BAS BAKKER'S ANSWERS AT PANEL DISCUSSION AT

Fitch conference: "Belarus Republic in 2018: Macroeconomic Situation and Banking Sector"

March 28, 2018

- ***Question:*** **Can you please provide us with your view regarding the progress that Belarus has made in terms of strengthening its policy framework and what challenges lie ahead to consolidate improved macroeconomic stability?**

Policy frameworks in Belarus have improved in recent years, and it is important that they continue to strengthen and remain prudent going forward.

Since 2008, Belarus has had three balance of payments crisis. In 2009, 2011, and 2015. In all three cases, large losses in foreign exchange reserves were followed by a sharp exchange rate depreciation, which led to a surge in inflation. In January 2012 inflation peaked at 110 percent y/y.

The cause of these crises was similar. Belarus was having large imbalances, and policies were too loose. There were several imbalances: the current account deficit was too high, the result of an investment boom. The government deficit was too high, particularly when off-budget expenditures were included. And SOE investment was increasingly inefficient: high investment resulted in ever lower growth.

In the first two crises, policies were tightened, but only temporary. Interest rates were increased, to make the ruble more attractive and stop the rapid depreciation. But once the situation stabilized and the economy recovered, policies were loosened again, and the exchange rate was repegged. Moreover, the underlying problems—including large scale support for SOEs were not addressed.

The response to the third crisis was different.

First. Belarus shifted to a flexible exchange rate. To keep the exchange rate stable, monetary and fiscal policies were tightened significantly. And they were kept sufficiently tight even after the exchange rate stabilized. The result has been that the exchange rate has *remained* stable, and inflation has come down sharply. As a result, interest rates have fallen, and growth has resumed. In the first two months of the year, GDP was 5.6 percent higher than the same months of 2017.

Second, the government has started to address the underlying problems of the economy. Large utility subsidies were reduced by raising tariffs. Some efforts have been made to liberalize prices and address SOE inefficiencies. Subsidies to SOES and directed lending were reduced. An asset quality review was completed for banks. And thinking on reforming SOEs has started.

These steps have moderated domestic and external imbalances and eased immediate financing pressures. External financing conditions improved further following a new energy pricing agreement with Russia, renewed financing from the Eurasian Fund for Stabilization and Development (EFSD) and Russia, and Eurobond issuances.

Does that mean that Belarus' economy is now out of the woods?

No, there are still significant vulnerabilities. Let me name several. You can read about them in the latest IMF Article IV report.

Foreign exchange reserves are low and financing needs are high. That combination is less of a problem during good times—when finance is plentiful. But when risk aversion rises, and financing dries up, this is challenging, as it may trigger a sharp exchange rate depreciation.

A renewed sharp depreciation is a problem because dollarization is high. When loans are in dollars, and the exchange rate depreciates, the local currency value of the debt surges. This makes it becomes much harder for firms to service their debt. NPLs rise, which in turn creates a problem for the banking system.

Fiscal buffers have eroded. Public debt has increased sharply over the past decade. Public debt, on IMF definition is now around 51 percent of GDP. Headline balances for the state government look fine, but they don't include several off-budget items. Over 2007–16, Belarus realized 2.2 percent of GDP on average annually in off-balance sheet liabilities through various channels, reflecting the dependency of loss making SOEs on subsidies and low interest rate loans. More recently, blanket debt restructuring (2.7 percent of GDP) was provided to failing state-owned agriculture entities, and off-budget spending on a new nuclear power plant (NPP) has been ramping up. As a result, public debt continues to rise despite positive headline general government balances in two of the last three years.

Weakened balance sheets in the largely state-owned corporate sector (including significant debt and currency mismatches) and state-owned banking sector continue to pose fiscal risks and hinder credit. Exports remain concentrated.

So, what needs to be done?

First, good macroeconomic policies. Fiscal policy needs to continue to strengthen—including, in particular steps to reduce quasi-fiscal risks emanating from the SOE sector—to bring debt down towards more sustainable levels. Moreover, the policy mix needs to be rebalanced to support growth. Monetary policy, which has been complicated by pressures from quasi-fiscal activities, is broadly on track to meet its inflation objective next year. Exchange rate flexibility should be preserved as a cushion against the impact of external shocks.

Second, structural reforms. Deeper and faster reforms are needed in the state-owned enterprise (SOE) sector, aiming to improve productivity and competitiveness and severing the dependence of SOEs on fiscal transfers and subsidized loans which creates a negative macro financial feedback loop. These should be combined with reforms in the labor and product markets to support the development of a vibrant private sector, and more efficient social safety nets (SSNs) to support social stability. All this will improve resource allocation and efficiency in the economy, leading to more robust and sustained economic growth.

I think it is fair to say that we see eye to eye with the economic team on what needs to be done: good macro policies and structural reforms.

Where we differ is on the speed of reforms. The government prefers a more gradual pace. Our worry is that a more gradual pace of structural and institutional reforms risks leaving vulnerabilities to linger for too long, putting Belarus at risk of shocks and inviting pressures for reversals to the type of state involvement in resource allocation seen in the past.

- ***Question:* What are the main risks for the country's economic outlook?**

There are both external and domestic risks.

External:

What happens with Belarus' key trading partners, for example the Russian economy, matters. Lower growth in Russia will hurt Belarus. Similarly, what happens with global risk aversion. If external market access becomes costlier, Belarus may have to rely on some combination of reserve drawdown, exchange rate adjustment, and tighter policies (and seek alternative domestic financing), which in a context of high dollarization and still low reserves, would likely generate renewed instability.

Given the better-than-projected performance of the world economy, there also upside risks, GDP Growth may well be stronger than we think.

Faster external integration via the Eurasian Economic Union (EEU), the Chinese Belt-Road initiative, and progress towards WTO membership, or significant remittances, could provide welcome support for policies and reforms and strengthen the medium-term external position.

Domestic:

As noted earlier, it is important that domestic policies continue to strengthen, if policies reverse, this could feed macroeconomic imbalances and lead to a renewed wave of nonperforming loans (NPLs) in the corporate sector and weakening bank balance sheets. Quasi-fiscal liabilities emanating from SOE and state bank balance sheets could be larger than currently estimated, thus pushing up public debt. Outward labor migration (including younger more highly-educated workers) could further exacerbate the already worsening demographic situation and pose additional pressure on the public finances.

I mentioned that it is important that domestic policies continue to strengthen. We worry that with the improved economic situation, there is less pressure to continuing strengthen policies.
In some areas, we have seen some reversals. Real wages are growing by 10 percent—a lot more than productivity.

- ***Question:* What measures can the government undertake to reduce fiscal vulnerabilities?**

- Strengthen fiscal frameworks essential for fiscal planning, management, and execution of fiscal policy.

- Set a medium-term debt anchor in the range of 45-50 percent of GDP, but expand its coverage to include government guarantees and local government debt.

- Expand the annual budget balance target to include all major debt-creating expenditures—namely, extra-budgetary funds (i.e. SPF), projects like the NPP, recapitalizations to cover losses, and interest rate subsidies on directed lending;

- Execute a fiscal consolidation to secure a firm downward PPG debt trajectory to a more sustainable level. Adjustment should continue until the primary balance reaches 2.5 percent of GDP, taking into account the phasedown of NPP spending. This will bring PPG debt down to around 52 percent of GDP by 2022, and a continued downward trajectory thereafter.

Employ a mix of revenue and expenditure measures to secure a growth friendly consolidation:

- *On the revenue side*: Tax expenditures should be curtailed—including repeal of VAT, interest income, and capital gains exemptions. Excise and environmental taxes should be hiked.

- *On the expenditure side*: Wage bill increases should be kept broadly in line with nominal GDP growth. Subsidies for directed lending should be scaled down and brought on budget. Additional pension reform measures should be brought forward to help close an emerging SPF deficit.

The policy mix should aim to open up space for other growth-friendly measures such as higher capital spending and more efficient SSNs—including an expanded unemployment benefit and training system and better targeted social support to offset utility tariff hikes, undertaken in parallel with SOE reforms.

The government should continue with close scrutiny of and limits on the issuance of new guarantees.