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The international financial crisis and Belarus: Risks and policy impli- cations

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The international financial crisis and Belarus: Risks and policy implications

Summary

Currently, the international financial system is threatened by a severe crisis, which turns out to be the most serious challenge in decades. Starting in the US housing market in 2007, it spilled quickly over to financial institutions and capital markets in the USA and other developed economies, especially in the EU. Worldwide, policy makers have already reacted strongly in order to avoid a collapse in the financial system, and to prevent a spillover to the real economy, i.e. a fall in growth and employment. For the authorities in Belarus, this poses the natural question, how their country has been affected by the crisis so far, and what future risks lay still ahead. This paper tries to assess these risks and the associated policy implications both in the short and the longer term.

Belarus as a small open economy is well integrated into the global trading system, and increasingly also into the financial system. With respect to trade integration, the world market price for crude oil is a key variable for net export dynamics. Similarly, other raw materials like potash fertilizers and ferrous metals are important linkages to the world market and determine trade balance dynamics. Regarding financial integration, starting from a low level, over the last couple of years the country became a more active borrower on international markets and attracted more FDI.

Parallel to the international financial crisis, and to some extent also causally related to it, global commodity prices started to surge. Energy commodities like crude oil, ferrous metals, and potash fertilizers (due to booming agricultural commodities) exhibited stunning gains, which positively affected countries that produced them (e.g. Russia). Taking aforementioned trade linkages into account, as well as the prominent role that Russia plays in external demand for Belarusian products, Belarus has actually benefited from global developments so far. The still relatively low level of foreign capital in the country has implied no substantial negative impact on external financing conditions. However, taking into account the increased pace of financial inflows into the country over the recent past, this might become a problem in the future.

The trade gains related to the recent commodity boom should be considered as “windfall profits”, which occur in the short term. The challenge for policy makers in Belarus is now to use this favorable “window of opportunity” and tackle more structural, long-term issues. Some of the most important lesson from the crisis relate to long-term policies regarding the attraction of foreign capital and the financial sector. First, due to its many advantages, Belarus should generally preferred foreign direct investment (FDI) as the major form of foreign investment. Second, the crisis abroad has shown that a diversified share of FDI in the banking system (as opposed to short-term foreign borrowings) provides an important anchor of stability. Third, the country should not repeat the mistakes of other countries like Kazakhstan and overstress foreign borrowing. For this to happen, and to make the country more resilient to global financial distress, domestic capital markets need to be further developed, including the participation of non-residents.

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1. Introduction

The world is currently experiencing the worst international financial crisis in decades, which seems far from being over. A large number of financial institutions have incurred heavy losses and financial markets became highly volatile as a result. Around the globe, policy makers have already reacted strongly in several ways in the hope of avoiding a recession in their countries: while central banks have cut interest rates, finance ministries have adopted fiscal policy measures such as tax cuts to support their economies.

The crisis, which had its epicenter in the USA, has spilled over quickly to other developed countries and to some emerging economies, including the CIS. By and large, no significant negative effect could be observed on Belarus so far. Under conditions of rapid financial integration with the world economy, it is only logical that policy makers and business leaders in the country wonder whether Belarus has passed the financial storm and avoided contagion for good, or if significant risks still prevail in the near future. This analysis has to take into account that substantial changes took place at global commodity markets, which had a positive effect on Belarus in the short-run.

In this paper we try to answer these questions. Part 2 gives an overview of the current trends of integration of the Belarusian economy with the world economy in terms of financial and trade links. This analysis is based upon the balance of payments and summarizes some potential risks. In part 3 we revise the origin of the crisis in the USA and analyse its spill-over into the world economy, i.e. developed and emerging markets. Using the analytical framework established in part 2, parts 4 and 5 identify potential future risks for Belarus in the short term. The former part deals with risks related to trade in case a world-wide recession develops and commodity prices are affected (real sector risk), whereas the latter part highlights the case when access of Belarus to international finance would be significantly restrained (financial risk). Finally, in part 6 we arrive at our conclusions and provide some more long term-oriented policy recommendations for the Belarusian authorities. In particular, we focus on the structure of capital inflows, as a way for reducing the potential negative effects of the crisis on Belarus.

2. Belarus and the world economy

2.1. The balance of payments for Belarus

The Belarusian economy is usually classified as a "small open economy". The commonly accepted definition of a small open economy foresees it as "is an economy that participates in international trade, but is small enough comparing to its trading partners that its policies do not alter world prices, interest rates, or incomes. Thus, small open economies are price-takers". Notwithstanding the definition is mostly focused just on the trade flows, contemporary small open economies are assumed to be integrated into the world economy not only through trade flows, but through capital flows as well. The latter is due to the rapid growth of capital mobility and development of financial markets during the last decades. Moreover, transition countries as a rule try to facilitate the inflow of capital by improving their investment climate and allowing legally a high extent of capital mobility. Hence, the majority of countries are involved in world trade and at the same time practice substantial borrowing (lending) from (to) abroad. These two linkages determine their dependence on the world economy. But while financial flows are more volatile rather than current (trade) flows, usually the impact of the changes in the world economy on the national economy begins from the financial linkages.

The case of the Belarusian economy is not so typical in its reaction to external shocks. Due to the number of reasons, foreign direct investments (FDI) have not become the substantial item of the financial account. Furthermore, other "traditional" capital flows

have not been so significant for Belarus until recently. This can be seen from the analysis of the Belarusian balance of payments (BOP). In Appendix 1, the major current and capital flows are presented as a share of the Belarusian GDP in 2007.

While traditional sources of foreign capital (borrowings by financial and non-financial sector) are not so widely used in the Belarusian economy they are somehow replaced by the government's borrowings and commercial credits. Borrowings by government in Belarus are mainly based on the bilateral intergovernmental loans and have no direct relation with market tendencies. As for commercial credits, usually they are closely connected with export-import transactions and provided for the short-term. Hence, this kind of financial flow is also much independent on the financial market environment. Thus, the dependency of the Belarusian economy from the world one is much stronger based just on the trade flows rather than on the financial flows.

2.2. Trade flows (current account)

Changing conditions at the world markets (changing prices) may affect Belarusian economy in two ways. First, if the change in price is beneficial for the particular industry then it will lead to a growth of export revenues.¹ Second, in case of unfavorable price dynamics it will lead to a decrease in export revenue, either through reduction in physical volume or through price adjustment. For imports, the situation is vice-versa. So the dynamics of export revenues and import costs, i.e. the change in the trade balance due to the international financial crises is the first linkage to the Belarusian economy. However, analyzing a particular market we must at the same time consider both exports and imports. While the majority of Belarusian exporters have favorable effect for their exports, they may feel negative effects for needed imports. This originates from the high dependence of the Belarusian producers from imported raw materials and intermediary goods.

Thus, we are to analyze the composition of the Belarusian external trade in order to find out which commodity goods have substantial share in the Belarusian exports and imports and hence changes in prices at which markets do matter for the Belarusian economy. Furthermore, the geographical destination of exported and imported commodities matters as well, while conditions of trade may differ substantially at the particular regional market and at the global market. In Table 1 main merchandize exported groups and the destination of their export are provided.

Table 1: Main Exported Merchandize Groups and Destinations of Exports in 2007

Merchandize group	Share in total exports, %	Geographical destination of export within the merchandize group, %	
		Russia	Non-CIS countries
<i>Oil and oil products</i>	35.2	0.4	93.7
Surface transport	11.7	63.0	15.7
Equipment and mechanical devices	6.4	78.1	6.9
<i>Potash fertilizers</i>	5.5	0.4	95.0
<i>Ferrous metals</i>	4.4	38.0	58.0
Electric machines, audio, video	3.1	77.1	15.8

Source: Own calculations based on the Ministry of Statistics and Analysis.

Table 1 shows that the main merchandize group – oil and oil products – is mainly exported to non-CIS countries (mainly the Netherlands and Great Britain) and hence we can argue about world prices at this market and about direct impact of world crude oil price on the Belarusian economy. Furthermore, the Belarusian economy should be affected in a similar way by prices at the world markets of potash fertilizers and ferrous

¹ For the short-term analysis we suppose that the quantity of production cannot be increased immediately, i.e. is inelastic. This assumption is rather realistic for Belarus in the short-term, while the rate of capacity utilization in major branches of the Belarusian economy is close to 100%.

metals. Other merchandize groups are mainly traded at the Russian market. Moreover mainly these merchandize groups are considered to be the goods of investment export. Hence, in this case the reaction of the Russian market of investment goods upon the international financial crises and correspondent impact on the competitiveness of the Belarusian goods will affect the Belarusian economy.

Composition of Belarusian imports (see Table 2) shows that the country depends on Russian energy resources such as crude oil and gas. While gas is mainly used for domestic purposes, its impact on the Belarusian trade balance is straightforward and depends just on the price. The latter depends mainly on the bilateral agreements with Russia and until 2011 depends on the world prices only partially.²

Table 2: Main Imported Merchandize Groups and Origins of Imports in 2007

Merchandize group	Share in total imports, %	Geographical origin of import within the merchandize group, %	
		Russia	Non-CIS countries
<i>Crude oil</i>	25.2	100.0	0.0
Equipment and mechanical devices	11.5	27.3	68.3
<i>Natural gas</i>	7.5	100.0	0.0
<i>Ferrous metals</i>	6.5	71.0	7.2
Surface transport	6.2	14.6	82.4
Electric machines, audio, video	4.7	32.7	61.8
Food and meal products	4.1	40.1	39.7

Source: Own calculations based on the Ministry of Statistics and Analysis.

The situation is more complex with crude oil. Refinery oil products are partially used for domestic consumption, but mainly this business is export-oriented. At the same time, oil-refinery producers have a possibility to vary slightly the supply between export and domestic market depending on the current market conditions, taking in mind the total physical volume of the exported oil³. Furthermore, until 2009 the price for acquisition of crude oil is more related to the world market price, with some special correction coefficient in the Russian export duty agreed on a bilateral basis.⁴ Thus, the total result of the trade balance in oil business is very sensitive to the world oil price dynamics. *Hence, the world oil price which is in turn extremely sensitive to the shocks in global financial markets is the first direct link between the world economy and the Belarusian economy.*

Besides the oil, Belarusian economy also exploits businesses connected with other raw and intermediary goods. Like in the oil and oil refinery sector, there are grounds to assume that world prices at these markets can be affected by the global financial distress. Among the merchandize groups stressed ferrous metals and potash fertilizers are of prior interest.

From the point of view of trade balance, the situation in the sector of ferrous metals is rather similar to the oil and oil refinery branch. However, it is more complex, due to (i) the production line in this industry is rather wide and not constant, (ii) the proportion between needed raw input and industry output may vary, (iii) a substantial part the imported ferrous metals are used as intermediary goods by other industries, rather than as raw materials by the Belarusian ferrous metal industry. But nevertheless the trade with this merchandize group may be the second linkage between the

² For more details see Chubrik, A., Kruk, D. (2008). Scenarii razvitija ekonomiki Belarusi posle energeticheskogo shoka: prognoz na osnove makroekonometricheskoy modeli [Scenarios of Development of the Economy of Belarus after the Energy Shock: A Forecast Based on the Macroeconometric Model], *Working Paper of the IPM Research Center* WP/08/01.

³ According to the Energy balance agreement between Belarus and Russia, the latter takes commitments for import of 21 mt of crude oil per year. In practice this volume may fluctuate insignificantly.

⁴⁴ For more details see Giucci R., Kirchner R., (2007). Energy Shocks and Macroeconomic Management: Policy options for Belarus, IPM Research center Policy paper PP/02/07.

world economy and the Belarusian one, in case if the world price for ferrous metals somehow depends on the global economy financial trends, like oil price does.

The next merchandize group of interest is potash fertilizers. This industry does not exploit regular raw imported materials needed just for its output. Thus the impact on trade balance through it may be considered as just the impact on the potash fertilizers export revenues. *So, changes in world prices for raw materials (ferrous metals and potash fertilizers) because of the global financial distress might be the second linkage between world economy and the Belarusian one.*

Other merchandize groups important for the Belarusian external trade (see Tables 1, 2) are mainly related to the group of investment goods. In brief the situation may be presented as follows: Belarus exports its investment production mainly to Russia and in turn imports investment goods from Western Europe.⁵

2.3 Financial flows (financial account)

Since 2007, when Belarus faced an adverse price shock connected with Russian energy resources, the necessity of attracting capital from abroad increased dramatically. It was consequent to the substantial increase in the trade balance deficit alongside with the policy task of maintaining an exchange rate peg.⁶ The policy performed by the government in 2007 led to a substantial increase in major financial flows compared to 2006.⁷ FDI, borrowings by the government and monetary authorities, and commercial credits by non-financial sector provided major net inflows of capital during 2007 (12.2% of GDP on a gross-basis). Moreover, 2007 was the year of the most active accumulation of the external debt (capital flows other than FDI). In 2007 it almost doubled (the growth rate was 87.4% yoy) to reach USD 12.7 bn⁸, while international investment position worsened by 45.2% to reach USD -8.2 bn.

The dynamics of the capital flows was mainly determined by internal market conditions and was only slightly dependent on the stance of global money and capital markets. First, FDI mainly depend on the political decisions on privatization deals.⁹ In their turn, authorities' decisions about privatization seem to be made in case of lack of other sources of capital inflow. However, the investor side also matters here. For instance estimation of risks by an investor determines the decision either enter the market or not. Furthermore the price, which is ready to be paid by the investor depends on the international situation. But however at the current stage with a small amount of privatization deals we may argue that steady linkages between world economy and the Belarusian one based on the FDI flows seem to be unlikely. Second, bor-

⁵ These linkages are indirect ones and assume analysis of possible reaction of Russia on the financial crises. Moreover, the adjustments of the Belarusian demand on the imported goods relates mostly to the medium and long-run. In this paper we mainly focus on the immediate short-run impact of the global financial distress and thus consider this linkage in the context of Russian regional growth as a proxy for Russian demand on Belarusian goods and services.

⁶ For more details see Chubrik, A., Kruk, D. (2008). Also see Giucci R., Kirchner R. (2007).

⁷ Net inflow of FDI increased by more than 5 times, net inflow of other investment increased by than 2.5 times.

⁸ This figure includes the debt by the public sector of USD 2.0 bn (growth rate of 245.7% yoy), monetary authorities (USD 0.6 bn, growth from 0), banks (USD 2.6 bn, 72.9% yoy) and non-financial enterprises (USD 7.0 bn, 59.5% yoy).

⁹ Increase in net inflow of FDI has been provided mainly due to a couple of particular privatization deals, i.e. JSC 'Beltransgaz', JSC "Mobile Digital Telecommunication", privatization of some banks. Apart from these deals the net inflow of FDI was pretty close to the level of 2006 and was not substantial from the point of view of the Belarusian financial market. Hence at the current stage the FDI inflow to Belarus might be mainly referred to privatization related FDI, while non-privatization FDI provides only small inflow of capital.

rowings by the government are also mainly dependent on the political factors¹⁰, rather than on market conditions. Despite Belarus got sovereign credit ratings in July 2007, it has still not referred to public borrowings at the global financial market. Hence this capital flow in the Belarusian case is independent from the global financial distress. Third, commercial credits are mainly short-term and provided to each other by trade partners. Despite the conditions of granting such loans might somehow depend on the trends at the financial market (i.e. the discount rate, the length of the delay in payment, etc.) their overall availability seem not to be correlated to these trends in a direct manner. Furthermore, while as a rule these credits are short-term, it means that the accumulation of outstanding liabilities cannot increase sharply during more than one year, while even in case of attracting new credits borrowers will have to repay previously granted credits. Hence this flow cannot be considered as the steady capital flow that depends on the trends at the global markets as well. Thus in overall it is difficult to say about increasing degree of financial integration of the Belarusian economy into the global one, while a substantial part of this capital has been attracted either for short-term purposes due to external transactions or for intergovernmental loans.

Financial flows that are severely subject to global market conditions mainly limited with loans from foreign banks, made either by Belarusian banks or enterprises of the real sector. During the last three years, Belarusian residents have been borrowing from abroad more actively (see Appendix 2).

Both agents of the financial (banks) and non-financial sector use foreign borrowing in approximately equal proportion (if considering outstanding claims). Nevertheless commercial banks may be related as more active and more important borrowers, while they mainly deal with short-term borrowing (up to and including one year) reacting at the demand for additional foreign currency inflow of the whole economy.

During last three years the flow of attracted loans by the Belarusian banks has been increasing dramatically. Most often these loans are made by a consortium of foreign banks (syndicated loans), which is the common practice for the global market.¹¹

As for enterprises, their loans might be of more long-term basis (and form major part of those loans granted with the period over two years), while they are mainly connected with their own foreign trade deals. Furthermore, in some cases these loans may be the part of the foreign trade contract, supposing the main deal alongside with granting loans by a foreign bank affiliated with the counterpart of the Belarusian resident.

If one considers the distribution of the borrowed funds by the country of bank-lender origin, it can be seen that Belarusian residents mainly operate at Austrian, German banking markets (see Appendix 3).

Thus, on the current stage we may state that lending from foreign banks became vital (though not critical) for Belarusian residents, both of the financial and non-financial sector. Hence, changing conditions of the access to foreign capital and conditions of lending (interest rate, maturity, etc.) due to international financial distress may alter this substantial source of the BOP financing. Hence, from a macroeconomic view it may affect internal currency market and can potentially lead to a decrease in foreign currency supply. From the micro view, it may lead to negative tendencies for Belarusian banks, i.e. their lending abilities and their risk assumption.

¹⁰ In December 2007, Belarus succeeded to get loan from Russian government of USD 1.5 bn. Access to such kind of borrowing is mainly explained by political reasons and is not strongly correlated with market conditions.

¹¹ Priorbank being the member of Raiffeisen Group may be the exception from this rule, while it has got a possibility to borrow funds directly from its parent bank without establishing a consortium.

3. The origin of the financial crisis in the USA and spill-over to the global economy¹²

3.1. Origin of the crises

Housing prices increased rapidly in the US ("housing boom") since the start of this century, fuelled by aggressive mortgage lending practices by financial institutions. To understand the origins of the current international financial crisis, it is important to stress the connection between these two factors, whose interdependency formed a spiralling effect in form of a "financial accelerator". An increase in housing prices raised the value of collateral for mortgage loans and led to the disbursement of further mortgages loans. This, in turn, increased demand for housing further and led to another round of higher prices for housing.

A major regulatory reason for this spiral is rooted in the underlying evaluation procedures. In the US, the evaluation of property is done at market values, which creates strong pro-cyclical effects. In Germany, for comparison, not the market value is taken, but a long-term value of property is used as a base for lending. This creates an anti-cyclical effect, and mortgage lending cannot fuel a housing price boom in the same way as in the US.

Structural changes in the US capital markets further facilitated this boom. Many housing loans were not kept at the banks' balance sheets, but sold immediately after origination to investors (off-balance sheet securitisation) in the form of (residential) mortgage-backed securities (MBS¹³). These investors included unregulated, highly leveraged and very intransparent hedge funds. Other new and complex instruments were created and used for the risk transfer, e.g. credit derivatives like collateralized debt obligations (CDO's¹⁴). A feature was the fact that such instruments were positively rated by international rating agencies. The originating banks released with such sales their own underlying capital, which was then used for originating new loans. This practise contributed towards a lax checking of (low) creditworthiness of borrowers by the originators, and eliminated incentives to monitor the borrower. In particular, the risk of higher interest rates (flexible rates!), and therefore of an increase in defaults on higher mortgage payments was not sufficiently taken into account by the originators. Consequently, a high number of mortgages were disbursed to borrowers with weak credit profiles ("subprimes"), with relatively high loan-to-value ratios.

The actual crisis took its course when the Federal Reserve (Fed) started its tightening cycle of monetary policy. Rising policy interest rates implied that mortgage payments tied to this rate increased as well. Many borrowers were suddenly not able to service the loans anymore. At the same time, housing price growth started to slow down, eventually leading to a fall in prices. This deterioration in housing markets caused the following chain of reaction in the financial and real sector of the US economy.

Effect on the liquidity of financial institutions

Especially during the first months of the crisis, banks did not know to what extent they and other banks were exposed to subprime or similar structures. This uncertainty

¹² This chapter draws on the policy paper W13 "The international financial crisis: Risks and policy implications for Ukraine" by Giucci/Kirchner/Movchan by the German Advisory Group on Economic Reforms in Ukraine.

¹³ In the process of securitization, mortgages are packaged into pools of collateral, which form the basis of residential mortgage backed securities (RMBS). Different tranches of these RMBS are then sold to investors, with varying levels of priority on the cash flows generated by the underlying mortgage pool.

¹⁴ A CDO is a security that is backed by pools of bonds, bank loans, or other assets. This may include asset-backed securities, RMBS, corporate bonds and other instruments. Again, these securities are divided into several tranches that have differing levels of credit tolerances.

affected interbank lending significantly, and interest rates went up. These problems had to be partly solved by the Fed through emergency liquidity provision.

Effects on the solvency of financial institutions

Depending on the form of concrete exposure to the subprime segment, the solvency of financial institutions was drastically affected. Significant write-downs had a negative impact on the capital base, with some institutions going bankrupt or being taken. Many banks were forced to take measures in order to maintain their capital strength¹⁵.

Effect on the real economy

A number of different transmission channels of the crisis to the real economy can be identified. First, a negative direct impact of the housing market recession on economic growth is already underway, as housing construction investments contracted. Furthermore, the fall in housing prices could lead to negative wealth effects, as housing is an important part of household wealth in the US. Second, the problems in the financial sector have led to a tightening of lending standards. There is less room for new loans ("credit crunch") to enterprises, resulting in higher cost of capital. This has a dampening effect on investment and consumption, i.e. on the major components of domestic aggregate demand.

As a result, a recession or a major slowdown in the US in 2008 is possible, even though the data give not a clear picture yet. This depends to some degree on policy reactions, and policymakers are clearly responding in a speedy and encouraging way. Both monetary and fiscal policy instruments are currently actively applied. The Fed slashed aggressively interest rates and injected extra liquidity into the banking system in order to reduce systemic risks for the financial system. The associated depreciation of the US dollar has positively affected net exports. But also fiscal policy is clearly expansionary. Upon initiative of the government, the US Congress passed a fiscal stimulus package, injecting around USD 150 bn (corresponding to 1% of GDP) into the economy. The near future will tell if the economy will respond to these policy stimuli in a positive way, preventing a deep and long recession.

3.2. Impact on developed markets

The crisis in the US spilled over the second half of 2007 quickly over to other developed markets, in particular in Western Europe and Japan. Over the last years, many financial institutions invested in such financial instruments issued in the US, or generated substantial income from them.¹⁶ Due to this direct involvement in those US market segments where the crisis had its origin, the impact of the crisis on the *solvency* and on the *liquidity* of financial institutions has therefore spread in a quite similar pattern:

Regarding *solvency* issues, several banks announced high losses due to their involvement in the US-subprime segment, which led to regulatory intervention and the rapid organization of a bail-out or a takeover by other banks (e.g. Germany, UK). Also a considerable tightening of *liquidity* conditions in money markets was observed. Banks' mistrust of each other made them reluctant to lend to each other, and money market rates increased sharply. Major central banks around the globe were forced to provide punctually emergency liquidity to calm down market disruptions.

Indeed, although many financial institutions in the developed world have written-down a huge chunk of their affected assets (reported losses of USD 193 bn up to March 2008), this is unlikely to reflect the full extent of losses. The IMF estimated in April

¹⁵ This includes a combination of the issuance of new equity, a cut in dividends (or share buybacks programmes), the sale of non-core assets or – as mentioned previously – a cutback in new lending, leading to a "credit crunch".

¹⁶ Globally active investment banks structure, underwrite, sell and trade such complex products actively.

2008¹⁷ potential aggregate losses of USD 945 bn, i.e. close to USD 1 tr. Global banks account for around half of these estimated write-downs, while the other half is due to financial companies like hedge funds, insurance companies, etc.

Effect on the real economy

In the future, a threat exists of a spill over into the real economy. This spill-over could take place along *two main channels*: higher cost of capital due to a credit crunch, or via trade channels if the US falls into recession.

The *first channel*, higher cost of capital, seems currently at play, as credit conditions are observably being tightened. However, while recent indicators are showing some deterioration in the economic outlook of several major markets, current growth in many developed markets (excluding the USA) is still relatively robust. The financial conditions of real sector enterprises are still fundamentally sound and do not currently pose a brake on expansion.

The *second channel*, via trade, is potentially much more dangerous, as all major economies are quite open to trade and a recession in the US would lower their exports and hurt growth. The key question here is how long and severe a recession in the US would be, which also depends on policy responses. Currently, there is a high degree of uncertainty on this issue and a clearer picture will evolve in the near future.

3.3. Impact on emerging markets

Emerging markets were not *directly* exposed to the current financial turmoil, as their financial institutions did not have large holdings of US subprime assets. Consequently, the damage through subprime losses has been rather limited as compared to developed markets. The fact that emerging markets proved to be broadly resilient to the turmoil in developed markets culminated in the theory of decoupling. This view states that emerging markets have become far less dependent on economic growth in the developed world due to improved fundamentals (sound and improved economic and fiscal policy, high international reserves and sound external positions, strong growth, etc.), turning them into a kind of "safe haven" in times of global market turmoil. The key question is if this view is justified, and whether it will continue to hold going forward. To put it another way, what are the possible transmission channels of the international financial crisis into emerging economies?

While a direct transmission of financial sector turmoil did not take place, the *indirect effects* of this turmoil have already started to affect emerging markets. The observed increase in the cost of external finance¹⁸ and the reduction in the availability of external funds¹⁹ are clear signs that turmoil in global markets has affected financial conditions in emerging markets, even though conditions varied widely across countries. While macroeconomic fundamentals play a significant role, including the size of current account and fiscal deficits, also the level of dependency on external financing especially by the country's banking system is very important. This includes also a maturity analysis of external financing. If the pressure on banks in developed markets continues and further worsens, another potential financial contagion channel for emerging markets could open up. Especially in Eastern Europe, the banking sector is often majority-owned by international banks, which continued to provide funds to their subsidiaries, sustaining economic activity. However, if the process of de-

¹⁷ Global Financial Stability Report, IMF, April 2008.

¹⁸ This can be seen in the increase in country risk premiums (EMBI+ spreads or Credit Default Swap (CDS) spreads) starting in the summer of 2007.

¹⁹ A significant drop in external debt issuance throughout regions (EMEA, CIS), instruments (especially Eurobonds) and types of borrowers (private banks) was observed. To illustrate this point further: while during the first four months of 2007 banks in the CIS issued 45 Eurobonds and attracted USD 15 bn, during the same period this year there were just 5 Eurobonds issues, which raised less than USD 1 bn.

leveraging underway in global banks will lead to a cut in parent bank funding, the economic outlook will deteriorate.

A further rapid increase in the cost of capital could result in significant financial and economic problems for countries with existing macroeconomic imbalances, as strong past economic performance was supported by large foreign capital inflows. Higher interest rates and/or a sharp drop in capital flows exert pressure on economic agents, causing a deceleration of consumption and investment activity. If the exchange rate is fixed, and net foreign capital inflows are not sufficient to cover a possible current account deficit, depreciation (devaluation) pressure on the national currency will result in central bank interventions and a loss of reserves. In the worst case, a full-fledged currency crisis could develop.

To date, observers remain quite optimistic regarding the ability of emerging economies to withstand the world credit crunch, although growth rates are forecasted to ease slightly. According to the IMF²⁰, growth is expected to be robust both in 2008 and 2009. At the same time, this forecast is subject to significant downside risks. If an economic slowdown in the US and other developed markets is observed, the real economy channels are to enter the picture. Even though high regional economic integration (e.g. among CIS countries with Russia as a growth engine) serves often as a stabilizing factor, no country will be able to remain completely insulated from such a slowdown. Here, the reliance on foreign trade and the share of exports to countries hit by the crisis is important.

In such a situation, when the real economy is affected, domestic policy makers would be confronted with the dilemma of balancing between economic growth and inflation objectives. Starting last year, booming commodity prices²¹ – including energy and food – put significant upward pressure on inflation, especially in emerging markets, where such items account for much higher shares of their respective CPI baskets, and where exchange rates are sometimes pegged to a weakening US dollar. This led to a broad-based collapse in real interest rates, which might also serve as an explanatory factor why credit growth has held up relatively well in the region. However, rapidly rising inflation is a challenging environment for many central banks across the region, which requires tightening monetary policy and making the exchange rate more flexible. In the short-term, such measures could have negative effect on economic growth.

4. Belarus and the international financial crisis: Risks linked to trade flows

4.1. Global financial disturbances and changes in the relative prices of goods

During the last couple of years, a tendency of growing prices at the world markets for raw materials has begun. This trend has become mostly evident for the crude oil price. There were a couple of reasons for this. The first group of reasons is on the supply side. There is a technological limitation in supply of raw goods. In regard to the majority of them, many suppliers cannot increase the production in the medium-term, because of the limitations in their production capacity. Furthermore a substantial increase in demand for major raw goods led to almost 100% capacity utilization. One more reason from the supply side is the monopolized supply (for instance OPEC in crude oil production) in any form for the bigger part of natural resources and raw goods. The second group of reasons is on the demand side. The demand for major raw materials such as crude oil and metals has been increasing dramatically during the last couple of years. From the side of developed countries it was mainly due to

²⁰ World Economic Outlook, April 2008.

²¹ The relation between the international financial crisis, which is mainly centred on credit markets, and booming commodity (goods) markets is subject to much analysis. Possible speculation motives, as well as the weak US dollar might have played a role in driving commodity prices, while at the same time the overall good economic performance of emerging markets supported such developments.

economic growth and it was somehow correlated with the economic growth rates in these countries. As for the emerging markets (especially China, India and Brazil) their demand for natural resources has been increasing dramatically due to very high, resource-intensive economic growth rates. Moreover in some periods their demand for raw goods was even higher than their own growth rates, which is due to the technological changes in their economies and establishing new productions just in the emerging countries. Furthermore, due to high economic growth a share of consumers in these countries reached the level of income that might be considered as the critical one from the view of consumption structure. In other words, the households' demand for gasoline in developing countries was increasing faster rather than their income.

These tendencies give ground for the discussion about changes in relative prices for goods and commodities at the world market, i.e. that proportions between the price of good A and good B that had been rather stable for a long time, began to change. From a micro perspective, the relative prices may be considered as the most important information that reflects consumers' preferences and producers' technologies. Thus, changes in relative prices signal about changing economic environment and changing proportion of different markets depth and demand potential.

The dynamics of world prices for major commodities (see Appendix 4) show that rather substantive changes in relative prices began in 2005. The biggest price growth rates were specific just to raw materials such as oil and metals, while prices for non-energy goods increased much lower. These changes could be considered as beneficial for the producers of corresponding goods.

When the disturbance at the global financial markets started, the vulnerabilities at the world commodity markets increased. The main reason here was a decline in investors' risk aversion and hence, a big amount of funds was redirected out of financial assets into real assets. From this perspective, natural resources seemed to be the safest real asset due to their role in the global economy. Furthermore, taking in mind its growing price trend in the world economy, investors may expect natural resources to be at least a non-risky asset (and in some cases more profitable than financial assets). Hence, many investors redirected their funds into futures and forward contracts on raw materials. This speculative motivation gave an additional push to the prices. Since the 4th quarter of 2007 this tendency has been strengthened by the depreciation of the US dollar. This linkage works in two ways. First, while major contracts for natural resources are nominated in US dollars, then its depreciating trend led to increasing purchasing power of those agents whose assets were nominated in other (appreciating) currencies. Second, it gave an additional motivation to those investors whose assets were nominated in US dollars to redirect their funds from financial to real assets. Thus, at the end of 2007 and first half of 2008 global financial turmoil led to the increase of prices for raw materials, making their prices in real terms higher relative to other goods.

4.2. Risks concerning commodity prices

Oil markets

The increasing trend was most evident at the global oil market because this commodity is one of the most liquid and the corresponding markets are of great depth. In projection to the crude oil market, the reasons of price increase since 2004 until the first half of 2008 may be concretized as follows.²²

- Strong world economic growth that drove growth in oil use.
- Moderate non-OPEC supply growth.

²² For more details see: Short-term Energy Outlook Supplement (2007). Why Are Oil Prices So High? US Energy Information Administration, November 2007.

- OPEC members' production decisions.
- Low OPEC spare production capacity.
- OECD inventory tightness.
- Worldwide refining bottlenecks.
- Ongoing geopolitical risks and concerns over supply availability.

Since the 4th quarter of 2007, a sharp increase in oil prices has begun - average world crude oil price has increased by more than 66% since September 2007 up to the May 2008.²³ It was mainly consequent to the financial turmoil and increasing speculative incentives at the global oil market.²⁴ Thus, global oil market has become much more dependent on the stance of the financial markets and much more volatile.

While Belarus is highly dependent on trade with oil and oil products, these price fluctuations will certainly alter the Belarusian trade balance, i.e. export and import flows and thus will affect the foreign exchange market. In Chubrik, Kruk (2008) the projections for the trade balance with oil and oil products have been provided, which showed that the trade balance might be slightly positive in 2008 and 2009 under the condition of increasing the proportion of the oil products exported and directed at the domestic market. These projections were based on the projections of the price dynamics given by the US Energy Information Administration for the short-term (2008 and 2009) and IMF projections for the price dynamics in 2010-2011. However, volatile prices sharpened the problem of adequate and consistent short-term projections.²⁵ Mainly this problem is on the agenda in respect for the short-term projections that are susceptible to speculative motivations, while long-term ones are based just on the fundamental tendencies in supply and demand. Through this, under the condition of highly volatile oil price for defining its impact for Belarus, the task of finding out the dependencies between price dynamics and its impact on trade balance is more prior rather than the estimation of trade balance under the given price. Hence, analyzing the mechanism of price formation for imported Russian crude oil and price formation for Belarusian oil products²⁶ (the same as in Chubrik, Kruk (2008)) we may derive a function of trade balance depending from the physical volumes of crude oil imports and oil products exports and the price of crude oil. For the year 2008 this function measured in USD is presented by the Equation (1), for 2009 by the Equation (2).²⁷

$$F(X,Y,Z) = 7.36 \cdot XZ - 4.45 \cdot XY - 63.79 \cdot Y \quad (1),$$

$$F(X,Y,Z) = 7.36 \cdot XZ - 4.55 \cdot XY - 61.78 \cdot Y \quad (2),$$

where X – market price for Russian crude oil (Urals), USD/b; Y – the physical volume of crude oil imports from Russia, mt; Z – the physical volume of oil products exports, mt.

Partial derivatives of these functions show that change the trade balance in trade with oil and oil products is positively related to the price of crude oil. In other words, despite being the country with lack of natural resources Belarus shows the dependency peculiar to exporters of oil, i.e. the higher the price, the higher the net export reve-

²³ End of period. Source: US Energy Information Administration.

²⁴ Also some increasing political risks should be taken in mind connected e.g. with Nigeria.

²⁵ For instance, projections for prices in 2008 and 2009 have been revised by the US EIA by almost 15% higher in Short-term Energy Outlook in May 2008 in comparison to the November 2007 projections.

²⁶ A couple of assumptions are needed to derive this formula. First, we assume that the dynamics of price for Russian oil Urals is identical to the average world crude oil price. Second, we assume the identical price dynamics for crude oil and oil products. Third, we assume constant proportion within the Belarusian exports of oil products between light and dark oil products.

²⁷ The difference between these years origins from the different special coefficient for Russian exported crude oil to Belarus. In 2008 it is 0.335, while in 2009 – 0.356.

nue. But however, while Belarus depends on both exports and imports, it will reach a zero level of the trade balance at a particular value of the price. If we fix the volume of crude oil imports at the level of 21 mt that is envisaged by the joint energy balance of Belarus and Russia, and physical volume of exports at 15.1 mt that is identical to the level of 2007, then we may find critical values of market oil price (Urals), which will result in zero net export revenue. For 2008 this value will be 76.11 USD/b, for 2009 84.48 USD/b.

However global financial turmoil led to the level of crude oil prices that is much higher rather than these critical values. According to the US EIA short-term projections, the average annual price of Urals²⁸ might be about 105 USD/b in 2008 and 99 USD/b in 2009. In this case, under the condition of the exported physical volume identical to 2007, Belarusian trade balance on trade with oil and oil products will be about USD 512 m in 2008 and USD 226 m in 2009. Previous projections of trade balance, based on the oil price projections excluding the impact of global financial distress were USD 196 m and -32 m for 2008 and 2009 correspondingly. Hence, it means changes in oil prices that are connected with financial turmoil (alongside with other factors) and might lead to increase of the trade balance by USD 315 m and 258 m in 2008 and 2009 correspondingly.

Potash fertilizers

As shown in Appendix 4, before the global financial turmoil energy goods performed a leading growth with respect to other goods. As for the prices for potash fertilizers, they grew during the last couple of years, but the growth rates were substantially lower than those of energy or metal goods. On the one hand the situation at this market is rather close to other raw markets – strongly increasing demand driven by economic growth especially in emerging countries alongside with limited production capacities. A couple of companies – joint Belarusian and Russian Belarussian Potash Company (BPC), Canadian Canpotex, Russian Sylvinit and German K+S – are the major producers whose market share in overseas exports is more than 85%. On the other hand the performance of this market was distinct from other raw markets, showing more flat dynamics. The latter is mainly explained by the specific features of this market, for instance, its stronger connection with global food market (which is susceptible to some regulations) and trends in agriculture.

But since the end of 2007, and especially in early 2008 the situation with the price dynamics changed at this market dramatically. To some extent, it was related to the global financial turmoil. First, again here was the impact of a depreciating US dollar, which is the major currency for contracts nomination. Second, this market was partially affected by the sharp growth of prices in energy sector. It worked as follows. High energy prices and the lack of energy supply made producers to redirect some crops at biofuel production, which was one of the factors for increasing prices in agriculture and food production. An increase in food price led to the substantial increase in price for agricultural raw materials. Third, problems with crops and low inventories of food led some producers to increase volume of agricultural productions, which consequently increased demand for agricultural raw materials, including potash fertilizers. The latter tendency is more peculiar for emerging market economies. In overall these tendencies resulted in lack of supply at the market, which led to more than a double increase in spot prices (during less than half a year) and revision of prices in long-term contracts between suppliers and consumers.

The impact of potash fertilizers price growth is rather evident for Belarus. While technological conditions within this branch do not assume any imports which price may be connected with potash fertilizers, then the impact is constantly straightforward, i.e.

²⁸ For Urals projections we use the same growth rates as for the WTI in STEO.

the higher the price, the higher the export revenues (taking in mind limited production capacities). In 2007, Belarus (through BPC) has exported 4.35 mt of potash fertilizers, which gave export revenues of USD 1.3 bn. The average price of total exports was 310 USD/t. The major consumers of the Belarusian potash fertilizers are China, India and Brazil, which acquire it based mainly on long-term contracts. Major part of supply to other countries is made at a spot basis, which assumes more flexible price conditions according to real-time factors. Since the beginning of 2008 the BPC agreed new contract price in trade with Brazil, which reach about 630 USD/t. During Jan-Feb 2008 the weighted average export price achieved 556 USD/t, taking in mind old prices on long-term contracts with China and India (about 270 and 330 USD/t, correspondingly). In May BPC succeeded to fix a new price in contracts with Chinese and Indian producers, which amounted to 650 and 625, correspondingly. Furthermore BPC informed about new price of 1000 USD/t starting from July 1st. According to this information, we estimate²⁹ a weighted average export price of potash fertilizers at about 696 USD/t. Under the condition of the physical volume identical to 2007, the trade with potash fertilizers will give export revenues of USD 3.03 bn. In comparison to 2007 it will give additional revenue of USD 1.68 bn. Hence, from the view of this market the global financial distress led to beneficial outcomes for Belarus.

Ferrous metals

The dynamics of prices for ferrous metals is similar to other raw goods, having exhausted its growth since 2005. Since the disturbances at the global financial markets it has got a new push to growth, though not so strong as in case of crude oil. Nevertheless, there is an explicit increasing trend at this market that impacts the Belarusian economy. However the impact on the Belarusian economy is ambiguous. On the one hand, increase in price leads to the increase in the export revenues, which is mainly formed by the products of primary conversion. But on the other hand, it means the increase in value of corresponding imports of raw ferrous metals involved in the production cycle (mainly from Russia). Furthermore, Belarus also imports ferrous metals of primary and secondary conversion for own purposes, which also means increase of imports value under the conditions of growing prices.³⁰ In this case the gross impact of changes in prices on trade balance may not be stable, while there is a probability of varying physical volumes of either exports or imports responding to price changes. Moreover, the price dynamics in different subgroups of ferrous metals varies substantially. However, the analysis of past dynamics shows that the price increase of primary goods – iron ore – spills over to other subgroups of ferrous metals and in case of Belarus leads to negative effect for the trade balance (see Appendix 5). The negative trade balance reactions to increasing price is mainly due to higher growth rates of imported raw ferrous metals rather than growth rates of exported price. At the same time the index of import prices (including all ferrous metals) is lower than those of exports, which implies beneficial terms of trade in respect to the whole group. Hence we may suppose that the increase in prices due to the global financial turmoil will have a negative absolute impact on the trade balance. However there might a positive relative effect resulting in lower negative trade balance relative to the total turnover of ferrous metals.

4.3. Risks concerning global and regional economic growth

Other major groups of Belarusian exports are closely connected with Russia. Russia is the major trade partner for non-energy export goods and hence the level of income in

²⁹ We assume constant physical volume of exports in 2008 in respect to 2007. Furthermore we assume the constant share of exports to China, India and Brazil.

³⁰ Finally the physical volume of exports is much less than the physical volume of imports of ferrous metals, which determines negative trade balance on this merchandize group.

this country will determine their demand for Belarusian goods.³¹ Hence, global financial turmoil might have a negative impact in Belarus through affecting Russian economic growth. The latter is the key severe factor for the Belarusian exports, which is evident intuitively and also has got rather good econometric specification (see Chubrik, Kruk (2008)). So the risk here might be formulated as follows: *global financial market may undermine economic growth in Russia which might result in lower external demand for Belarusian goods.*

Russian economy has been integrated into the world one much more than the Belarusian one. Besides real linkages through foreign trade, there were significant financial flows, mainly revealing Russian's borrowing from abroad. For Russian residents it became wide-spread to become net borrower on portfolio investments and loans from foreign commercial banks.

As shown above, since 4th quarter 2007 emerging and developing markets including Russia faced outflow of investors' funds. This became a real concern for the financial distress of Russian financial agents. For instance, some analysts gave a forecast of mass bank runs on small and medium-sized institutions, and mass outflow of capital from Russia. But nevertheless capital outflows were painful for Russia, they have not become critical. The latter is explained by rather favorable stance of Russian enterprises that are mainly connected with raw and primary resource-extracting sector. Russian enterprises connected with oil (and other raw) sectors may exploit the advantages of growing prices for natural resources. Furthermore, despite integration through indirect financial flows, investments of Russian banks and investment funds into US mortgage markets were not so big and hence not as painful as for Western Europe. Thus we may argue about relatively better outcomes of the world financial crises for Russia rather than for other big countries.

Noting these tendencies for a couple of emerging markets, the IMF estimates the regional growth rate for CIS countries and Russia as almost unsusceptible to the global financial turmoil. For instance, the revision of the IMF projections in April 2008 in comparison to those in January 2008 was negligible for the CIS region and Russia (and it was almost the only case of a positive revision by 0.2 percentage points).³² Slightly negative consequences for Russia are reflected in slowing growth in 2009, i.e. negative revision of growth rates by 0.2 percentage points in 2009. Thus, we may argue about low risks for economic growth in Russia because of the international financial turmoil and hence low risks of steadily decreasing external demand from Russia for Belarus.

The latter coincides with last trends in Belarusian foreign trade with Russia. First, we must admit that the growth rates of Russian imports in Jan-Apr 2008 was still rather high at 49.9% yoy, despite lower than in Jan-Apr 2007 (54.8% yoy). Furthermore, Russian markets that are most important for Belarus also performed pretty high growth rates. Russian demand for imported machines, equipment and transport grew in Jan-Apr by 63.8% yoy (69.7% yoy in Jan-Apr 2007), while demand for imported textile grew by 56.9% yoy (92.9% yoy in Jan-Apr 2007). So the capacity of Russian markets important for Belarus is still going to widen, though its growth rate might decrease gradually. From this point of view international financial turmoil doesn't lead to negative outcomes for Belarus through Russian market, at least in short-term.

³¹ The second large Belarusian trade partner is the EU, but oil products consist about 70% of these exports. Furthermore potash fertilizers and ferrous metals form a substantial part of the Belarusian exports to the EU as well. Hence the impact of change in the external demand from the EU (for other merchandise groups) due to the financial turmoil is not so influential for Belarus. Hence in respect to regional economic growth we focus just on Russian market, which is essential for Belarusian producers (other than oil products, ferrous metals and potash fertilizers).

³² See *World Economic Outlook*, April 2008.

However, there is a long-term tendency at the Russian market of investment goods, which assumes increasing competitiveness between CIS-producers and producers from other world (mainly developed Western European countries). It results in a gradual crowding out of CIS-producers from this segment of the Russian market in favor of producers from developed countries that are more compatible in terms of quality and technologies. The latter also corresponds to the growing incomes in the Russian economy. In respect to the international financial turmoil this tendency might strengthen, i.e. in conditions of adverse global environment and relatively beneficial stance of the Russian non-financial sector they will reorient on more technological investment goods. The data on Jan-Apr 2008 might support this assumption, while the growth rates of Russian investment goods imports from non-CIS countries are much higher than from CIS-countries. For instance, in respect to the market of machines, equipment and transport the growth rate for imports from non-CIS countries amounted to 65.9% yoy, while for CIS-countries it was only 45.4% yoy. In Jan-Apr 2007 the corresponding growth rates were 71.8% yoy and 54.0% yoy. In other words, changing environment resulted at this market in bigger deceleration of the growth of demand from CIS-countries (by 8.6 percentage points) rather than non-CIS countries (by 5.9 points) and difference in growth rates between these two segments increased from 17.8 percentage points in Jan-Apr 2007 up to 20.8 percentage points in Jan-Apr 2008. Overall the share of CIS-countries in Russian merchandize imports decreased by 2.1 percentage points and amounted to 14.2% in Jan-Apr 2008.

However, despite of a couple of negative trends at the Russian market for CIS-countries, Belarus succeeded in increasing its exports to Russia with definitely high growth rates (44.8% yoy in Jan-Apr) that are the biggest ones within the whole CIS region (30.6% yoy in Jan-Apr). In 2007, foreign trade with Russia took place in conditions of high growth of Russian markets, but Belarus was loosing its market share on major positions. Furthermore, for the first time during a long period, Belarus succeeded in improving its competitive positions at the Russian market, at least in comparison to other CIS countries.³³

Therefore, we may argue that the main tendencies at the Russian commodity markets have been maintained. First, there are still rather big growth rates of these markets, driven by high economic growth rates. Second, at the same time there is still a tendency of increasing share of imports from Western Europe at the Russian market, while the same production from CIS countries is still loosing its market share. Third, changes at the Russian market gave a chance for Belarus to compensate its reducing market share by means of more intensive competition with other CIS countries.

Finally, we may state that in 2008 Russian demand for Belarusian commodities is still increasing in absolute terms (though growth rates are declining in comparison to 2007). Alongside regional tendencies, which are favorable for Belarus, it may increase its share at the expense of other CIS countries.

5. Belarus and the international financial crisis: Risks linked to financial flows

5.1. Risks with respect to foreign private borrowing

In part 2 we have shown that borrowing from abroad by means of loans by financial and non-financial enterprises is not extremely substantial for Belarus as it is for majority transition countries. However, the amount of borrowed funds has increased significantly in 2007. The major risks due to global financial distress here may be formulated as follows: (1) outflow of funds borrowed in 2007; (2) lower (lack of) access to

³³ The share of Belarusian production in Russian imports from CIS-countries increased by 3.0 percentage points to reach 32.0%. Overall Belarusian share in Russian imports decreased by 0.2 percentage points and amounted to 4.5% of total Russian imports.

capital by Belarusian borrowers, i.e. higher interest rates and shorter period of borrowing.

The first one has not become vital for Belarus (say unlike Kazakhstan) just because in 2007 Belarusian banks and enterprises attracted mainly short-term capital in form of syndicated loans, which are mainly repaid according to a fixed schedule (see Appendix 6). Furthermore, since the end of 2007, the intensity of borrowing through syndicated loans have declined substantially. Consequently the level of net foreign claims of the Belarusian banks that was declining³⁴ during 2007 is hesitating at the rather stable level in 2008.

This tendency is explained by the worsened conditions of borrowing for Belarusian residents. While foreign investors and banks began to classify investments in emerging and transition countries as much riskier in comparison to the investments within the developed markets, the interest rates for such borrowers increased dramatically. Furthermore, a crunch of liquidity was crucial at the world credit market during the 1st quarter of 2008. Hence, borrowing with longer terms also led to a substantial increase in the interest rate. But while there almost no experiences of transactions during 2008 so far, it is difficult to verify such evidence in regard to Belarus. Moreover, there is no index of interest spreads calculated for Belarus, as there is no external tradable debt outstanding. For demonstrating these trends we may consider as a proxy EMBI+ index³⁵ for neighboring countries such as Ukraine and Russia and also the total index for Emerging Europe (see Appendix 7). The EMBI+ indexes demonstrate that sharp increases in the interest spreads over the benchmark were peculiar to the end of 2007 and 1st quarter of 2008, which was unfavorable for new borrowings. Hence, Belarusian residents (especially banks) preferred to limit their borrowings from abroad under these conditions.

Thus we may argue about materialized risks in regard to foreign borrowing, which led to worsening conditions of borrowing abroad. But in the short-term (2008-2009) these risks are not very significant. First, due to positive trends in foreign trade the necessity of borrowing abroad, both by banks and enterprises, is not so urgent³⁶. Second, the US dollar is the currency in which the vast majority of settlements on external deals are made, and thus Belarusian residents prefer to borrow in this currency. But since the monetary policy of the US Federal Reserve is aimed at liquidity provision and has being softened in terms of interest rates³⁷, market interest rates in US dollar are decreasing over the financial turmoil development. Hence, for instance LIBOR interest rate in US dollars (12 months) has decreased during the year from the level about 5.5% per annum, down to the level of about 3% per annum (see Appendix 8). It results in substantially more favorable absolute values of interest rates in US dollars for Belarusian residents. Furthermore, this tendency gives an additional incentive to borrow in US dollars rather than in Euros (interest rates on this currency are substantially higher). Third, in case of necessity there is still a space for new borrowing, while even higher interest spreads at the global credit market mean absolute values of interest rates that are relatively small in terms of the Belarusian domestic credit market.

5.2. Risks concerning other financial flows

Part 2 showed that among other financial flows, FDI and borrowing by the government are the most important for Belarus. But both these kinds of financial flows have got specific features in Belarus.

³⁴ Declining denotes to increasing borrowing abroad or to decrease claims on foreign resident.

³⁵ It denotes returns on national Eurobonds, Brady bonds and loans from abroad in respect to US Treasury Bonds identical by the term of borrowing.

³⁶ But it may be much more vital in 2009, for instance in case of substantial increase in gas price in 2009.

³⁷ Currently US federal funds rate is 2% per annum, which is the minimum since 2004. It has been reduced gradually since September, 2007, when it was 5.25% per annum.

In 2007, an inflow through FDI mainly resulted from large privatization deals (see Section 2). At the same time, a net inflow from other FDI was negligible. It means that in case of Belarus, only a small part of FDI is susceptible to the conditions in financial markets. In 2008 the situation seems to be rather similar, i.e. major funds are to be obtained through the next payment by Russian Gazprom for Beltransgaz, and a couple of deals in the banking sector, which has become a major placement for FDI. Furthermore, Belarusian authorities declared an agreement on the deal in the telecom sector in regard to the third mobile operator "Best" and auto maker (MAZ). However, all these deals are not related to the substantial risks, while they are based either on a strong incentive of investors to enter the Belarusian market (banks, MAZ) or partially on the low efficiency of the sold state enterprise (Best). Hence, there is almost no risk of underestimating the price of these deals and outflow of such investments in the near future.

However, since 2008 Belarusian authorities have declared an intention for severe improvement in the investment climate, which may assume attracting FDI in new businesses and sectors without extra profits. This kind of FDI assumes high competition level among neighboring countries and may be associated with some risks. Attracting such investments at the time of financial turmoil may lead to underestimated price of the projects and vulnerabilities of such investments. Hence, in order to avoid such kind of risks, at least further privatization deals should be thoroughly analyzed and prepared, which may shift them till 2009 or 2010 when the global economy might restore. Alongside wide preparation (i.e. legal and institutional changes) may be done just during the period of high vulnerabilities at the financial markets. Furthermore, we may argue that inflow through FDI will not be as urgent for the Belarusian economy as it was in 2007. Hence in 2008 risks connected with global financial distress may be avoided if targeting FDI under more favorable global conjuncture. But herewith we must admit that at the strategic level FDI should be the first option, which solves not only the problem of external indebtedness, but leads to the technological restructuring of the economy and provides long-run preconditions for its further perspectives.

The situation with foreign borrowing is also rather specific. Despite Belarus obtained two sovereign credit ratings in 2007, there is not much progress in sovereign borrowing by means of issuing Eurobonds. The main source of borrowing by the government was an intergovernmental loan obtained from the Russian government. In the context of the global vulnerability, the terms and conditions on this loan are definitely favorable for Belarus. The interest rate for this loan was fixed with spread of 75 basis points over the LIBOR on US dollar, under the condition of postponement interest payments for 5 years and with the maturity of 15 years. The same scheme on interest payments is valid for other intergovernmental loans. Hence we may argue that increasing of sovereign spreads due to global financial disturbance will not alter Belarus from the point of view of existing liabilities in short-term perspective.

However there may be some risks if entering the market of sovereign borrowing in the time of distress. But from the point of view of the consolidated budget and trade balance in 2008 a huge necessity of such borrowing is unlikely. Hence there is no need to accept extra risks. However, Belarusian government may accept these risks in a small extent entering the market just for the future purposes. In any case, a debut issuance of Eurobonds is usually associated with higher interest spreads, which will gradually come down during the next borrowings. Thus, for the purposes of using this instrument of borrowing in the future, current conjuncture may be partially ignored and some risks might be accepted.

6. Conclusions and policy implications for Belarus

Until 2006, international capital flows did not play a major role for Belarus. As a consequence, the stocks of foreign debt and investment are still very low. This fact explains in part the so far limited impact of the international financial crisis on Belarus.

But things have changed since 2007, following the rise in import gas prices and the start of a substantial "energy shock" on Belarus. The country needs to attract foreign capital to absorb the energy shock and to remain competitive on the global economy. A growing current account deficit, coupled with the goal of a fixed exchange rate puts this topic high on the agenda of policy makers. Accordingly, the flows of international capital have increased heavily, a trend which will certainly continue and even strengthen in the coming years. As a result, the stock of foreign capital is likely to increase significantly in the near future, a trend that has already been observed throughout 2007. This in turn will increase the potential vulnerability of Belarus to financial crisis in the world. Thus, one of the key questions for Belarus in the context of the current international financial crisis is how to avoid being hit by future global financial problems, once the stock of foreign capital has reached high levels. In this context it is crucial to establish and/or further develop a system of monitoring of the main economic variables, such as credit growth, foreign borrowing, credit standards, asset price developments and the current account deficit. Such a monitoring could help to identify risks and could work as an early warning system. Below, we present three recommendations for making Belarus more robust against turbulences on international financial markets.

Recommendation 1: FDI as the generally preferred form of foreign investment

The decision to acquire companies abroad or to conduct green-field investments is as a rule a long-term decision. Thus, foreign direct investments are much less likely to be liquidated because of a financial crisis than e.g. portfolio investments or short-term loans. And even if the foreign direct investor decides to quit the country, the decision requires much more time than in the case of a purely financial investment. Besides, foreign direct investors in many cases have good access to finance and are less vulnerable to changes in the mood of financial investors, where contagion effects are wide-spread. If there are economic problems in the country, e.g. due to a recession, foreign direct investors will directly share the negative associated effects, as they will experience a drop in profits and dividends to be repatriated. This is in opposition to debt inflows, where interest payments have to be served regardless of the economic situation. Last, Belarus has a wide range of interesting assets that are still in the hands of the state. For all these reasons, we recommend to target FDI attraction as the main form of capital inflow to Belarus.

Recommendation 2: FDI into the banking sector

A large part of foreign borrowing is usually channelled through the banking sector. Domestic banks receive loans or issue bonds abroad and the resulting funds are used to provide loans to domestic borrowers. As a result, the financial situation of banks is crucial for the possible spill over of international financial crisis to other countries.

The ownership structure of domestic banks is a key determinant for the magnitude of this spill over. Domestic banks owned by foreign banks are less likely to face a sudden cut in foreign borrowing or a major increase in interest rates than banks owned by domestic business people. It is not in the interest of foreign banks to stop providing loans to their domestic subsidiaries, because this would reduce their profits and market share. Consequently, the attraction of foreign capital into the domestic banking system is a stabilising factor and should be considered as a priority for avoiding future problems in the financial sector.

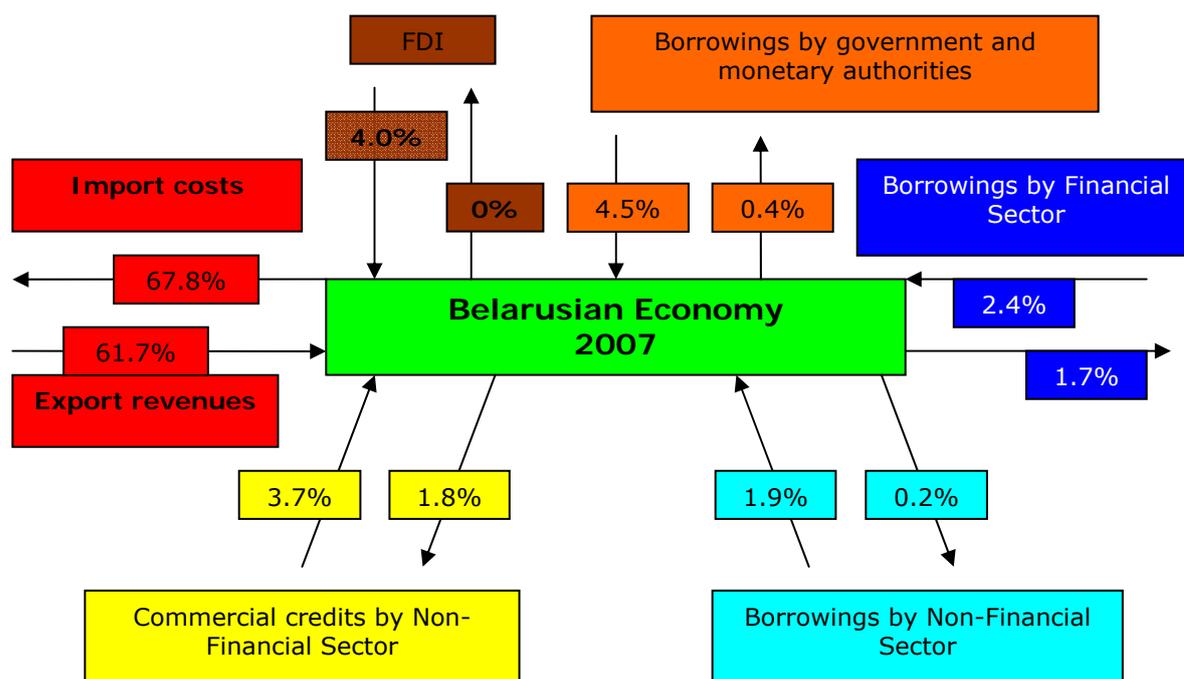
Following the same logic, it is important to secure a diversified regional structure of foreign ownership. If a large share of the banking sector belongs to banks from one single foreign country, then financial problems in this country will rapidly spill over into Belarus.

The so far positive experience of Ukraine in facing the international financial crisis illustrates the arguments above. Foreign banks paid relatively high prices to acquire banks in Ukraine and are in no mood of restricting lending to them. Also the diversified regional ownership structure (e.g. banks from EU countries such as Austria, Italy, France, Germany, but also from Russia) has shown to be a stabilising factor. The negative experience in Kazakhstan, a country with a low foreign ownership in the banking sector, but a high reliance on external borrowing also supports the views presented above.

Recommendation 3: Developing of domestic capital markets

The current international financial crisis has clearly shown the risks involved with excessive foreign borrowing. While capital inflows into Belarus are necessary for macro-economic and for structural reasons, the country should not overemphasize the role of foreign borrowing, here understood as borrowing at external markets and in foreign currency. Instead, it is necessary to further develop domestic financial and capital markets. The strengthening of domestic markets decreases the negative effects of turbulences at international financial markets and contributes to decreasing key risk factors in Belarus such as currency mismatches and high dollarisation. At the same time, non-residents will increasingly participate in such domestic markets, while carrying the associated exchange rate risk.

Appendix 1: Major Flows between the Belarusian Economy and the Rest of the World, as the Share of Belarusian GDP, %



Notes. Non-financial sector – non-financial enterprises plus households. Borrowings include items of other investments (loans, currency and deposits, other items) except commercial credits.

Source: Own calculations, based on the NBB data.

Appendix 2: Borrowings of Belarusian Residents from Foreign Banks by Sector and Maturity, USD m

	01.01.2005	01.01.2006	01.01.2007	01.10.2007	01.01.2008
Total foreign claims	635	1345	2223	3308	3406
Total international claims	635	1066	1735	2763	2795
Up to and including one year	403	675	1003	1685	1762
Over one year up to two years	11	62	119	200	181
Over two years	221	281	554	807	769
Banks	466	472	859	1235	1407
Public sector	23	61	71	76	38
Non-financial sector	146	485	749	1389	1274
Local assets in local currency	-	279	488	545	611
Net transfer of risk	-	-223	-313	-467	-433
Total foreign claims on an ultimate risk basis	369	1122	1910	2841	2973

Source: Bank for International Settlements.

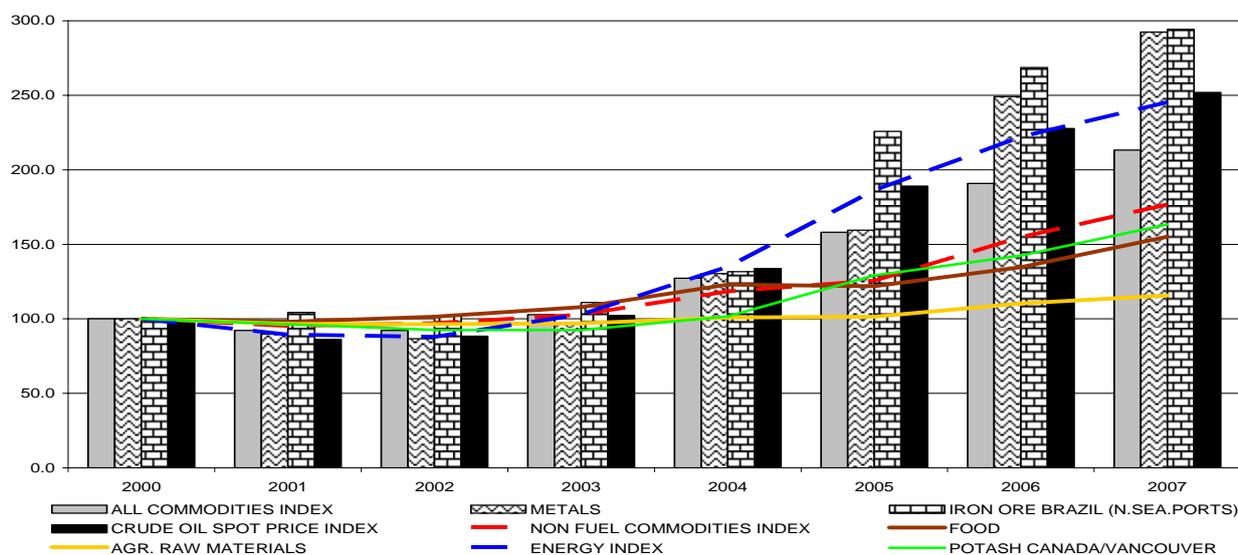
Appendix 3: Borrowings of Belarusian Banks by Domestic Country of the Lending Bank, USD m

Domestic Country of the Lender	01.10.2007	01.01.2008
Total foreign claims on Belarus, including:	3308	3406
Austria	1404*	1663
Belgium	47	45
France	104	121
Germany	1033	1013
Italy	147	187
Japan	4	4
Netherlands	108	144
Portugal	27	24
Spain	16	23
Sweden	4	3
Switzerland	68	83
Great Britain	4	10
European banks	3048	3334

Note. * - as of 01.07.2007.

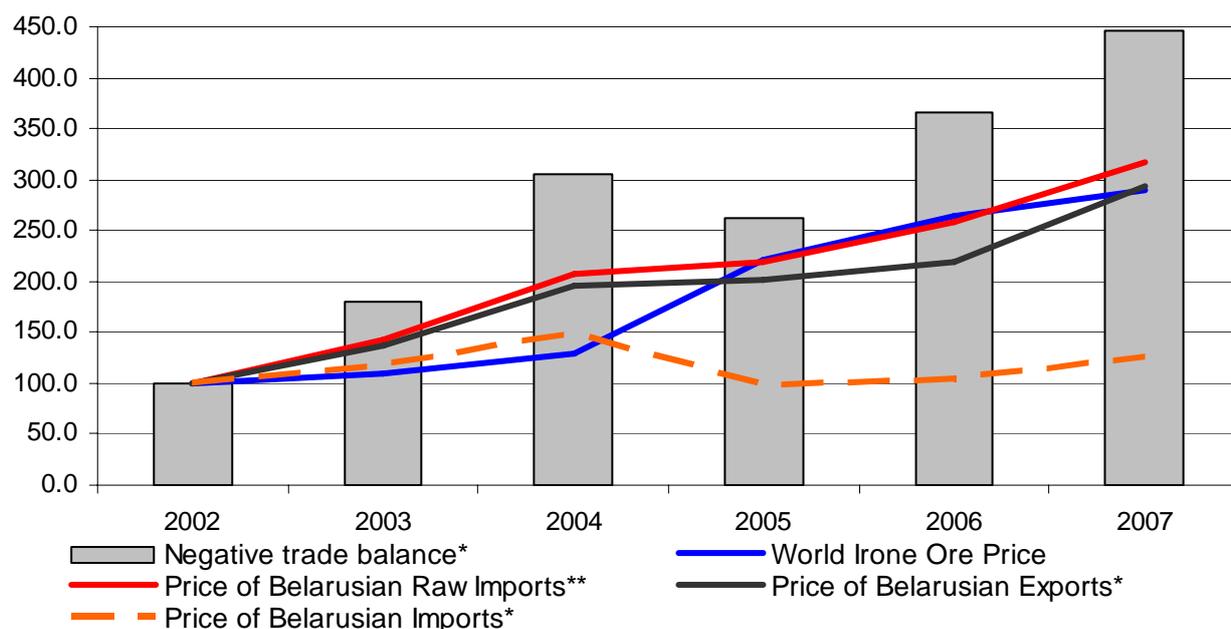
Source: Bank for International Settlements.

Appendix 4: The Dynamics of World Prices at Commodity Markets (indexes, 2000=100)



Source: International Financial Statistics (IMF).

**Appendix 5: Belarusian Trade with Ferrous Metals:
The Dynamics of Prices and Trade Balance (Indexes, 2000=100)**



Note. * - total for ferrous metals (group 72 according to HS), ** - iron-and-steel scrap, imports from Russia (group 7204 according to HS).

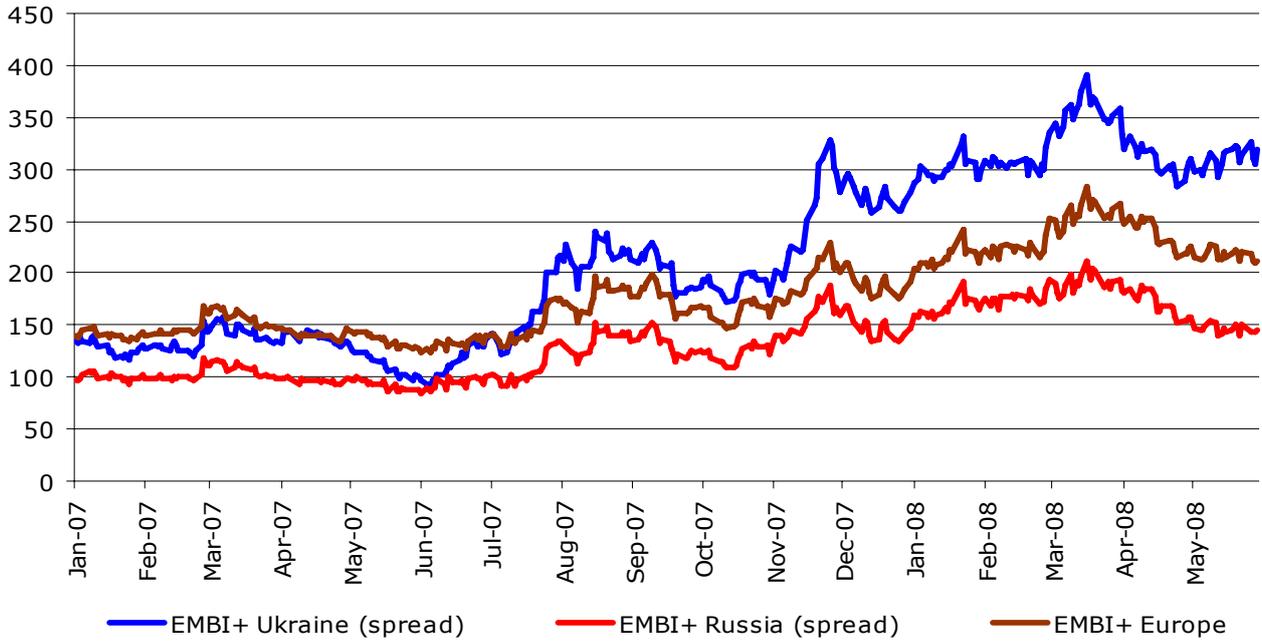
Source: International Financial Statistics (IMF), Ministry of Statistics and Analysis.

Appendix 6. Interbank Syndicated Loans Borrowed by Belarusian Banks

Bank-borrower and date of borrowing	Sum, m	Currency	Borrower's rating	Interest rate	Term of loans, month	Bank-lenders
Belarusbank, 6.2008	45	USD	- /B2/B-	LIBOR+285	12	BayernLB, Commerzbank, Banco Finantia, BayernLB, Credit Suisse, Fortis Bank
BPS-bank, 5.2008	78	USD	- /B2/B-	LIBOR+320	12	
Belagroprombank, 2.2008	40	USD	- /B2/B-	LIBOR+310	12	Banco Finantia, Commerzbank, UniCredit Group
Belinvestbank, 11.2007	41	USD	- / - /B-	LIBOR+330	12	BayernLB, VTB
Belgazprombank, 11.2007	35	USD	- / - /B	LIBOR+288	12	BayernLB, VTB
Belarusbank, 9.2007	105	USD	- /B2/B-	LIBOR+300	12	BayernLB, Banco Finantia, Commerzbank, VTB
Priorbank, 7.2007	100	USD		LIBOR+312	24	RZB Group
Belagroprombank, 6.2007	1000	RUR	- /B2/B-	970	12	VTB
Belgazprombank, 6.2007	35	USD	- / - /B	LIBOR+325	12	BayernLB, Gasprombank, VTB
Belinvestbank, 4.2007	11	USD	- / - /B-	LIBOR+365	6	VTB
Belarusbank, 4.2007	38	USD	- /B2/B-		12	BayernLB
Belgazprombank, 9.2006	20	USD	- / - /B	LIBOR+375	12	VTB, Gasprombank, VTB Bank Europe (MNB)
Belarusbank, 8.2006	65	USD	- /B2/B-	LIBOR+370	12	BayernLB, VTB, BTA bank
Belagroprombank, 8.2006	30	EURO	- /B2/B-	EURIBOR+400	12	VTB, VTB Bank Europe (MNB)
Belarusbank, 3.2006	38	EURO	- /B2/B-	EURIBOR+400	6	BayernLB

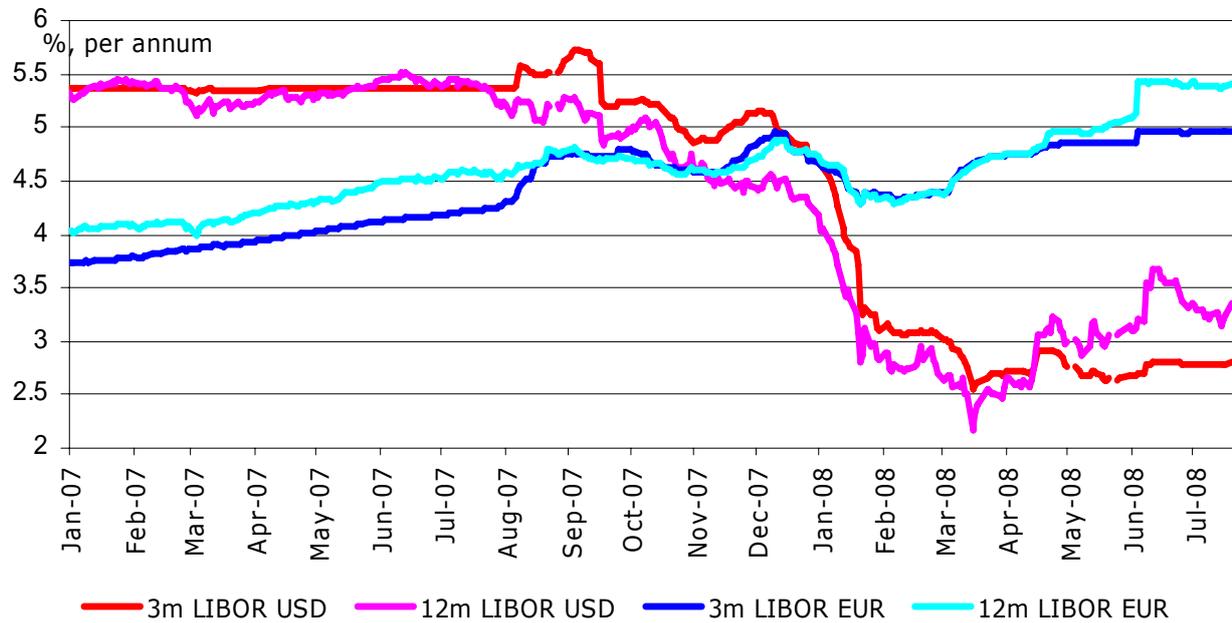
Source: loans.cbonds.info.

Appendix 7: EMBI + Indexes for Ukraine, Russia and Emerging Europe



Source: cbonds.info.

Appendix 8: The Dynamics of LIBOR-rates in USD and EUR (3 months and 12 months)



Source: cbonds.info.