



REPUBLIC OF BELARUS

SELECTED ISSUES

July 2014

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June 24, 2014

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Approved By
European Department

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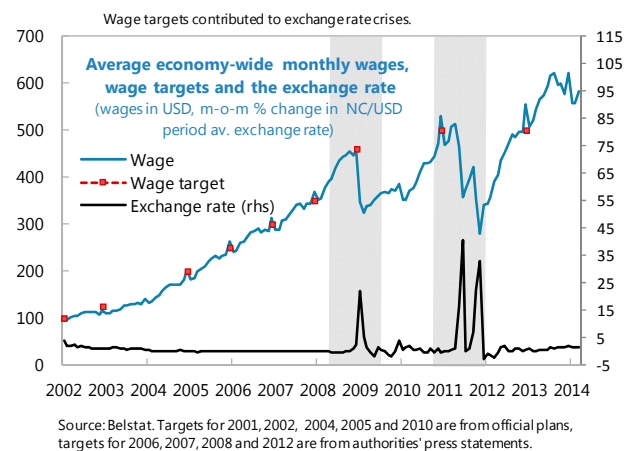
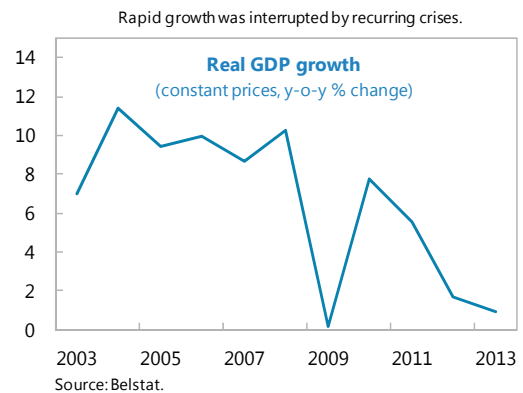
WAGE DYNAMICS IN BELARUS¹

Rapidly increasing wages remain a key concern in Belarus as they contribute to inflation, hurt competitiveness, and fuel exchange rate pressures. This note examines wage setting, in particular the role of wage targets, as well as wage dynamics, and the relationship with productivity. It finds that wage targets set by the government appear to be the key driver of rapid wage growth. Little regional and sectoral variation also suggests close adherence to official targets and a high degree of government control. Wage growth has outpaced productivity growth as the targets do not take productivity developments into account. To resolve these issues, in the short run, the authorities should aim for wage restraint to contain domestic demand and improve competitiveness. More generally, wage targets should be phased out to make way for more market-oriented wage-setting mechanisms. This should be complemented by deeper structural reform, in particular dismantlement of the wider system of mandatory economic targets.

A. Overview

1. **In the last ten years Belarus saw very high growth rates interrupted by two crises.** In the years 2003–2008 the economy grew rapidly, driven by high rates of investment and directed and subsidized lending, made possible by large subsidies on energy imports and direct financial support from Russia. However, domestic overheating exacerbated external imbalances leading to a crisis in 2008–09 and a second crisis in 2011.

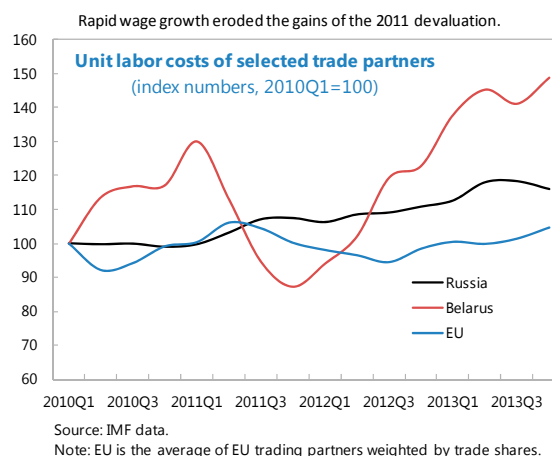
2. **Rapid wage growth was an important contributor to the crises.** Wage increases boosted domestic demand beyond the economy's productive capacity and decreased competitiveness, thereby stoking inflation and fueling imports. Rapidly increasing external imbalances in the context of a fixed exchange rate regime then led to repeated crises, characterized by abrupt and sharp devaluations. Nonetheless, wages have continued to grow rapidly even after the 2011 crisis, outpacing productivity growth, fueling domestic demand,



¹ Prepared by Zsoka Koczan (EUR), with contributions from Alina Kafarava (local economist, Minsk office).

increasing imports and putting strains on financing as enterprises struggle to pay the continuously increasing wages. Rapid wage growth has also eroded the gains from the 2011 real effective exchange rate adjustment, suggesting that competitiveness has fallen below the pre-crisis level.

3. **Wage targets set by the government appear to be a key driver behind rapid wage growth.** Wages are set according to a complex system, with economy-wide wage targets affecting both private and state-owned enterprises. While, contrary to past practice, official targets in US-dollar terms have not been set in the current five-year plan—or “Program of Socio-Economic Development” of 2010—they still appear regularly in media statements of the authorities. In addition, annual targets in rubel terms continue to be set and have been a key driver of wage dynamics.



4. **Wage targets are part of a broader system of production targets.** Ensuring growth in quantitative output indicators is at the heart of the economic model of Belarus. Quantitative targets are set in yearly plans in line with the five-year plan, broken down by ministries and administrative territories, and monitored by line ministries and local authorities. Targets, for instance on production, profitability, or exports, are compulsory for state-owned enterprises and companies that rely on government support, but even companies with a state share below 50 percent are subject to economy-wide or regional targets and state influence is also strong in private sector enterprises.

Structure of the economy by ownership type
(as measured by share in employment in 2012)

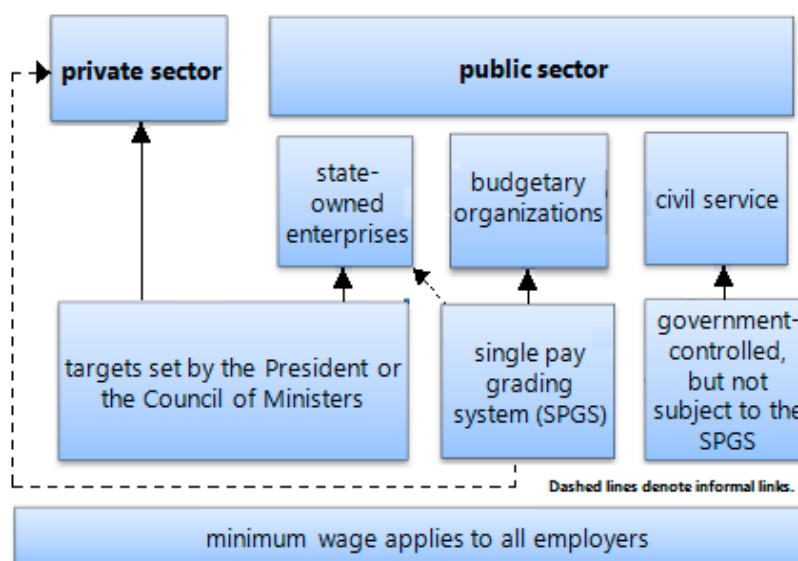
	share of employment (percent)
State , of which	42.1
SOE	19.2
Budgetary organizations	19.3
Civil servants	3.6
Private , of which	55.5
Less than 50 percent state ownership	21.3
No state ownership	34.2
Foreign	2.4

Source: Belstat.

5. **Since strong external pressures reemerged last fall, the emphasis on mandatory wage growth targets in public statements of the authorities appears to be reduced.** However, the impact of this is so far unclear, and being mainly a reaction to an increasingly challenging environment, it remains to be seen whether this will result in more permanent changes to the system. Also, the authorities continue to pursue ambitious GDP growth (3.3 percent) and real income (3 percent) targets.

B. Wage Setting

6. **Wage formation in Belarus is heavily regulated.** Economy-wide wage targets, and corresponding regional and town-level targets, are set in most years by the President and the Council of Ministers. The Programs for the Socio-Economic Development of Belarus for 2001–2005 and 2006–2010 set overarching medium-term objectives for the economy as a whole in dollars (US\$250 by the end of 2005 and US\$500–540 by the end of 2010), as well as intermediate targets. Complementing these, rubel wage targets or targets in terms of the growth of disposable incomes of the population are set in most years. These targets apply to the entire economy, including the private sector as the majority of ‘non-state’ medium and large enterprises are subordinated to branches of ministries or to ‘concerns’ (state-owned industrial complexes), which impose the targets on their members. The government thus has significant control over this ‘non-state’ sector as well. The government also influences wages in both non-state and state-owned enterprises by restricting managers’ wages to no more than eight times the average wage in the company. An administratively set minimum wage applies to all employers.

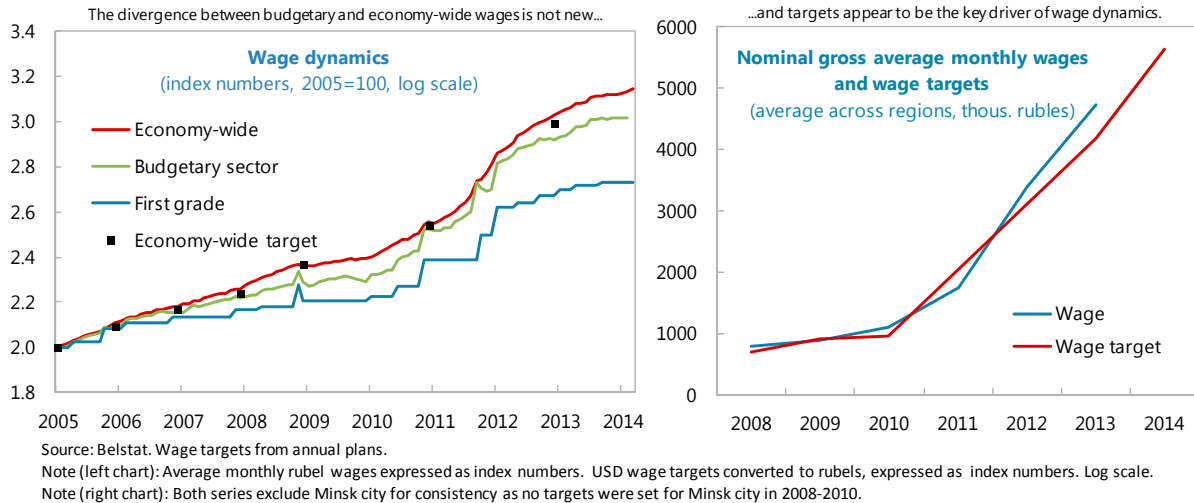


7. **Wages in budgetary organizations are subject to the single pay grading system (SPGS).** Budgetary organizations (organizations in education, health, providing social services) account for around 20 percent of employment. In the SPGS the government sets the so-called “first grade wage” and all other salaries as multiples of the first grade salary (see Annex 1 for details). While until 2011 all wages and salaries had to be determined in line with the SPGS, since mid-2011 real sector enterprises (‘non-state’ and state-owned) are no longer obliged to use the SPGS. However, due to inertia, many real sector companies continue to abide by the SPGS. The wages of civil servants (employed in ministries, the presidential administration, central and local government and government agencies) are directly government-controlled, but are not subject to the SPGS (see Annex 1 for details).

C. Wage Dynamics

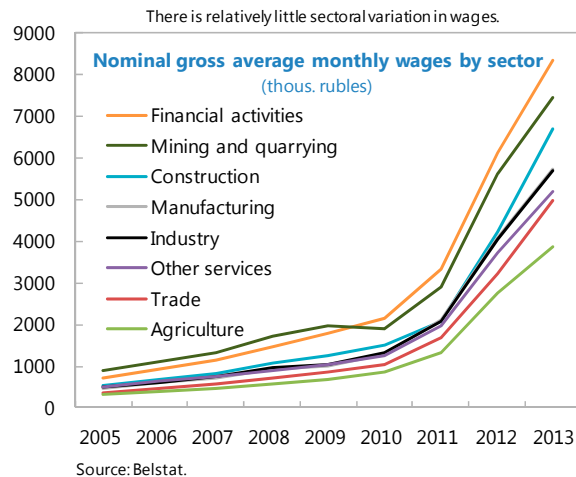
8. **Wage targets appear the key driver of wage dynamics.** Overall wage growth tends to be in line with the targets: rubel wages have tracked regional targets very closely (see chart on the right) and overarching dollar targets have been met every time. Contrary to what is often assumed wage targets appear to be a more important driver of wage dynamics than the SPGS. Even before

the abolition of the SPGS for real sector enterprises (June 2011) there was a divergence between economy-wide wages, wages in the budgetary sector, and the first grade wage.² And while the first grade wage set a floor, it did not show high correlations to budgetary or economy-wide wages.

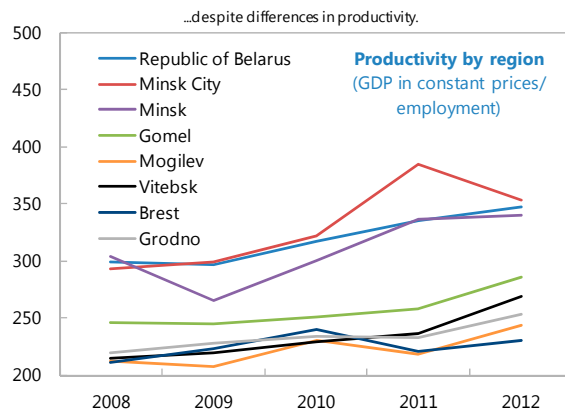
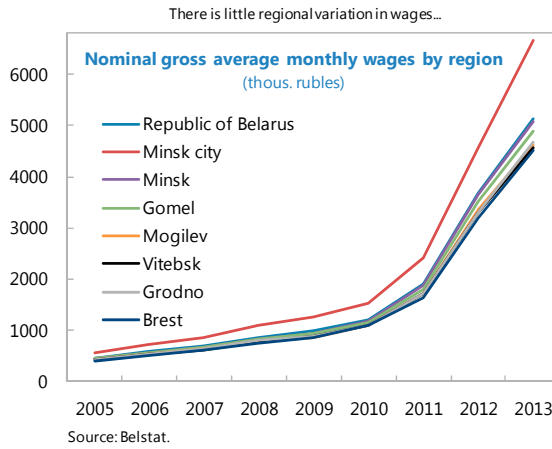


9. **There is relatively little regional and sectoral variation in wages within Belarus, illustrating the importance of official targets.** Wages are much higher (about US\$150 or 35 percent) in the capital and are growing faster compared to the rest of the country. However, most other regions are close (the difference between Gomel, fairsing best, and Brest, fairsing worst, is only around US\$40, or 9 percent of the average wage), despite differences in productivity. There is somewhat more variation in wages across

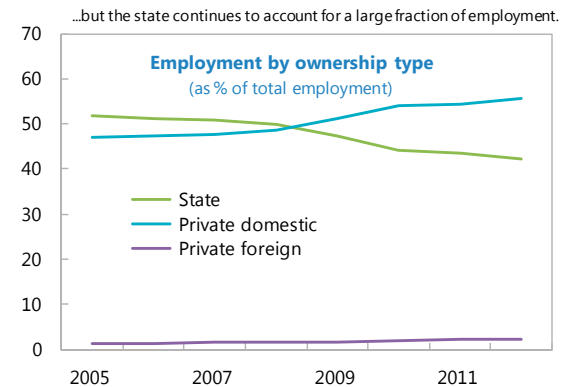
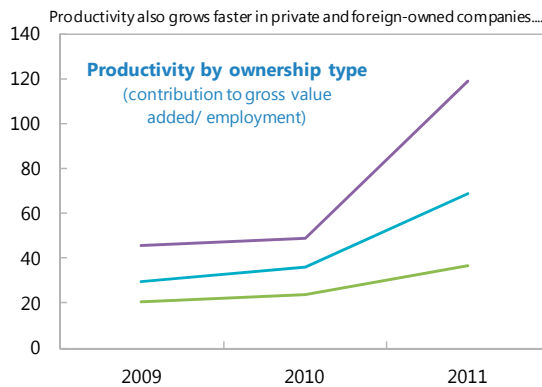
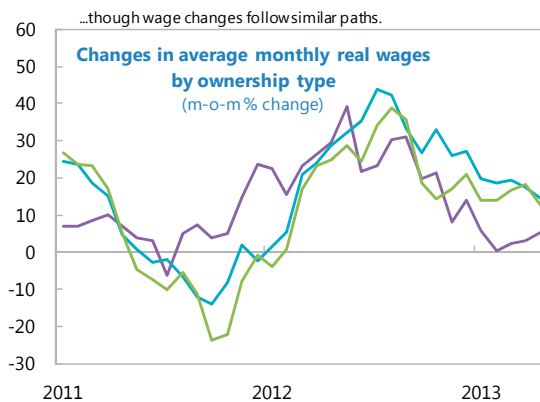
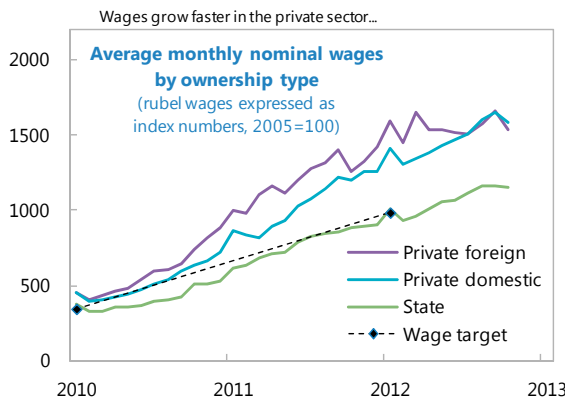
sectors, though even this is low compared to other countries (e.g. while in Belarus wages range from 68 percent of the average wage in the lowest paying sector to 166 percent in the highest paying sector, the corresponding range in Russia is 50 percent to 218 percent). Wages across different regions and sectors also show very similar trends over time. The lack of regional and sectoral variation suggests a close adherence to official targets and a high degree of government control. Policies also explicitly redistribute incomes in favor of low-income workers and sectors with lower wages, for instance through administrative restrictions on wage structures.



² Note that the economy-wide wage does not include small and micro organizations without departmental affiliation, accounting for 23 percent of employment. The budgetary sector includes civil servants, but does not include state-owned enterprises.

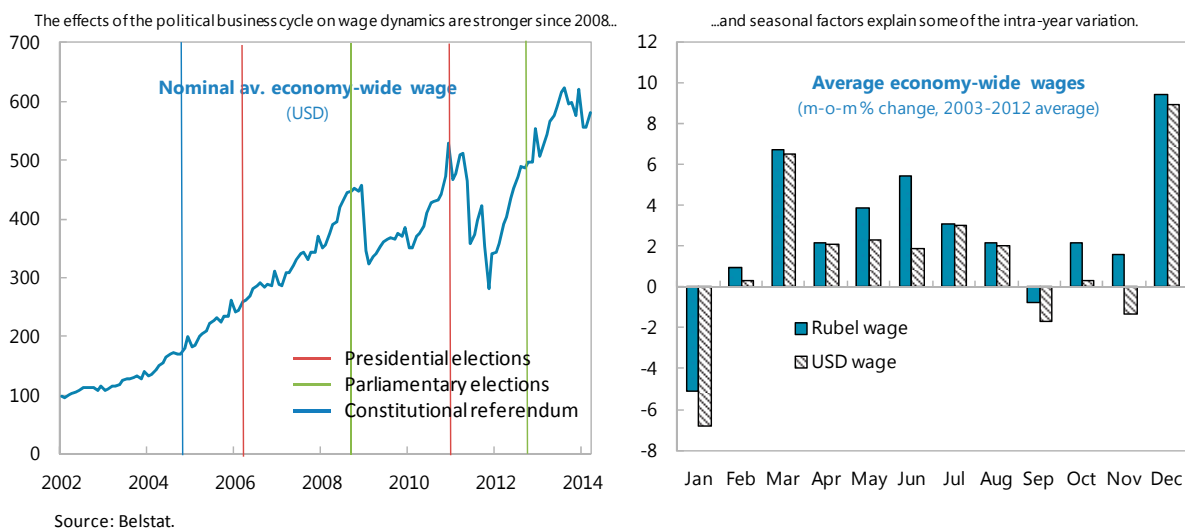


10. **Wages in the private sector, and in particular in foreign-owned companies, have increased faster than in the state sector.** The majority of state-owned enterprises operate in industry, transport and communication and agriculture and forestry and on average have more than 500 employees, while a typical 'non-state' company employs on average 18 employees. Wages in 'non-state' companies have exceeded wage targets and anecdotal evidence suggests that since 2012 'non-state' companies have continued to increase wages even at the expense of their profits to retain qualified employees in the context of spillover effects from one sector to another in a tight labor market (official unemployment has been below 1 percent since 2007). Foreign companies saw more rapid wage growth than domestic companies as they could likely afford higher wages owing to their much larger productivity gains.

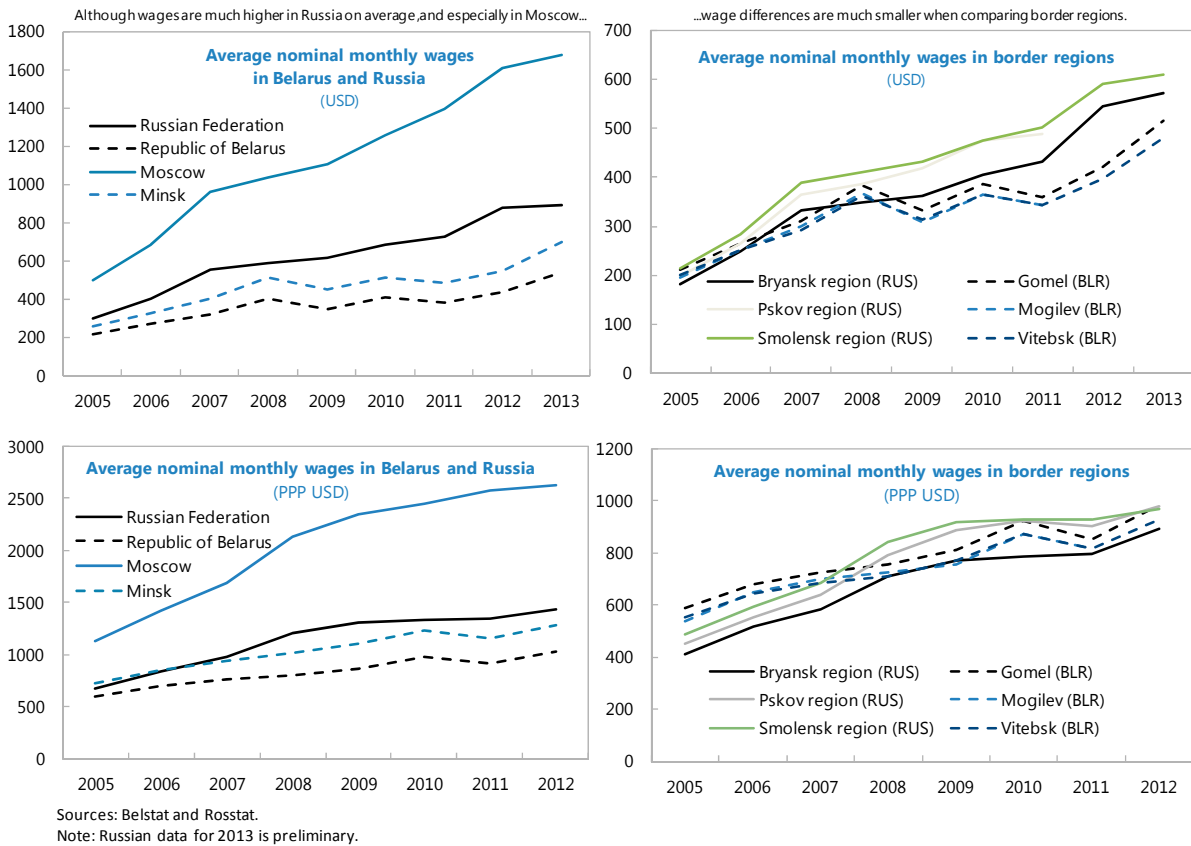


Source: Belstat.
Note: USD wage target converted to rubels, expressed as an index number.

11. **Wage dynamics are also affected by political and seasonal factors.** The political business cycle is a much-discussed determinant of wage dynamics in Belarus (see e.g. Chubrik and Giucci 2006, Chubrik 2012, or Akulava, Kirchner and Shymanovich 2013) and its effects are clearest in the run-up to the 2008 parliamentary and 2010 presidential elections. In 2011–2012 wages were increased rapidly to achieve the levels preceding the 2011 crisis and to prevent outmigration, especially of the highly skilled. Seasonal factors explain some of the intra-year variation, with marked peaks in December and dips in January reflecting seasonal payments as well as the importance of end-year targets. This also illustrates the importance of dollar wage targets, which are set in terms of end of the year levels, and are often followed by dips in subsequent months.

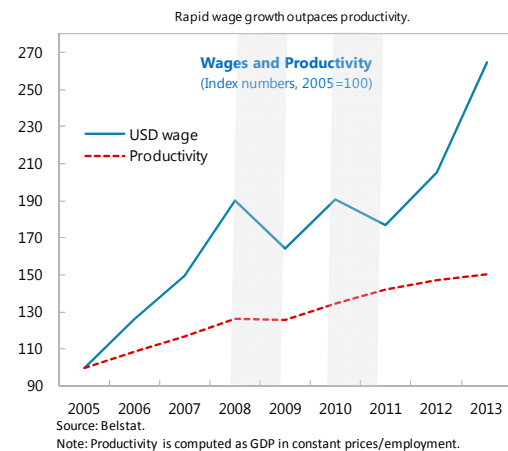


12. **Concern about labor outmigration, especially of the highly skilled continues to be an important driver behind target and wage increases.** While comparisons are often made with Russia, and Moscow in particular, wage differences are much smaller when compared to bordering Russian regions, especially in PPP terms (though given free movement of labor within the Customs Union, the roughly US\$100 difference still seems substantial). Comparisons with border regions are likely to be relevant for unskilled migration, while comparisons with Moscow may be more important for the more mobile highly skilled. After the 2011 devaluation increased the wage gap between Belarus and Russia it has been shrinking since 2012 as a result of rapid wage growth in Belarus. Nonetheless it remains around 40–50 percent in several sectors, including construction, transport and communication, financial activities and health care and education services. Unskilled outmigration is concentrated in construction and services, while there is concern about brain drain of senior managers, engineers and doctors (see e.g. Akulova, Kirchner and Shimanovich 2013), as policies compressing the structure of wages have resulted in substantial pay differences for the highly skilled.



D. Wages and Productivity

13. **Rapid wage growth has outpaced productivity growth.** Wage targets do not take actual ex post productivity into account and have exceeded even official productivity growth targets. For instance recent plans during 2010-14 aimed for annual productivity growth rates of 7–11 percent y-o-y, while dollar wage targets implied 30–40 percent growth rates.³ The disconnect between wage targets and productivity growth has resulted in a large multi-year divergence between wages and productivity, which has weighed on competitiveness.



³ A series for hours worked, which is generally used to obtain a per labor unit measure of GDP is not available for Belarus. Wages are deflated here using CPI since this is the relevant deflator in this context, measuring the purchasing power of wages.

E. Conclusion

14. **Rapid wage growth driven by ambitious official wage targets has contributed to repeated crises.** Wage targets appear to be a key driver of wage dynamics in Belarus. However, the targets have consistently exceeded productivity growth and therefore resulted in domestic overheating, fuelling inflation, reduced competitiveness and worsening external imbalances.

15. **Wage restraint should be complemented by structural reforms affecting wage setting.** In the short run authorities should aim for wage restraint to contain domestic demand and recover lost competitiveness, in order to address external imbalances and reduce inflation. This should be complemented by structural reforms affecting wage setting. Ultimately, wage targets should be eliminated as they restrict the flexibility to respond to market conditions. However, reform of wage setting will not be sufficient on its own and should be complemented by further structural measures to remove other distortions, such as direct and indirect subsidies to state-owned enterprises, which allow them to generate profit while at the same time maintaining excess employment (as the state acts as an 'employer of last resort'), while limiting their incentives to increase their productivity. Such measures should be further complemented by deep structural reform, in particular the dismantlement of the wider system of mandatory quantitative targets, in order to improve incentives, liberalize the economy, improve overall resource allocation and promote productivity growth and sustainable income growth.

Annex I. Wage Setting in the Budget Sector

16. **Budget-financed wages and salaries are set in line with the SPGS.** In the single pay grading system all jobs are matched to a specific grade level with the first grade consistent with low-skilled jobs and the highest (27th) grade consistent with jobs requiring highly skilled labor. The government sets the first grade wage for budgetary organizations and companies benefiting from the government's financial support. Base salaries for all other grades are multiples of (up to eight times) the first grade salary. Employees' wages W are thus defined as

$$W = (W_b) * (1 + A_1 + A_2 + \dots + A_n + B_1 + B_2 + \dots + B_m) + C_{gr}, \text{ where}$$

$$W_b = W_{igr} * TC * (1 + K_1 + K_2 + \dots + K_i)$$

W_b is a base salary, A_i and B_j are coefficients of allowances, bonuses and other payments (for instance allowances for experience, qualification, complexity of work, knowledge of foreign languages, and bonuses for plan performance, absence of complaints, achieving good indicators). W_{igr} is the first grade salary, TC is the tariff coefficient consistent with an employee's grade, set as a multiple of the first grade salary (ranging between 1 and 8) and K_i are multiplying coefficients, which depend on profession, field of the economy, age of the employee, organization, etc. (approved by the government). C_{gr} is a monthly allowance, used to adjust the level of wages and salaries so that an increase in the first grade wage does not necessarily translate into increases in actual wages and salaries in the budgetary sector.

17. **Civil servants' wages are government-controlled but not based on the SPGS.** Civil servants work for government agencies outside the budget sector. Their wages are set according to

$$W = (W_b + A_c) * (1 + A_2 + A_3 + \dots + A_n + B_1 + B_2 + \dots + B_m) + W_b * A_1$$

where W_b is a base salary (depending on the position and approved by the government for each agency), A_c is an allowance consistent with the civil servant's grade, $(W_b + A_c)$ is known as the current salary, $W_b * A_1$ is an allowance which is calculated on the basis of the base salary, and A_i and B_j are coefficients of allowances, bonuses and other payments.

For further details see the Ministry of Labor's Resolutions No.6 (January 21, 2000) and No.56 (June 17, 2013).

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Chubrik, A., 2012, "The new old choice for economic policymakers in Belarus," IPM Research Centre Commentary SN/12/02 (in Russian).

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EXTERNAL SECTOR ASSESSMENT¹

Assessing external stability is a key element of Article IV surveillance and of particular importance for Belarus in light of building external imbalances. The purpose of this chapter is to further contribute to the understanding of external vulnerabilities and risks in Belarus. To this end it discusses recent developments in the current account balance and its financing, the valuation of the exchange rate, and reserve adequacy.

A. Introduction

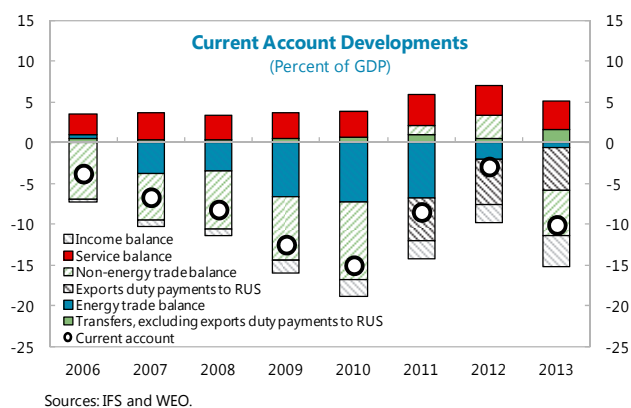
1. Belarus faces large external stability challenges stemming from an overvalued exchange rate and persistent current account deficits financed by external debt accumulation.

An exchange rate assessment by staff now clearly indicates overvaluation of the real exchange rate of the rubel, suggesting a complete erosion of the competitiveness gains from the large devaluation in 2011. Correspondingly, the current account deficit has recently widened again. Meanwhile, the external debt burden has increased significantly in recent years. Going forward, large financing needs—reflecting both the current account deficit and repayments on existing external debt—and very low international reserves present high risks to external sustainability. Strong commitment to more rapid exchange rate adjustment, inflation reduction, and deep productivity-enhancing structural reform is critical to restoring external competitiveness and mitigating the risk of a disorderly adjustment of imbalances.

B. Recent Developments of the Balance of Payments and External Assets/Liability Positions

2. The current account balance deteriorated sharply in 2013, after a temporary improvement during 2011–12.

The sharp devaluation of the Belarusian rubel during the 2011 currency crisis, which temporarily helped regain external competitiveness, and a one-off large-scale trade in solvents and related products in early 2012² contributed to smaller current account deficits in 2011 and 2012. However, those factors have since been reversed. The solvents trade came to a halt after the Russian authorities took remedial measures in August 2012. And an insufficiently flexible



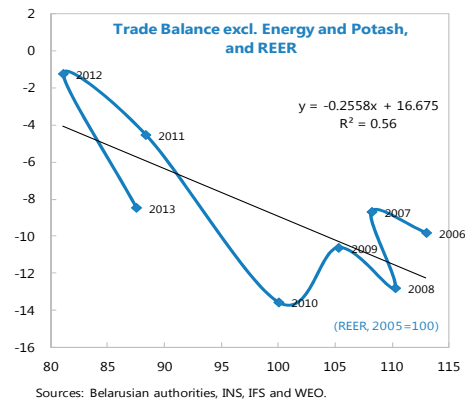
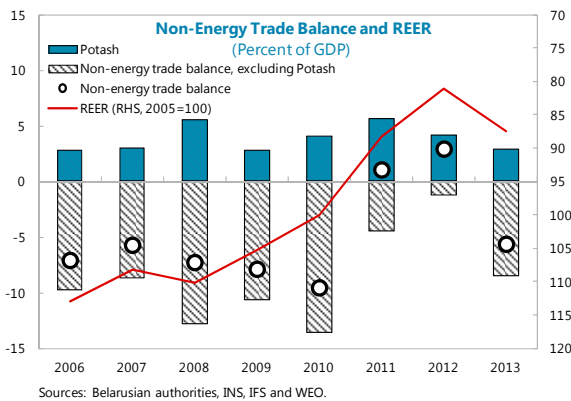
¹ Prepared by Kenji Moriyama (SPR).

² These were oil products imported from Russia at low common market prices and re-exported at a higher price to the EU as solvents, which are exempted from duty payments to Russia.

exchange rate, together with overly expansionary macroeconomic policies, has contributed to a sharp renewed real appreciation of the exchange rate and an erosion of the earlier competitiveness gains. Separately, trade-partner growth—especially in Russia—also slowed substantially, reducing demand for Belarusian exports. In combination, these factors reversed the balance of payments improvement after the 2011 crisis and caused the current account deficit to balloon to 10 percent of GDP in 2013.

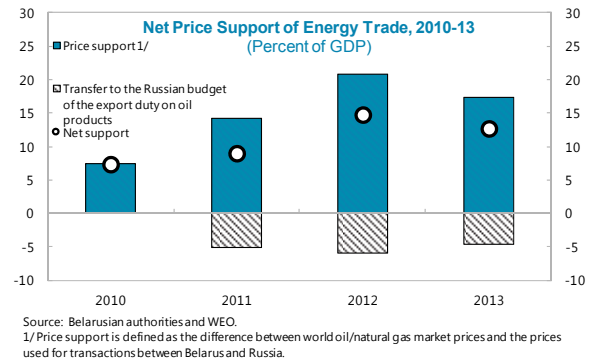
3. The nonenergy balance has been a key driver of recent current account fluctuations.

During 2011 and 2012, the nonenergy balance improved markedly—a development that appears closely associated with the sharp depreciation of the real effective exchange rate (REER) by about 20 percent during the period, given a historically strong negative correlation between REER and nonenergy balance.³ In line with this relationship, the non-energy trade balance turned to deficit again in 2013—a year in which the REER appreciated by about 8 percent. This said, the speed of the current account deterioration has been amplified by other factors such as the halt of the solvents trade since the middle of 2012, the slow-down in trade partner growth, and expansionary macroeconomic policies that boosted import demand.



4. Meanwhile, the energy trade balance improved on energy agreements with Russia.

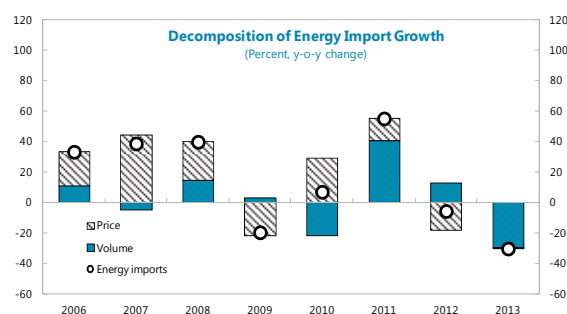
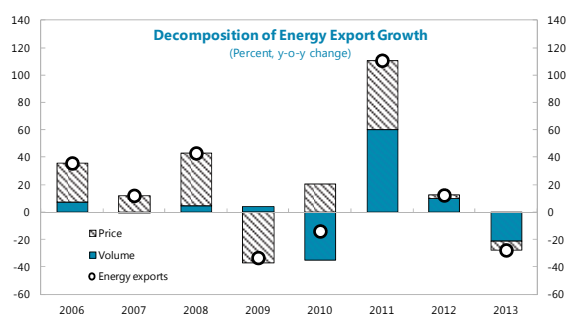
Declining trade deficits in crude oil and natural gas reduced the energy trade deficit since 2011, nearly closing the balance in 2013.⁴ While interpretation should be cautious because the energy trade data has been distorted by the temporary solvents trade in



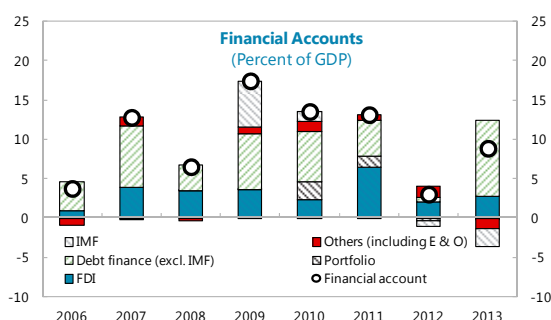
³ The observation in the scattered chart is robust to including/dropping potash exports.

⁴ Improvements of energy trade balance after 2010, however, have been to some extent offset by the export duty payments to Russian budget—an obligation under the Custom Union when oil products are exported to countries other than Russia.

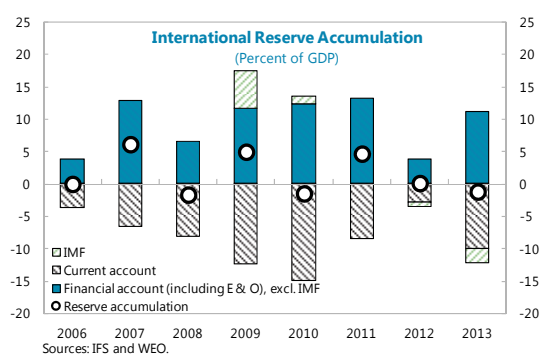
2012, in general, the decomposition of energy export/imports receipts into volume and price effects indicates substantial positive impact of the introduction of the Common Economic Area since 2011. Under its agreement, Belarus is allowed to import oil from Russia duty free, implying a discount equivalent to about half the world market price. In exchange, Belarus transfers to the Russian budget export duties that are imposed on petroleum products produced from duty-free Russian oil. Belarus has benefited from the substantial positive difference between the price discount and the export duties on refined products⁵, as is highlighted in the text chart on net price support. As a result both export and import volumes increased but a large simultaneous increase in oil product export prices in 2011 helped structurally improve the energy balance.



5. **The current account deficit has been financed by debt liabilities and privatization.** Over the past 5 years, the current account deficit has been financed in particular by foreign debt. This included (i) IMF borrowing (US\$3.5 billion); (ii) the issuance of two Euro bonds (US\$1.8 billion); (iii) disbursements from the Eurasian Anti-Crisis Fund (US\$2.6 billion); and (iv) bilateral support (US\$1.3 billion). In addition, receipts from the privatization of the natural gas infrastructure operator (Beltransgas) in 2009 and 2011 were another major source of financing (US\$6 billion). These various large external financing items helped not only finance the large current account deficits, but also allowed for a substantial increase in international reserves (before declining in 2013, reserves improved from 1.2 months of import cover at end-2008 to 2.1 months of cover by end-2012—a nominal increase of about US\$5 billion).



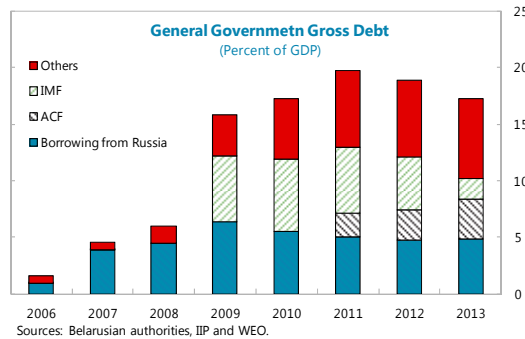
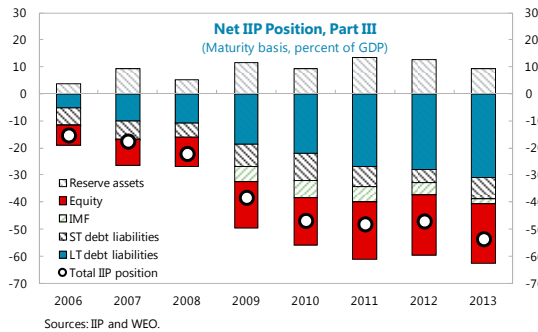
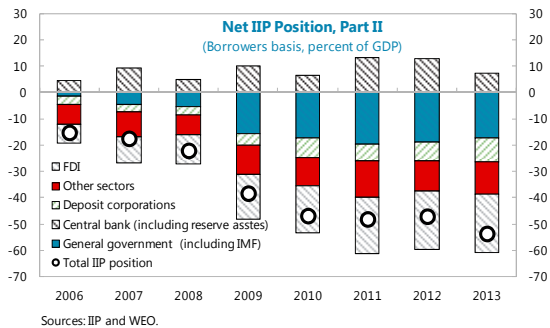
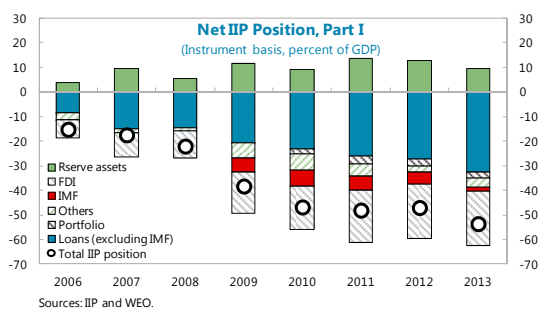
Sources: IFS and WEO.



Sources: IFS and WEO.

⁵ For details, see Box 1 in the 2011 Article IV staff report (EBS/11/25).

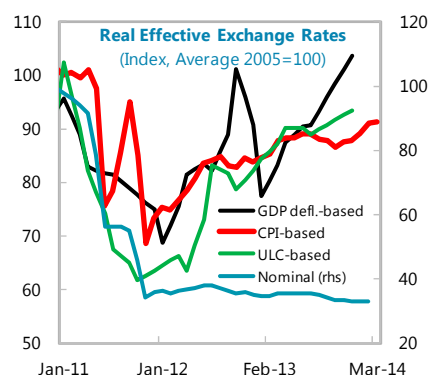
6. **Accordingly, the net external position has deteriorated.** The sharp increase in foreign borrowing since 2008 contributed to an increase in net foreign liabilities. However, deeply negative interest-growth differentials muted the deterioration of net external position, which has been moderate relative to the size of current account deficits. As the borrowings from the IMF were gradually repaid, the composition of government external debt has shifted toward obligations to Russia and to the ACF—a trend that will continue in the near future if loans promised by Russia (totaling US\$2 billion) and the final tranche of ACF (US\$440 million) are disbursed. With Belarus having only limited access to international financial markets, the share of short-term foreign debt liabilities remains modest.



7. **Low reserves, a persistent current account deficit, and large debt repayments in the coming years, pose significant risks to external sustainability during 2014 and 2015.** Where current account deficits were financed with borrowings from the Fund in 2009–10 and subsequently from the ACF during 2011–13, in addition to the proceeds from the stepwise sale of Beltransgas, going forward external financing sources are highly uncertain. As the current external imbalances cannot be sustained without significant new foreign financing sources, this implies high external risks for the upcoming period.

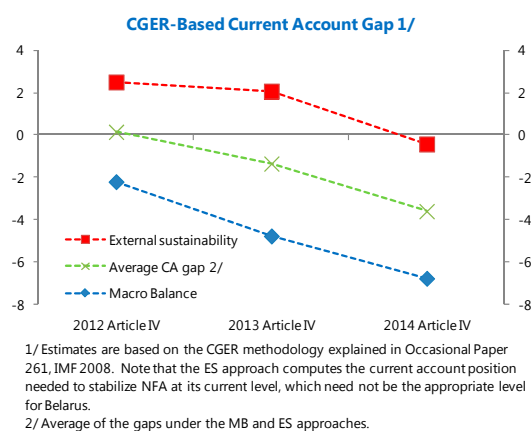
C. Exchange Rate Assessment Based on the CGER Methodology

8. **Inflation differentials and an insufficiently flexible exchange rate have led to overvaluation of the rubel.** Total REER appreciation in consumer price index (CPI) terms of about 35 percent—and over 50 percent in unit labor cost (ULC) and GDP deflator terms—since the 2011 devaluations suggests a serious erosion of competitiveness. An assessment based on the standard CGER methodology (IMF, 2008) suggests a significant overvaluation of the exchange rate, indicating a weakened external competitiveness position.



9. **Applying CGER methodology to Belarus is challenging.** The External Sustainability (ES) approach is less informative because stabilizing NFA at the current low reserve levels is not desirable. Meanwhile, data constraints render the Equilibrium Real Exchange Rate (ERER) approach infeasible for Belarus. The Macroeconomic Balance (MB) approach is best suited for an assessment of Belarus' external stability, but needs to take into account the unsustainable nature of the current external imbalance, which reduces the accuracy and relevance of any projected medium-term current account balance. Given these challenges, the staff's exchange rate assessment is mainly based on the MB approach using the projected 2014 current account balance (rather than the medium-term balance forecast) as a proxy for the underlying balance.

- The MB approach estimates a further widened gap between the projected medium-term current account and the estimated norm to around -7 percent. This is consistent with a significant overvaluation.
- Moreover, different from the assessment in the 2013 Article IV Consultation, the ES approach now indicates a negative gap, despite the deeply negative interest-growth differentials.



10. **These estimates should be interpreted carefully.** The high degree of state control in the Belarus economy and related administrative interference with price formation significantly weaken the role of price signals relative to a market based economy. This introduces considerable uncertainty in the estimated effectiveness of exchange rate adjustment.

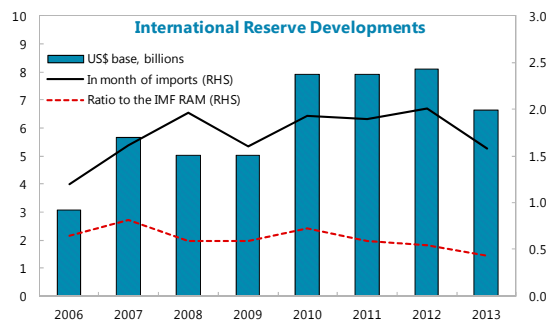
11. **An assessment based on wage differentials broadly confirms the above CGER findings.** Economic fundamentals (per capita GDP, US\$ basis) and hourly labor cost (US\$ basis) among CESE countries in 2011 and 2012 show very strong positive correlation. The size of misalignment, defined

as the deviation from the cross country tend line, suggests that the hourly labor cost in Belarus is 20–25 percent higher than the fundamentals would suggest at the current exchange rate.

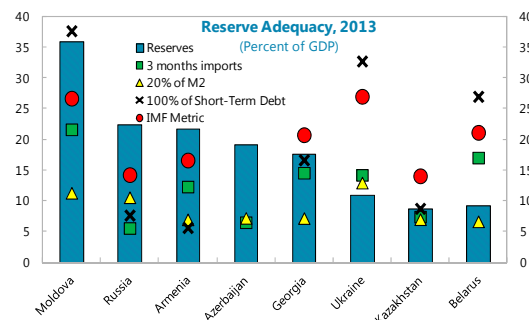
D. Reserve Adequacy

12. **International reserve levels have fallen to precariously low levels.** Despite significant current account deficits, reserves increased substantially during 2009–11 on the wings of multilateral and bilateral financing, including from the IMF, and the privatization proceeds from the sale of Beltransgas. However, from 2012 reserve levels have fallen again, reaching a low level of 1.8 months of imports at end–2013 and less than 1½ months of imports at end–April 2014. Coverage of short-term external debt liabilities is 47 percent and well below the 100 percent that is commonly regarded as adequate. In addition to these traditional metrics, international reserves are also low when measured against the IMF reserve adequacy metric in 2013. The IMF reserve adequacy metric is a composite metric of risk factors (such as export declines, deposit outflows, rollover risks of short term liabilities, and deleveraging) that intends to combine various precautionary motivations for reserve holdings to prevent and mitigate crises in a country.⁶

13. **Belarus’ reserve position is weak relative to peers.** Belarus has the lowest level of international reserves among regional peers when measured as a share of GDP and also compares highly unfavorably on relative measures of reserve adequacy. In particular, measures relative to short term debt and import cover suggest that reserves are far below regional comparators. It also compares unfavorably on the IMF’s risk-weighted metric, with only Ukraine being more vulnerable on this measure.



Sources: Belarusian authorities, WEO and IMF staff estimates.



Source: IMF

⁶ For details, see IMF (2011, 2013). In general, an international reserve level of 100–150 percent of IMF metric is considered adequate.

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