BELARUSIAN MACROECONOMIC FORECAST

No. 1(12), June 2016

Adjustment process towards fundamentals still underway

Executive summary

GDP: We expect the recession to continue in 2016, as real output will shrink by 2.0%. Meagre growth will be registered in 2017 - we expect it to be 0.6%. However, such development implies more a stagnation after a prolonged recession, rather than a quick recovery. From a broader perspective, 2016-2017 will be the period of adjustment of the income level to its fundamentals. However, there are a number of risks even to this rather unattractive scenario in 2016-2017: Growing NPLs might become a challenge to bank solvency and the high debt burden poses further risks.

Monetary environment: Under the baseline scenario, we expect the maintenance of relative financial stability. Inflation in 2016-2017 will be about 11-12%, with a similar adjustment of the exchange rate. However, growing NPLs and high debt pressure (both for firms and the government) may violate this scenario and lead to some new turbulence in the domestic financial markets.

Public finances: The general government budget is expected to run a surplus of 1% in 2016 and 0.2% of GDP in 2017, which is directed to debt repayment. The surplus reduces due to a fall in revenues caused by the contraction of the real sector and fallen oil prices. Reduced fiscal space promotes the revision of public expenditures from support to the real sector to social policy financing.

Balance of payments: It is expected that in 2016 the current account deficit will be slightly lower in comparison to the previous year and account for USD 1.6 bn, or 3.5% of GDP on the back of a sharper drop in imports than in exports, and an increase in the positive balance of secondary incomes. In 2017, the current account deficit will rise and reach USD 1.9 bn (4.2% of GDP). We expect the FDI net inflow will be approximately at the same level as last year, and expect it to be about USD 1.5 bn in 2016 and USD 1.3 on 2017. We expect the capital and financial account balance to be in surplus at around USD 2.1 bn in 2016 and at USD 3.1 bn in 2017.

Key forecast figures

	2013	2014	2015	2016F	2017F
Real GDP, % yoy	1.0	1.7	-3.9	-2.0	0.6
General government balance, % of GDP*	0.1	1.1	1.4	1.2	0.5
Current account balance, % of GDP	-10.3	-6.7	-3.8	-3.5	-4.2
CPI, % yoy (aop)	18.3	18.1	13.5	12.2	11.4
Gross external debt, % of GDP**	54.2	52.6	72.5	90.1	95.7

* Including Social Security Fund
** Gross external debt at the end of the period in relation to annual GDP in US dollars
Sources: National Statistical Committee, NBB, GET forecasts

Forecast calculations were completed in June 2016. Next revision is scheduled for December 2016.

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MACROECONOMY

Cloudy real economy

In 2016, the economy is going through a process of 'adjustment by recession'. There are numerous reasons for the current recession. First, and the most powerful, are depressed investments. The firms are reluctant to invest, having in mind the poor growth potential and low expected returns on investments even in case of an improving external environment. From this view, depressed investments may be treated as the reflection of structural weaknesses and lack of growth engines. Furthermore, the reluctance to invest is strengthened by a high level of real interest rates, which have to be maintained by the authorities in order to secure relative price and financial stability. In 2016, due to the low base (capital investments were decreasing for two years in a row, and in 2015 they amounted to about 80% of the 2013 level, or only about 77% of their historical peak in 2011) the contraction of investments is going to be not as high as in 2015 (9.2% vs 15.9%). The same trend is going to be maintained in 2017 as well: we expect capital investment to shrink by 6.7%. From the long-term view, this structural trend is going to facilitate the adjustment of the capital stock to a more reasonable level, given excessive and unproductive building of capital in previous years.

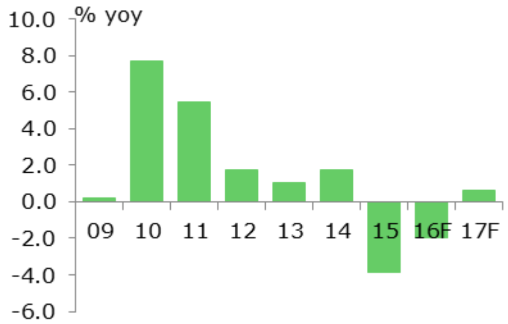
Second, expenditures for household consumption are going to adjust to a new reality in 2016, while in 2015 only a preclusive phase of the adjustment took place. In other words, in 2015 the households hoped that the reduction of disposable income would be short-lived, and hence, the reduction of their consumption was not as high as those of incomes. Thus, a more sensitive reduction of consumption is going to happen in 2016: we expect it to fall by 5.1% (after 2.4% in 2015). In 2017, the consumption level is likely to stabilize, given a roughly frozen level of real disposable income.

Third, an accomplishment of adjustments to a 'new normality' is going to happen in foreign trade. The bulk of such adjustments have already happened, due to a floating exchange rate regime and the low level of oil prices. The mechanism of such adjustment – lower foreign demand for Belarusian goods, lower export prices, and less domestic demand determine more than proportional cuts in imports – will persist. However, its focus will be shifted to the relationship between domestic demand and demand for imported goods. Due to this mechanism, we expect that imports from countries other than Russia (mainly consumer and capital goods) will drop by 10.6% in physical volumes. A modest decrease in imports from Russia (by 3.1%) will persist as well. As for the export side, we expect it to be roughly stable in terms of physical volumes, given the huge contraction in exports to Russia in 2015. Thus, net exports are going to provide a considerable positive contribution to GDP dynamics in 2016 (5.6 percentage points). In 2017, we expect that major export-import components will stabilize somehow (although imports are going to exhibit some minor contractions). So, the positive contribution of net exports will be much more modest (1.8 percentage points).

The described scenario for the demand components implies that the recession will continue in 2016: Real GDP is going to fall by 2.0%, after 3.9% in 2015. A weak recovery is going to take place only in 2017: we forecast that output will grow by 0.6%. However, given that this meagre growth will take place after a deep and prolonged recession, 'withering in stagnation' seems to be a better description for 2017 rather than recovery.

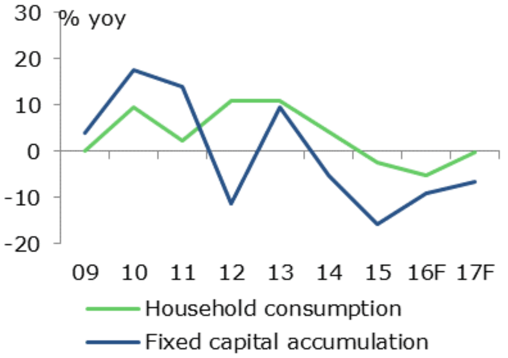
Policy makers can hardly react to this adverse environment. While they are constrained by structural weaknesses in the economy, they cannot use economic policy tools intensively.

Real GDP growth



Source: National Statistical Committee, GET forecasts 2016–2017.

Household consumption and fixed capital accumulation



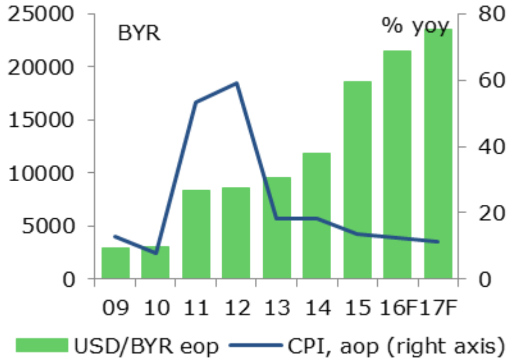
Source: National Statistical Committee, GET forecasts 2016–2017.

Contributions to GDP Growth

	2015	2016F	2017F
GDP	**-3.9**	**-2.0**	**0.6**
Household consumption	-1.6	-3.4	-0.1
Gross fixed capital formation	-5.9	-3.0	-2.0
Net exports	5.3	5.6	1.8
Other components+ statistical discrepancy	-1.7	-1.2	0.9

Note. Contribution to growth – in percentage points of GDP.
Source: National Statistical Committee, GET forecasts 2016–2017.

Exchange rate and prices



Source: NBB, GET forecasts 2016–2017.

That's why the majority of economic policy tools are 'forcedly restricted' and there is a lack of options for softening policy without introducing new threats to price and/or financial stability. To describe the developments during the recession with a simple analogy, one could say that an adjustment of the level of well-being towards its true fundamentals has taken place. Further improvements in well-being require getting rid of existing structural obstacles for development (say, inefficient mechanisms of allocation of resources) and institutional changes that can expand growth potential.

However, the baseline scenario of a recession as a kind of 'purification procedure' and further stagnation might be even optimistic. The expected reduction of output by around 6% (in 2015-2016) might be a threat per se and trigger further waves of slowdown. First, the long-lasting recession denudes past mistakes of improper allocation of resources, causing a growth of NPLs in the banking sector. But this can also have implications for the future. The negative scenario of a huge expansion of the NPLs might undermine financial stability internally and cause a new impulse for output decline. Second, despite the fact that real output contraction is not that high, in nominal dollar terms the reduction is enormous. For instance, in 2016 and 2017 we expect GDP to amount to USD 45.3 and 44.8 bn, while it was USD 76.2 bn in 2014. Hence, despite a roughly constant level of gross external debt, its relative level is going to spike. Thus, the increasing debt burden and possible insolvencies might become further triggers for new shocks.

MONETARY ENVIRONMENT

Growing NPLs have become a prior issue

As a baseline scenario in the monetary sphere, we expect a continuation of rather tight policies embodied in restricting monetary aggregates. For hitting the targets with respect to broad money (which is an official intermediary goal of the NBB), we expect that base money will grow about 4.5% both in 2015 and 2016. The constrained growth of broad money along with the 'autonomous' part of demand contraction will secure the maintenance of the disinflation trend. However, due to adjustments of regulated prices and tariffs, and some exchange rate weakening, the absolute level of inflation will still be relatively high. On an annual average basis, we expect that CPI inflation will amount to 12.1% and 11.4% in 2016 and 2017, correspondingly.

However, we emphasize a number of risks that may lead to financial instability and might cause a much higher inflation. First, the NBB might have to radically soften its policy stance, given the pressure from real sector representatives. Still, some policy makers consider monetary softening as the feasible solution for pushing the economy out from recession. Second, if the problem of NPLs intensifies to the extent that it will be a threat to banks' solvency, the emergency provision of financial support might be considered as an option. Third, certain issues of sovereign debt sustainability may become a trigger for volatility at the money market. This issue seems extremely vital for financial stability, given a relatively high share of government bonds in the assets of the banks. Furthermore, the capital of two largest state-owned banks is partially formed by government bonds, which may raise doubts about their possibility to absorb losses given sovereign problems. Fourth, external shocks may become again a trigger for domestic turbulence, given poor buffers of the authorities for absorbing such shocks.

Given a floating exchange rate regime, we expect that the real effective exchange rate in 2016-2017 will be roughly constant, reflecting that its current level corresponds to the level of the current account deficit that can be treated as medium- term equilibrium. Thus, the evolution of the exchange rate will be rather close to the dynamics of CPI inflation. Hence, in 2016 we expect the BYR/USD exchange rate to be around 20,500 on an annual average basis, and about 22,500 in 2017. Nevertheless, it should be mentioned that increased fluctuations around these average levels are possible (for instance, due to oil price volatility).

PUBLIC FINANCES

Fiscal policy has become procyclical

The contraction of the economy automatically leads to a reduction of the tax base. In order to sustain the level of consolidated budget revenues, the government revised the system of tax privileges. In 2016, the most significant changes have occurred in legislation on VAT tax, as utilities are no longer exempted from this tax. This measure is expected to compensate for a reduction in VAT revenues that occurred in 2015 (by 0.6% of GDP). An increase of excises is another measure aimed at restoring the pre-crisis level of related revenues. First of all, a reduction of oil prices provides space for an increase of excises on fuel. An increase in revenues from excises on beverages is expected only in 2017, as the financial stance of the sector is rather weak. These measures will allow avoiding a reduction of total consolidated budget revenues in 2016–2017. Furthermore, a fall of revenues from petroleum export duties (to USD 1 bn) will not statistically affect the budget due to falling GDP in USD terms.

Assuming a tight fiscal policy, revenue dynamics imply a moderate surplus of the consolidated budget that will be spent on debt repayment. We forecast a reduction of the expenditure lines that are related to the public support to the economy, including the housing utilities sector. However, the scale of this reduction is limited as it entails financial stress to the sector of state-owned enterprises and the banking sector in the short-run. On contrary, social expenditures will remain at the level of 2015, as the state is expected to increase support to the social vulnerable groups affected by crisis.

BALANCE OF PAYMENTS

Further reduction of the current account deficit

We expect that in 2016 both goods exports and imports will contract at approximately the same rate, which will result in a reduction of the merchandize balance by 11.0% towards a deficit of USD 1.9 bn. It will be attributed to the continued contraction of Russia’s economy, which will lead to decreasing sales of Belarusian capital goods, i.e. machines and equipment, as well as consumer goods to Russia. The fall in exports to non-CIS countries will be caused by the cutback of trade in petroleum products and potash fertilizers due to falling prices. The cutback in imports will stem from a reduction of supply of capital, intermediate, and consumer goods both from Russia and non-CIS countries due to a shrinking of domestic demand. In 2017, we forecast that exports will be approximately at the same level as in 2016, while imports will slightly increase in comparison with the previous year (0.9%). In 2017, the deficit of the balance of merchandise trade will widen to USD 2.1 bn.

In 2016 and 2017, the balance of trade in services will be positive at around USD 2.4 bn and 2.5 bn, respectively.

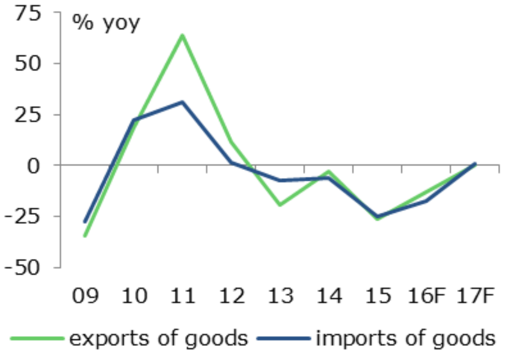
The service export growth will come from an increase in oil and gas transit and transportation services, while service

Fiscal indicators, % of GDP

	2015	2016F	2017F
Consolidated revenues	30.6	32.5	32.5
Consolidated expenditures	28.8	30.6	31.2
Consolidated budget balance	1.8	1.9	1.3
Social Security Fund balance	-0.4	-0.6	-0.8
General Government balance	1.4	1.2	0.5

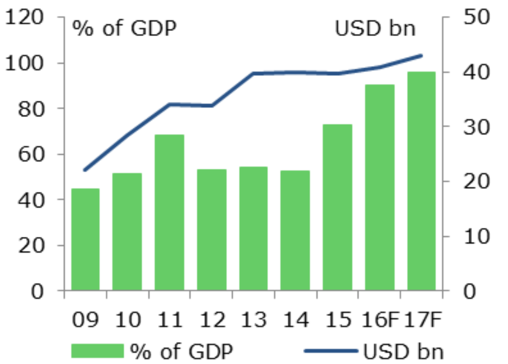
Source: Ministry of Finance, GET forecasts 2016–2017.

Merchandise trade (growth rate in USD)



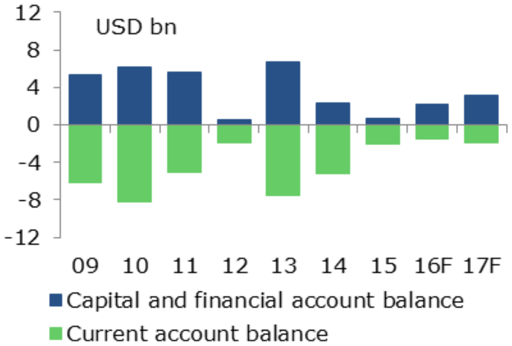
Source: National Statistical Committee, GET forecasts 2016–2017.

Gross external debt



Source: NBB, National Statistical Committee, GET forecasts 2016–2017.

Balance of payments



Source: NBB, National Statistical Committee, GET forecasts 2016–2017.

import growth will be supported by an expansion of construction, financial services, and royalties. We expect that the balance of trade in goods and services will be positive, amounting to USD 0.5 bn in 2017 and 0.4 bn in 2017.

We expect that the balance of primary incomes will be negative in 2016 and 2017 as a consequence of the increase of interest payable under general government and non-financial sector obligations, including payment on the loans of banking and nonfinancial sectors, and income payments on FDI. The balance of secondary income will turn positive in 2016 and 2017 because the inflow of customs duties accrued according to the agreement between Russian, Belarus and Kazakhstan on the distribution of import customs duties within the Customs Union exceeds the amount transferred to the account of the authorized agency in the Eurasian Economic Union.

We expect that in 2016 the negative current account balance will decrease to USD 1.6 bn, or 3.5% of GDP due to a reduction of the deficit of trade in goods. In 2017, it will worsen and amount to USD 1.9 bn or 4.2% of GDP.

Capital and financial account: Repayments in focus

We expect that both in 2016 and 2017 the net FDI inflow will be approximately at the same level as in 2015 (USD 1.4 bn in 2016 and USD 1.3 bn in 2017). The FDI inflow will be attributed to reinvested earnings and acquisition of equity capital in industry, banking and service sectors.

In 2016 and 2017 the necessity of repayment of external debt under previously attracted loans (including the repayment of the principal amount of Russia’s and the Anti-Crisis Fund’s loan) and financing the current account deficit will influence the balance of the other investment account, and will raise liabilities to non-residents as a result of foreign loans and credits attraction. For instance, we expect that the government will almost fully refinance its FX debt in 2016 and 2017 (both external and domestic), either due to the loan from the IMF, or through other options if the IMF funds will not be available. In latter case, a new issuance of Eurobonds may take place as a kind of last resort (although we do not expect this step under baseline scenario).

Annex. Tables

		2013	2014	2015	2016F	2017F
Table 1. GDP						
Nominal GDP	BYR bn	649 111	778 095	869 702	907 018	1 008 792
	USD bn	73.1	76.2	54.8	45.3	44.8
Real GDP	% yoy	1.0	1.7	-3.9	-2.0	0.6
Household consumption	% yoy	10.9	4.3	-2.4	-5.1	-0.1
Public consumption	% yoy	-2.1	-2.0	-0.4	-1.6	2.8
Gross fixed capital formation	% yoy	9.6	-5.3	-15.9	-9.2	-6.7
Exports	% yoy	-17.4	14.7	1.0	1.0	0.5
Imports	% yoy	-6.1	9.4	-6.3	-6.8	-2.2
Table 2. Fiscal Indicators*						
Consolidated budget revenues	BYR bn	189 232	219 281	266 321	294 603	327 900
	% of GDP	29.2	28.2	30.6	32.5	32.5
EPT revenues	BYR bn	21 525	19 994	21 819	20 482	22 182
	% of GDP	3.3	2.6	2.5	2.3	2.2
VAT revenues	BYR bn	56 223	69 829	72 670	79 532	88 897
	% of GDP	8.7	9.0	8.4	8.8	8.8
PIT revenues	BYR bn	26 992	32 092	37 009	41 319	46 971
	% of GDP	4.2	4.1	4.3	4.6	4.6
Consolidated budget expenditures	BYR bn	187 751	211 154	250 377	277 675	314 301
	% of GDP	28.9	27.1	28.8	30.6	31.2
Current expenditures	% of GDP	22.5	21.8	23.8	26.2	27.6
Capital expenditures	% of GDP	6.8	5.5	4.2	4.4	3.6
Consolidated budget balance	% of GDP	0.2	1.0	1.8	1.9	1.3
Social Security Fund balance	% of GDP	-0.1	0.0	-0.4	-0.6	-0.8
General government balance	% of GDP	0.1	1.1	1.4	1.2	0.5
Table 3. Balance of Payments and External Debt						
Current account balance	USD m	-7567	-5 222	-2 074	-1 575	-1 883
	% of GDP	-10.3	-6.9	-3.8	-3.5	-4.2
Export of goods	USD m	36 540	35 423	26 190	23 181	23 172
Import of goods	USD m	41 134	38 059	28 327	25 084	25 300
Balance of services	USD m	2 253	2 153	2 312	2 425	2 542
Financial account balance (analytical view)**	USD m	6 755	2 260	678	2 121	3 088
Foreign direct investments (FDI), net	USD m	1 984	1 789	1 466	1 450	1 337
Portfolio investments	USD m	-20	-968	0	0	0
Gross external debt	% of GDP	54.2	52.6	72.5	90.1	95.7
Table 4. Money, Inflation and Exchange Rate						
Base money	%, yoy eop	13.4	13.8	14.9	4.3	4.3
CPI	%, yoy aop	18.3	18.1	13.5	12.2	11.4
Exchange rate, USD/BYR	aop	8 876	10 216	15 865	20 435	22 500

* Social Security Fund is not included into consolidated budget.
** '+' denotes net inflow of funds, '-' net outflow.
Sources: National Statistical Committee, Ministry of Finance, NBB, GET forecasts 2016.

Notes:

aop	average of period	NBB	National Bank of Belarus
avg	average	p.a.	per annum
bn	billion	PIT	personal income tax
eop	end of period	VAT	value added tax
EPT	enterprise profit tax	yoy	year-on-year
m	million	ytd	year-to-date

Annex. Assumptions of the forecast

- World prices for crude oil (oil basket) will be USD 45 per barrel on average in 2016 and USD 50 in 2016.
- Belarus will get 23 m t of crude oil from Russia both in 2016 and 2017.
- The prices of imported gas from Russia will be USD 120 and 125 per tcm (annual average) in 2016 and 2017, correspondingly.
- In 2016 and 2017 the government will obtain about USD 1.1 bn of oil duties, and will attract about USD 3.0 and 2.5 of new borrowings.
- The Russian real GDP will decrease by 1.8% yoy in 2016 and will display 0.8% growth in 2017.

About the German Economic Team Belarus (GET Belarus)

The main purpose of GET Belarus is to conduct a dialogue on economic policy issues with the government, civil society, and international organizations. Experts of German Economic Team have experience in policy advice in several transition economies, including Ukraine, Russia, and Moldova. In Belarus the IPM Research Center and the German Economic Team provide information and analytical support to the Council of Ministers, the National Bank, the Ministry of Foreign Affairs, the Ministry of Economy and other institutions involved in the process of formation and implementation of economic policy.

About the IPM Research Center

The IPM Research Center was established in 1999 within the mutual project of the Institute for Privatization and Management (Minsk, Belarus) and CASE - Center for Social and Economic Research Foundation (Warsaw, Poland). It is a member of the CASE research network, William Davidson Institute NGO Alliance, and Economic Policy Institutes Network (project of the UNDP's Regional Bureau for Europe and the CIS). The IPM Research Center actively cooperates with the German Economic Team Belarus (GET Belarus). Within this cooperation the IPM Research Center provides independent policy advice on economic issues to the different official agencies, namely to the Council of Ministers, National Bank, Ministry of Economy, Ministry of Finance and other organizations involved in the process of formation and implementation of economic policy.

The Mission of the IPM Research Center is to enhance national competitiveness through elaboration of the research-based economic policy recommendation and the promotion of professional dialogue on the urgent issues related to economic performance.

Activities

- Regular analysis of the economy of Belarus;
- Monitoring of main sectors of the economy;
- Promotion of professional dialogue between Belarusian and German experts on important issues for the economic development of Belarus.

Analytical materials

Current research products and publications of the project are available via the Internet:

http://research.by/get and www.get-belarus.de