank	Banking

Source: Ministry of Foreign Affairs of Belarus.

To sum up, both privatisation and FDI give Belarus an important chance to generate foreign exchange inflows, as the country has not fully utilized its potential in the past and is lagging far behind other transition countries. Since these assets have an unlimited maturity, and are not interest-bearing, there are no regular interest and principal payments to be made to foreign investors<sup>7</sup>. This is a major advantage compared to borrowing, where interest-bearing liabilities are being created for a short period of time. On top of that, there is most likely a productivity gain to be recorded, as private sector ownership most likely increases the efficiency of operations.

## **5. Macroeconomic policy options: How to decrease demand for foreign exchange**

### *5.1 Investment in energy saving technologies*

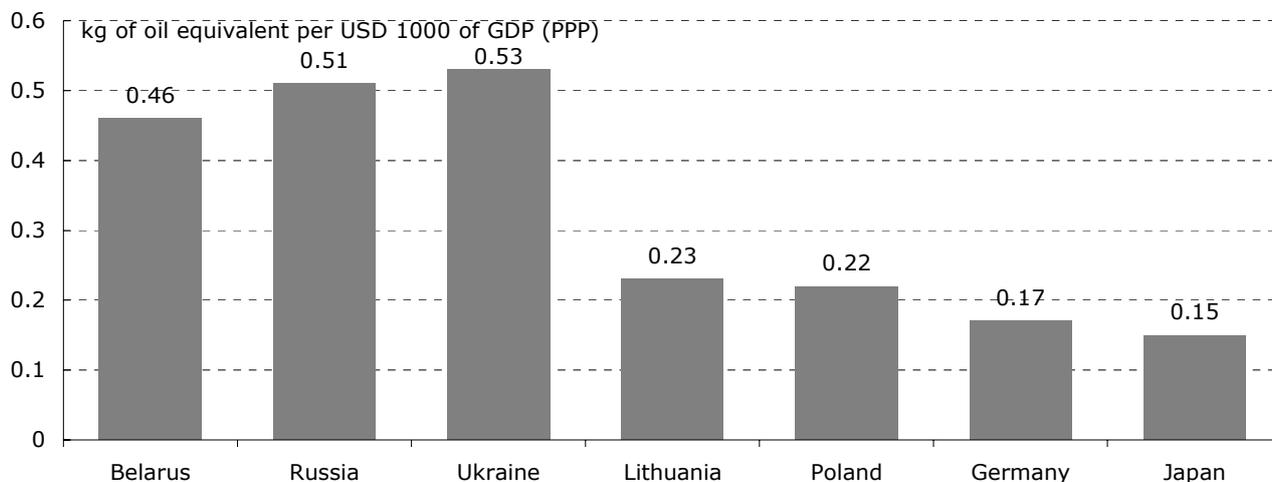
The underlying reason for the disequilibrium on the foreign exchange market is the price hike for imported energy. While this price increase has to be accepted now as a form of economic reality, a possible way to reduce the corresponding import bill would be to reduce energy consumption, i.e. the quantitative dimension of energy imports. This would lead to a similar reduction of demand for foreign currency. The most effective way to conduct such a reduction of energy consumption would consist of new investments in energy saving technologies. This would save at the same time foreign exchange otherwise needed for importing energy.

Is this a realistic target, i.e. can such investments generate the necessary energy savings? We think yes, because of the very low level of energy efficiency in GDP generation in Belarus. The following Figure 4 shows the high level of energy inefficiency in Belarus (and in other CIS-countries, indicating its common heritage) as compared to other countries. If we take neighbouring Poland and Lithuania as examples, the

<sup>7</sup> The return on these assets will mainly come in the form of dividend payments, when the economic situation of the company allows it. Investors can of course sell these investments to other investors (both resident and non resident) in the capital market.

amount of energy needed to produce a certain amount of GDP can be halved. If we take more developed Germany as a very long-term benchmark, it can be even reduced by roughly two-thirds:

**Figure 4: Energy intensity for selected countries, 2005**



Source: IEA, Energy Statistics.

However, turning to the practical implementation, how can this be achieved in concrete steps? A crucial precondition of attracting new investments in such technologies consists of a necessary pass-through of the higher import prices to final consumers (enterprises, households). While social objectives need to be seriously taken into account, the increase in domestic energy prices is necessary to increase the yield of investments in energy saving technologies in order to allocate productive resources to this sector. The price mechanism that fulfils this control function needs therefore to mirror the new reality.

Regarding the issue of financing such new investments, there are attractive opportunities for financing energy saving investments from official lenders from abroad. Sources could be multilateral financial institutions like the World Bank or the EBRD, but also bilateral financial cooperation (e.g. the German KfW) seems promising. Besides the long-term nature of such official lending, the associated interest costs will likely be lower than those charged on lending operations by private market participants.

### 5.2 Fiscal policy (Reduction of aggregate demand)

The Belarusian model of economic development attaches a major role in the economy to public institutions. Regarding the behaviour of domestic demand, the state used and continues to use several instruments to support high growth figures. Besides government-determined wage dynamics- which have often exceeded productivity growth- aggregate demand has also been influenced in the past by directed lending operations of the NBB and state-owned commercial banks to preferred sectors and conducted below market conditions. Such administrative allocation of loans can be considered a quasi-fiscal activity undertaken by the respective banks since it subsidises in effect certain economic agents and creates an economic distortion<sup>8</sup>.

The effect of heavy state intervention was a high level of growth of domestic demand, including imports, and relatively high inflation in the past. However, with the expected deterioration in the current account, which has actually already begun, the historic speed of domestic demand growth seems unsustainable and needs to be controlled. A

<sup>8</sup> This is for example the case when these loans are directed to (long-term) loss-making enterprises, which would not be able to obtain loans at market conditions.

possible policy strategy would consist of a fiscal policy tightening, which dampens domestic demand and hence imports. The import reduction and the associated fall in inflation would both decrease the demand for foreign exchange, and therefore have positive effects for maintaining exchange rate stability.

Judging the fiscal policy measures undertaken over the recent past, it seems that a shift towards some tightening measures has already occurred. The budget recorded a fiscal surplus of 1.3% of GDP in 2006 and during the first months of 2007, and the creation of a "National Development Fund" in 2006 has saved a certain part of fiscal revenues rather than spending them. However, further measures are needed to constrain aggregate demand. First, a (real) wage policy that targets below productivity increases is here to mention. Second, coming back to the quasi-fiscal activities performed by banks mentioned above, a credit policy that strictly limits credit expansion by banks is equally important. This is due to the impact of credit expansion on aggregate demand. If these measures are applied in a consistent manner, a further sharp deterioration of the current account can be avoided.

### *5.3 Protectionist measures / trade policy*

While above described policy measures to reduce import and therefore foreign exchange demand are compatible with the efficient functioning of open markets, policymakers often resort to less market-oriented and even outright protectionist measures. The increase of import tariffs or the erection of other, non-tariff import barriers ought to reduce import of goods and services and consequently the demand for foreign exchange<sup>9</sup>.

What looks at first glance like an attractive policy option, however, is creating a huge burden for the economy. An increase in import tariffs would lower the competitiveness of the Belarusian economy considerably, which could result in a fall in exports (and, connected, a fall in foreign exchange supply). Furthermore, such unilateral recourse to protectionist measures is likely to generate retaliation responses from main trading partners. Again, this could lead to a decrease in exports and foreign exchange earnings. Given authorities' ambitions to join WTO at some time in the future, which is of crucial importance for an open country like Belarus, such measures would completely contradict this objective and should therefore not be considered.

## **6. Conclusions and policy recommendations**

The pre-shock macroeconomic policy of Belarus can be characterised by a de facto fix exchange rate to the US dollar, a very low level of capital imports and low domestic energy prices. The current energy shock on Belarus implies that the old "macroeconomic formula" does not work anymore; it is technically not possible to continue combining the three policy directions mentioned above. Thus, Belarus needs to change its general macroeconomic policy.

But in our view, the change in macroeconomic policy should not relate to the current exchange rate policy. A devaluation of the Belarusian Rouble would contribute to higher inflation and have negative consequences on the financial sector, because of the substantial level of financial dollarisation in the country. Consequently, the change in macroeconomic policy should be conducted in the remaining two fields, i.e. in the fields of capital imports and energy sector regulation, supported by a general tight stance on aggregate demand, and thus imports.

Within our balance of payments approach, the energy shock raises the nominal energy imports (i.e. the energy bill), thus misbalancing the foreign exchange market. The most effective way to absorb this shock would be to permanently reduce energy con-

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<sup>9</sup> This can be also considered a key element in inward-looking import-substitution strategies, which follow similar objectives (to save foreign exchange) and use therefore such protectionist measures.

sumption and imports in real terms, thus contribution to lowering the energy bill. As stated above, there is much room for increasing energy efficiency in Belarus. But a necessary condition for this to happen is to increase domestic energy prices, since artificially low prices in the past bear the main responsibility for the low level of energy efficiency in the country. Only once prices go up will investment in energy saving projects yield an adequate rate of return.

**Recommendation 1:** Energy saving must become a high priority in order to recover macroeconomic stability. The reform of the sector is a pre-condition for attracting investment in energy saving technologies.

Since energy saving is very high on the international political agenda and global warming is a global issue, many international and bilateral financial institutions are ready to finance energy saving projects at very favourable conditions (long-term loans and low interest rates). Thus, the financing of investment in energy saving technologies should not be a problem for Belarus. Besides, this external financing would lead to a supply of foreign currency on the foreign exchange market and add to the absorption of the energy shock through the capital account (double effect). Also joint implementation (JI) projects in the context of the Kyoto Protocol should be pushed ahead.

**Recommendation 2:** Belarus should try to attract foreign financing for energy saving investments, which are nowadays readily available at very favourable conditions.

In the same way as specific energy saving measures lower the demand for foreign exchange, supporting measures that contain aggregate demand and thus imports are needed. While conventional fiscal policy has been tightened to some degree in response (and anticipation) of the shock, there are other, quasi-fiscal activities by the banking sector which need to be phased out. The resulting slow-down of the current credit expansion will effectively lower imports and thus contribute to a more balanced foreign exchange market.

**Recommendation 3:** A reduction of the current high growth of credit expansion seems necessary to contain aggregate demand and thus imports.

Since the energy shock on Belarus is rather large, additional measures will be required to completely absorb the shock, especially in the short-term. In this regard, we generally propose a much more active policy of attracting foreign investment. In particular, FDI and the selling of state enterprises to non-residents should be pushed ahead.

**Recommendation 4:** Attraction of FDI and the selling of state assets to non-residents should become major priorities of economic policy.

Even though it cannot be considered an appropriate sole response to a permanent shock, also the possibility of borrowing from abroad should be pursued. But borrowing in foreign currency can be risky. Thus, we favour borrowing from non-residents, but in local currency. This would in turn contribute to the development of local capital markets, which is necessary to finance future investment and economic growth.

**Recommendation 5:** Borrowing in local currency from non-residents should be increased. In such a way, the government can obtain a rather flexible instrument, which can help absorbing the energy or any other terms-of-trade shock in the short run.

To conclude, we think that Belarus is in a good position to deal with the energy shock. By following the recommendations presented above, Belarus will not only master the situation and restore macroeconomic stability, but also be able to maintain a high level of economic growth in the long-term.