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The impact of the currency crisis on the Belarusian banking sector

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Executive Summary

The severe balance-of-payments/currency crisis in 2011 created major turbulences in the economy of Belarus. As a result, the exchange rate depreciated massively, interest rates surged, while the inflation rate exploded to more than 100% yoy. Surprisingly, real activity proved relatively resilient to these shocks, although some slowdown is expected to take place in the future. Due to a combination of tight macroeconomic policies and vital external assistance, especially in 2H 2011, some macroeconomic stabilization has been achieved at the beginning of the 2012, which also helped to shore up confidence by the population.

An immediate question that arises in such a context deals with the impact of such turbulences on the banking sector. By now, a wide range of theoretical and empirical research has provided convincing evidence that currency crises and banking crises are usually linked ("twin crises"), and often turn into a vicious spiral. Policymakers thus need to have a clear understanding of the complex linkages between both phenomena, in order to be able to formulate an adequate policy response.

Turning to Belarus, while a negative impact of the recent currency crisis on the situation in the banking system cannot be denied, a systemic banking crisis was fortunately avoided. However, a number of issues like an expected increase in non-performing loans (NPLs) in the future will continue to put pressure on the system in the medium to longer-term. Coupled with less room for additional state support in the future, these developments pose significant challenges to the authorities.

Thus, policymakers should adopt measures to shield the banking sector from any possible future negative impact of the previous currency crisis, but more so to make the system more resilient so that it can withstand any adverse developments in the future. This requires action both on the macroeconomic and microeconomic (i.e. banking) level.

On the macroeconomic level, the National Bank should proceed more cautiously with future interest cuts, as inflation is still high and confidence has not been fully restored. The recently started process of exchange rate flexibilisation is important in our view, and should continue. This requires also establishing a new anchor of monetary policy. In our view, targeting low and stable inflation over the medium term is the best strategy in this respect, and also beneficial for the development of the banking sector. More general, macroeconomic policies, and that includes also income/wage policies need to be kept tight, in order to sustain macroeconomic stabilisation and provide the basis for the recovery of the economy after the crisis.

On the microeconomic level, state-direct lending needs to be phased out, as this contributed to the crisis, and provides the wrong signals for both the banking sector and the real economy. A significant opportunity is the newly founded Development Bank, which should clear the banking sector from the legacy of this lending, and be the only bank to provide any new directed lending under a transparent scheme. In order to strengthen market-based credit allocation and risk management further, private (including foreign) banks should play a more visible role in the sector. This will also have positive spill-over effects in terms of efficiency and profitability for state-owned banks and ultimately also contribute to the stability of the banking sector.

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1. Introduction

It seems to be a conundrum: Given the heavy balance-of-payments/currency crisis Belarus experienced last year, one would have expected these crises to be accompanied by either a banking crisis, a deep recession, or both. However, at first sight the banking sector proved remarkably resilient to the economic turbulences so far. Furthermore, the economy grew in 2011 at a still robust rate of more than 5% in real terms. During the current year, real GDP is set to grow further, even though at a slower pace - real growth slowed already down to 2.9% yoy over the first half of 2012.

By now, a wide range of theoretical and empirical research has provided convincing evidence that there is a strong connection between balance-of-payments/currency crises and crises in the banking sector. A balance-of-payments crisis which could be described by way of a sudden increase of capital outflows leading to a strong depreciation of the local currency is usually reflected by withdrawals of foreign currency bank deposits as well as the reluctance of foreigners to refinance domestic banks through capital market instruments like bonds and shares as well as loans. This, in turn, leads generally to a de-stabilisation of the banking sector. Thus, components of such "twin crises" are intrinsically linked, and often turn into a vicious spiral. Policymakers thus need to have a clear understanding of the complex linkages between both phenomena, in order to be able to formulate an adequate policy response.

Given the currently relatively stable banking environment in Belarus, this paper addresses the crucial question if the banking sector could still take a serious hit from the aftermath of last year's currency crisis. The paper is structured as follows: In Chapter 2 and 3 we analyse the recent currency crisis of 2011 as well as the subsequent developments in 2012, providing evidence that neither the banking sector nor the real economy have withstood the turbulences as unscathed as it seems at first sight. In particular, we will show that the overly high degree of state ownership and the associated lending practices have both contributed to the critical developments in the financial sector prior to the crisis and to the hiding of its most obvious effects so far. In this respect, we look in particular at the risks of repeating the errors that led to the 2011 crisis and the possible impact on the banking sector. Finally the paper will conclude with some policy recommendations as to which measures should be taken to ensure a sustainable development of the banking sector that will in turn contribute to a positive development of the real economy.

2. The currency crisis of 2011 in Belarus in retrospective

2.1. Exchange rate, interest rates and inflation

From a macroeconomic perspective, the currency crisis of 2011 can be explained rather straightforward. At the root of the crisis was an excessive stimulation of internal demand via a strong increase of state-engineered "directed lending" as well as excessive wage increases in the end of 2010. This excessive and rapid stimulation of domestic demand, in combination with a fixed exchange rate led to a steep rise of the current account deficit up to 24% of GDP in the first quarter of 2011. To defend the de-facto fixed exchange rate against the US-dollar (USD), the National Bank of Belarus depleted almost all of its foreign exchange reserves, which decreased confidence into the Belarusian ruble (BYR) further (see Figure 1).

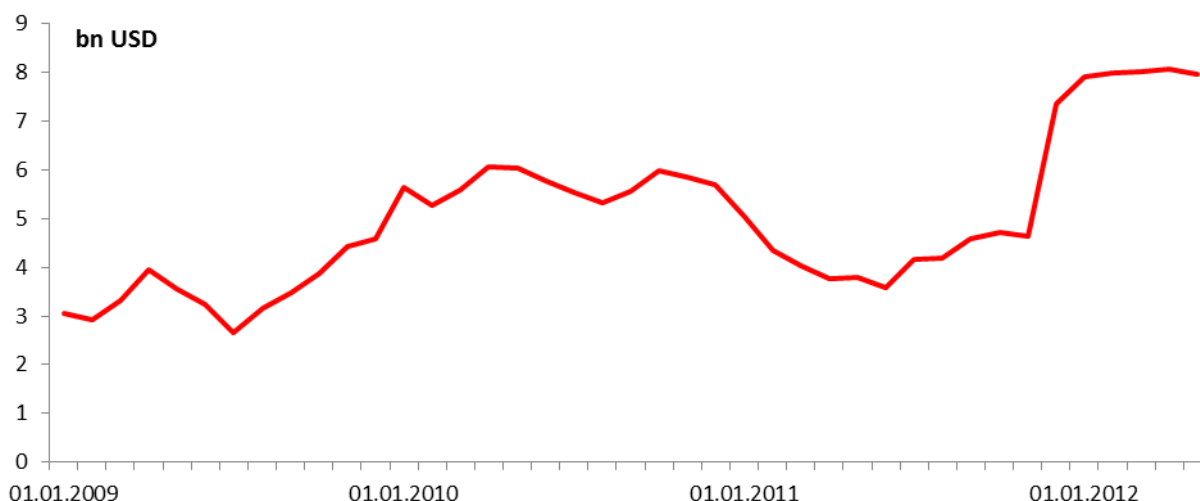
The rapid increase in foreign exchange reserves at the end of 2011 has very much to do with FX inflows that Belarus received from abroad. These inflows came from privatisation proceeds from the sale of the remaining 50% stake of Beltransgas, two tranches of the Anti-Crisis-Fund of the Eurasian Economic Community and a loan from Sberbank. In total these inflows amounted to USD 4.7 bn and increased reserves.

In March 2011 the government put on the emergency brakes. It implemented capital controls, while at the same time introducing a multiple exchange rate regime. On May 24, 2011 a new (depreciated) official exchange rate level of around 4930 BYR/USD (from 3155 BYR/USD before) was defined. However, on the black market, which developed in parallel, the BYR was traded at much lower levels, signaling that the official exchange rate was not at its equilibrium level. The authorities gave in to the continued pressure and ended in October 2011 the multiple currency regime by unifying the exchange rates. This was a major step forward, which increased confidence among the population, even though it implied another official devaluation

towards the market rate of around 8700 BYR/USD. However, from the middle of November some gradual appreciation tendencies have been observed (see Figure 2a).

Figure 1.

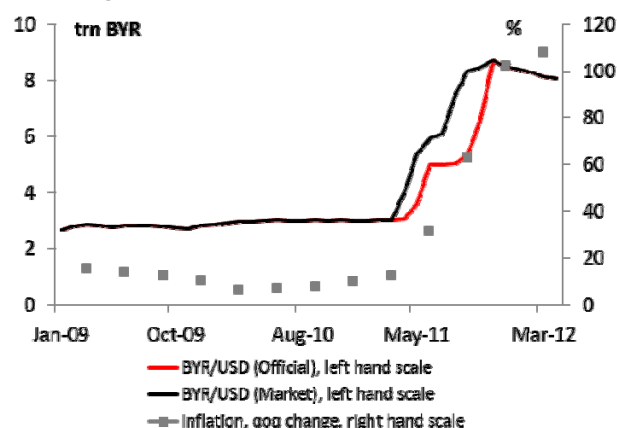
Development of foreign exchange reserves



Source: National Bank.

Figure 2a

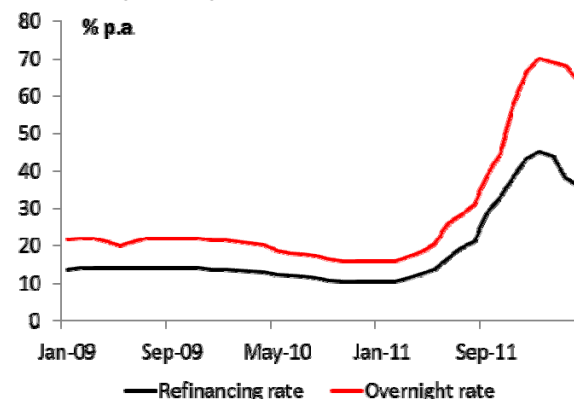
Exchange rate and inflation



Source: National Bank, Belstat, own calculations.

Figure 2b

Monetary policy interest rates



Source: National Bank.

Further measures were carried out by the government and the National Bank to get the crisis under control. The latter started to increase the refinancing rate to 43.2% by December 2011 from 13.5% in May in order to restore macroeconomic stability (see Figure 2b). With the gradual stabilisation of inflation that started around the beginning of 2012, the National Bank started to ease interest rates gradually.

The massive devaluation described above had a direct and immediate impact on inflation. The inflation rate (CPI) reached already 43.8% yoy by mid-2011 and increased further to 108.7% yoy by the end of the year 2011 (see Figure 2a). This was at that time a (negative) world record which put significant strains on people's real incomes. In light of the gradual stabilisation recorded in the beginning of 2012, inflation came down gradually from its peak, and is currently running at 69% yoy. It is expected that inflation will further go down, especially as base effects have now kicked in, but the speed of disinflation will crucially depend on the future macroeconomic policy stance of the authorities.

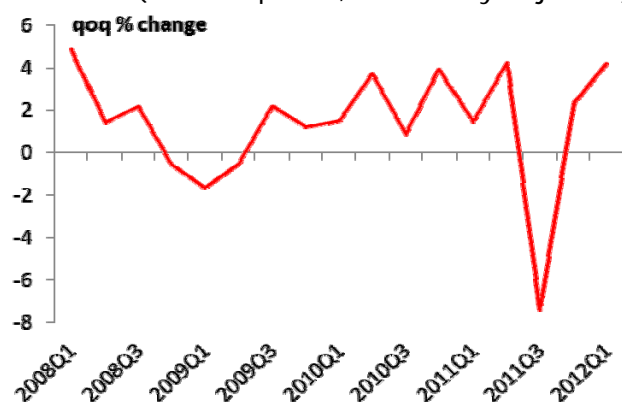
2.2. Economic activity

In light of the turbulence described above, economic activity took a serious hit in Q3 2011 (see Figure 3a). Fortunately, due to the depreciation of the currency and thereby the increased competitiveness of the industrial sector, including mining, the economy expanded again by the end of 2011. The structure of GDP growth changed completely, with net exports turning into

the main growth contributor while investment and consumption – the main drivers of growth during the 2010 boom – represented a drag for the economy. This could be interpreted as the classical export-led reaction to a depreciation, which improves competitiveness by changing relative prices.

Figure 3a

Real GDP (in 2009 prices, seasonally adjusted)



Source: Own calculations based on Belstat data.

Figure 3b

Current account balance



Source: Own calculations based on Belstat and National Bank data.

However, while the current account deficit shrank significantly in Q2 2011 and the balance turned even positive in Q3 2011, it became negative again in Q4 2011, amounting to a deficit of 11.2% of GDP (see Figure 3b). In Q1 2012, a positive balance was recorded. Our forecast¹ of a deficit of 5.7% for 2012 as a whole signals an overall improvement in comparison to 2011, even though this level is still too high.

Conclusion: The currency crisis in 2011 created major turbulences in the economy. The exchange rate depreciated on a massive scale, interest rates surged while inflation rose rapidly to record levels. Surprisingly, economic activity was affected relatively mildly. Due to a combination of tight macroeconomic policies and external support, especially in 2H 2011, macroeconomic stabilization has been achieved at the beginning of the 2012, which also helped to shore up confidence by the population. The continuation of these policies is vital for the continuing recovery of the economy after the crisis.

3. Assessing the impact of the crisis on Belarus' banking sector

While the previous chapter discussed the broad impact of the crisis on Belarus' economy, this chapter now turns specifically to the banking sector and analyses the impact of the crisis. Before we discuss these developments, we will provide more insights into the structure of the banking sector, which can also be seen as one important culprit of the crisis.

3.1. Structural features of the Belarusian banking sector

The Belarusian banking sector had total assets of BYR 283 trn as of 01.07.2012, equivalent to USD 34 bn (around 73% of GDP) and consists of 32 banks. The largest two banks, Belarusbank and Belagroprombank, accounted for 59% of total assets as of 01.04.2012 and are state-owned (the total share of state banks in the system is 65%). Among foreign banks, especially Russian banks have increased their market share rapidly over the last number of years. At the end of 2011, they owned around 25% of the system.

The top 10 banks account for 93% of total assets as of 01.04.2012. These figures show that there is a high degree of concentration in the sector. This concentration becomes a relevant issue in combination with one of the most distinctive features of the Belarusian banking sector, which are the state directed lending programs ("lending under government programs"). These programs are a cornerstone of economic policy in Belarus. Each year the government defines a number of projects which are to be financed via directed lending programs. The two largest

¹ Belarusian Macroeconomic Forecast No. 1(4), May 2012 by GET Belarus/IPM Research Center.

state banks usually implement the biggest share of these programs, even though a number of privately-owned banks also qualify for such programs.

Table 1

Ownership structure of the Belarusian banking sector (as of 01.04.2012)

	Total banking sector	Banks owned by the state	Banks not owned by the state	Banks owned by domestic investors	Banks owned by foreign investors
Number	32	4	28	8	24
Share of Assets	100%	65%	35%	67%	33%
Assets (BYR trn)	269.511	176.383	93.129	179.330	90.181

Source: National Bank.

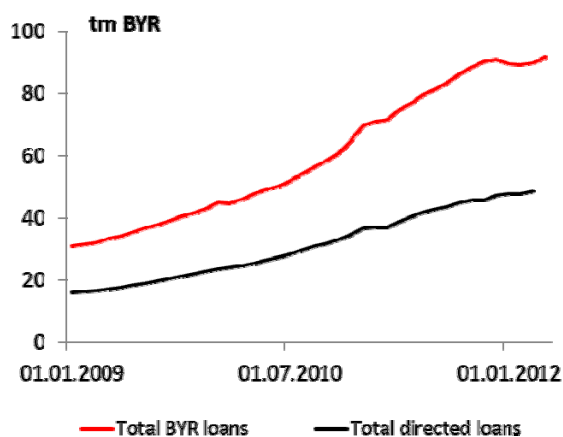
A big share of such loans is extended for housing construction and agriculture, e.g. housing loans to private households are granted at highly subsidised rates with very long maturities of up to 40 years. In 2010, the maximum loan to value (LTV) ratio was increased from 90% to 100%, thereby fueling the ongoing credit boom further.

State-owned companies are among the main recipients of directed loans, which are regularly rolled over without looking too closely at the credit worthiness of the borrower. This behavior implies “soft budget restrictions” for the enterprises at the micro level, causing inefficiencies and increasing the vulnerability of the economy towards external shocks at the macro level. By utilizing directed lending programs, the state has a powerful instrument at hand to stimulate investment demand through the banking sector. The policy of excessive investment stimulation via this channel proved to be the culprit of the crisis experienced in 2011, together with excessive wage increases.

Figures 4a and 4b give a quantitative overview of directed lending. We estimate that directed loan programs contributed around 50 to 55% to total loan growth in 2010 – 2011, which is a significant number.

Figure 4a

Stock of total loans and directed loans



Source: National Bank, own calculations².

3.2. Impact of the currency crisis 2011

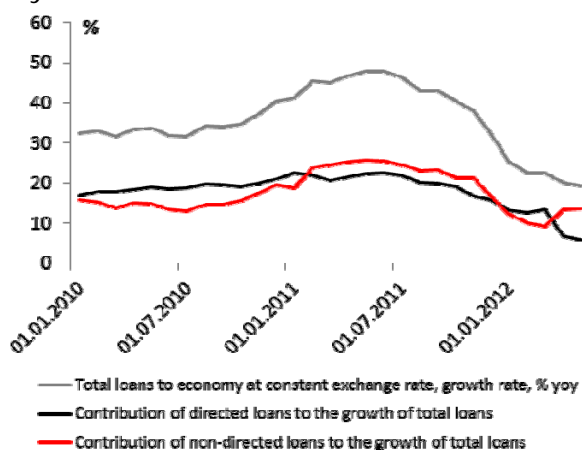
While at first sight the currency crisis of 2011 seems not to have left any serious traces in the banking sector, a closer look to the main indicators show that the banking sector did take a hit in various forms and remains vulnerable to new shocks.

Loan dynamics

As was stated above, the rapid increase in lending prior to the crisis was one of the reasons for its emergence. During the crisis in 2011, the adverse exchange rate and inflation developments described above had a clear impact on the ongoing credit boom, which was most appar-

Figure 4b

Dynamics of total loans and directed loans



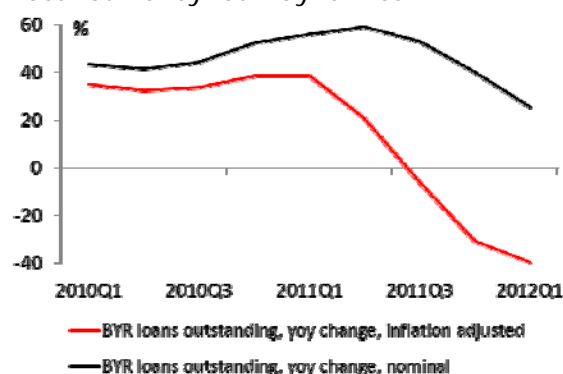
Source: National Bank, own calculations.

² As banking statistics do not publish data on directed loans, we use in both figures a definition for directed loans that is taken from the following publication: Kruk (2011): The Impact of directed lending on long-run growth in Belarus, BERO Working Paper No. 014. Basically, it includes all loans granted to agriculture and households in national currency.

ent in the segment of BYR loans. Lending in local currency slowed down significantly in nominal terms, while in inflation-adjusted terms loans outstanding even shrank (see Figure 5a). The impact on foreign currency loans was much less severe, as can be seen in Figure 5b.

Figure 5a

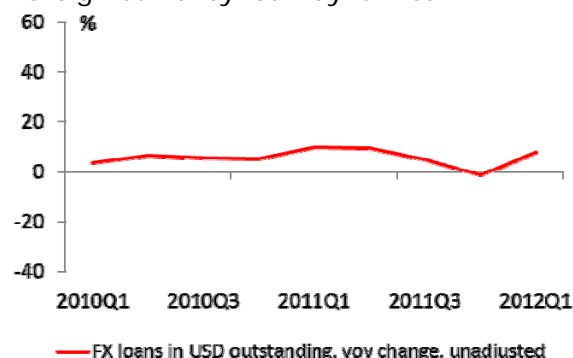
Local currency loan dynamics



Source: Own calculations based on National Bank and Belstat data.

Figure 5b

Foreign currency loan dynamics



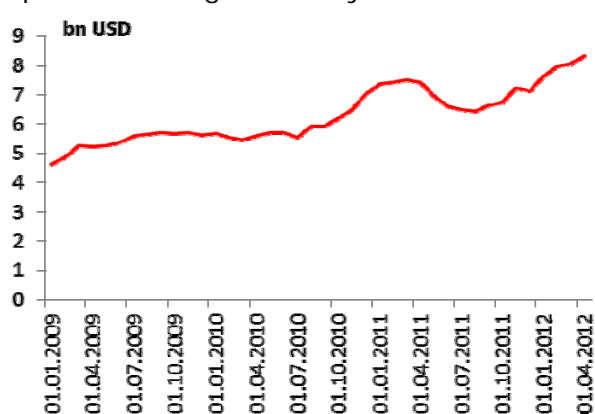
Source: Own calculations based on National Bank data.

Deposit dynamics

The crisis was fostered by foreign exchange outflows, as could be seen in the depletion of foreign exchange reserves (Figure 1). With respect to foreign currency deposits in banks, an increase could be witnessed until March 2011, the month when the government finally gave up supporting the BYR/USD exchange rate. Only then depositors reacted and withdrew within a few months around USD 1 bn from their accounts, which corresponded to a decrease of approx. 13% (see Figure 6a). Especially household depositors reacted, and withdraw a quarter of their FX deposits until July 2011. Positively, this movement did not trigger an overall deposit flight (which would have had very negative implications for the funding situation and posed a direct threat to banks' liquidity), which can be seen with respect to BYR-deposits, which increased during the period (see Figure 6b).

Figure 6a

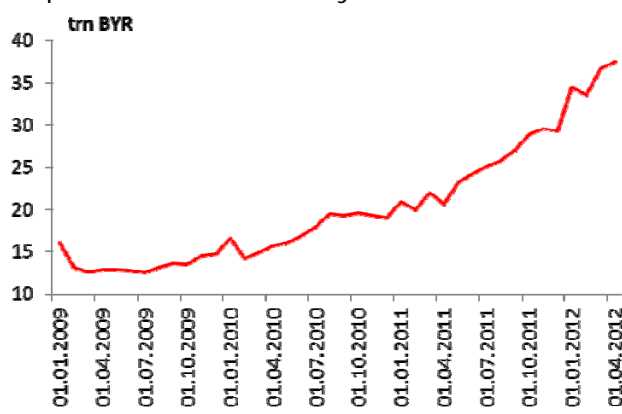
Deposits in foreign currency



Source: National Bank.

Figure 6b

Deposits in local currency



Source: National Bank.

Foreign currency deposits rebounded after a few months of crisis, but the stable growth has begun in the end of 2011 driven by an increase in confidence due to the observable macroeconomic stabilisation. At the same time the National Bank helped to support inflows into local currency deposits by hiking interest rates. Those steep interest rate hikes were needed to shore up confidence in the local currency, as inflation was rapidly increasing during this period. To some extent, the observable deposit dynamics are also a direct function of very high interest rates on deposits, given that deposits simply increase due to interest payments³.

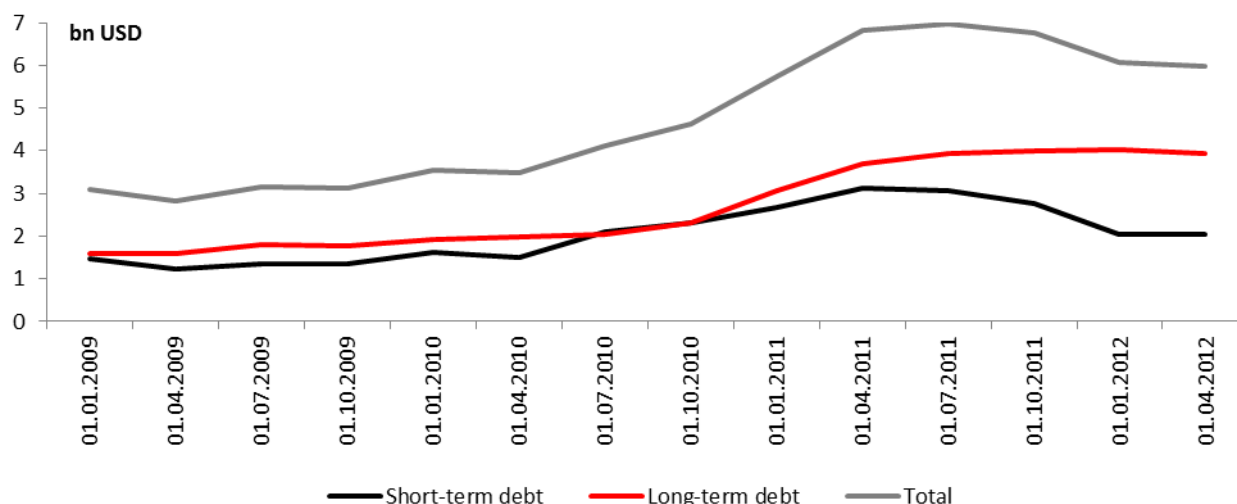
³ All other things being equal, with an annual interest rate of 40% on deposits, the deposit volume increases by 40% simply due to interest accrual, without any fresh money provided to banks.

External debt

The external debt of the banking sector rose significantly prior to the crisis, as state-owned and foreign-owned banks increasingly relied on external funding, around half of it with short-term maturity. This increased the vulnerability of the system to negative external shocks, such as the currency crisis in 2011. Starting in the middle of last year, the external debt stock went down, driven by outflows of short-term debt. Recently, this deleveraging process seems to have come to a stop, as Figure 7 suggests.

Figure 7

External debt of the banking sector



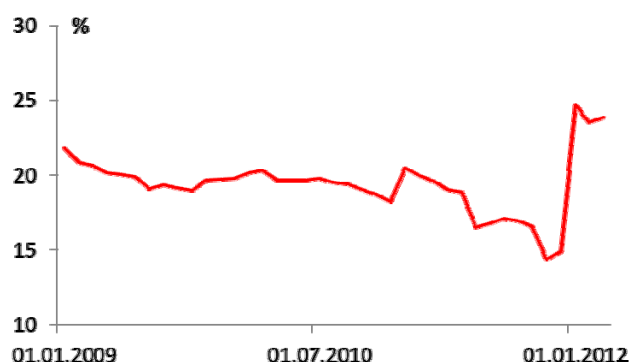
Source: National Bank.

Capitalisation

While an outright banking crisis could not be witnessed, the drop of the banking sector capital ratio from 20.5% by the end of 2010 to 14.3% by October 2011 is another indicator for the vulnerability of the banks to a depreciation of the local currency (see Figure 8a). The deterioration of the capital adequacy ratio has to do with the fact that risk weighted assets are calculated in BYR terms which means that a strong depreciation of the BYR leads to an increase of risk weighted assets if the bank has a high share of USD assets (see Figure 8b). As the capital is denominated in BYR the depreciation means that the capital adequacy ratio deteriorates. While this could be misinterpreted as a simple accounting problem, it should be clear that banks have in fact less capital to compensate for losses when the BYR depreciates.

Figure 8a

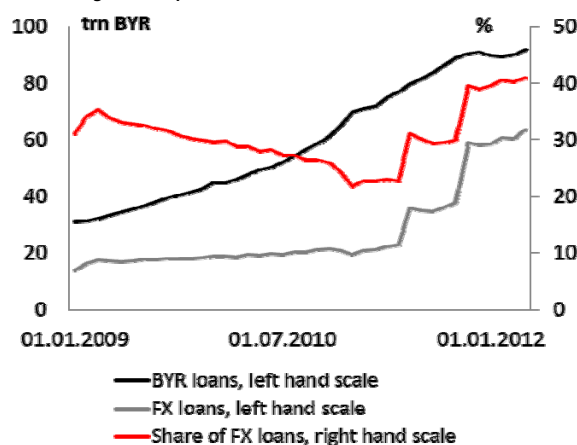
Regulatory capital adequacy ratio (CAR)



Source: National Bank.

Figure 8b

Currency composition of loans



Source: National Bank, own calculations.

At the end of 2011, the state injected significant amounts of equity capital into the two main state banks (Belarusbank and Belagroprombank) in order to raise their capital ratios (by USD 1.7 bn in total). This explains the increase in the overall sector capitalisation and can be considered an important step to improve the loss-absorbing capacities of both banks and to bol-

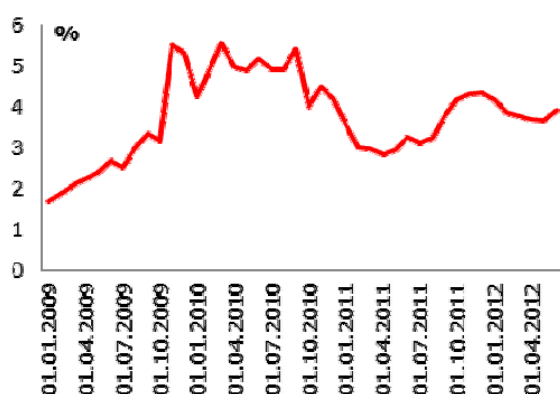
ster general confidence in the sector. At the same time it has to be stated once more that the crisis was a self-inflicted one: If loan expansion had been less aggressive and wage increase more moderate, it would not have been necessary to support individual banks through massive capital injections, amounting to several percent of GDP.

Asset quality

The quality of the loan portfolio has deteriorated due to the crisis, though the effect so far is considerably smaller than one would have expected, also taking international experience into account. The share of problem assets (defined as assets exposed to credit risk classified by groups III-V of the National Bank) of the banking sector to total assets exposed to credit risk⁴ barely increased during 2011, and reached a maximum ratio of 4.4% on 01.12.2011 (see Figure 9a). However, if reference is made to assets exposed to credit risk classified by group II⁵, the ratio of these assets to total assets exposed to credit risk increased much more significantly: from 3.6% on 01.01.2011 to 13.1% on 01.04.2012 (see Figure 9b). This seems to be a natural consequence of the fact that internal demand shrank dramatically, thus presenting a challenge to all those companies which are exposed to the local market. The same importance has the increase of the interest rates (especially for non-subsidized lending) combined with a higher roll-over risk as banks were less generous with respect to new loans. The lack of FX availability and afterwards the depreciation of the BYR has certainly played a role, too. However, this factor is at the sector level (it may differ at individual banks) much less important than in countries (like, for instance, Ukraine), given that households are not allowed to apply for foreign currency loans since 2009 and most companies which take out a loan have corresponding foreign currency revenues. Finally, it should be noted that according to Rating agencies, the existing high single borrower concentration means that at some financial institutions the exposure towards the biggest four or five companies could wipe out 100% of banks' equity.

Figure 9a

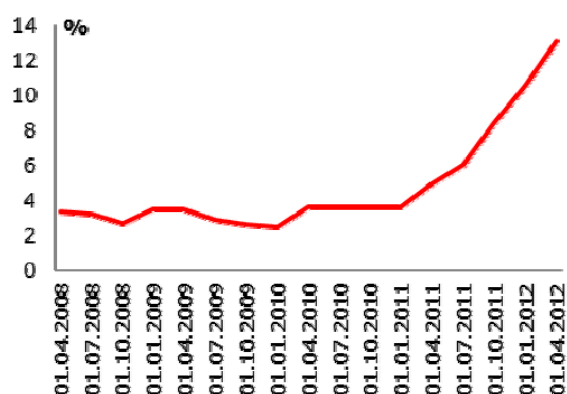
Share of problem assets in total assets exposed to credit risk



Source: National Bank.

Figure 9b

Share of assets belonging to group II in total assets exposed to credit risk



Source: National Bank.

Different industry analysts forecast that the level of non-performing loans will gradually increase in the future, as the realisation of the full impact of the past depreciation on unhedged borrowers is still underway, the economy is set to slow down and high interest rates will start to hurt borrowers⁶. This expected deterioration in asset quality has in turn implications for capital adequacy, which is forecast to decline.

Limits to future state support

On a positive side it must be noted that the government managed to avoid a full blown spill-over of the balance-of-payments crisis to the banking sector and thus avoided a systemic crisis. However, this came at a heavy cost. The most obvious is the increase of public debt, as

⁴ This measure can be viewed as an approximation of the share of NPLs in total loans, as there are no public official data on NPLs.

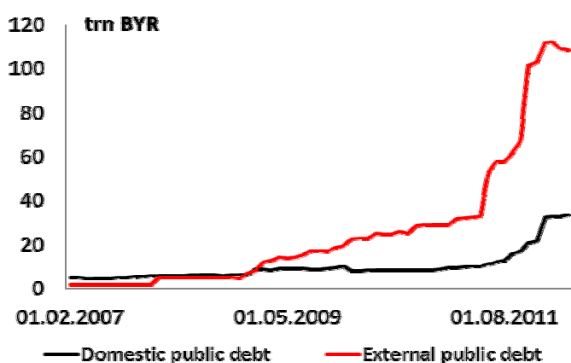
⁵ In general, the higher the classified group number, the higher is the credit risk of the underlying asset (e.g. loan) in question.

⁶ Moody's forecasts a NPL-level of 10-15% in the next 12-18 months, significantly higher than their estimate of 5-7% at the end of 2011. Their NPL definition includes loans overdue 90 days+ and restructured/ refinanced loans that would have otherwise turned non-performing.

foreign assistance was vital to the stabilisation. Public external debt jumped dramatically in 2011 in BYR-terms due to the steep depreciation, but increased also in USD terms due to the support from official sources (see Figure 10a). Also overall external debt continued its upward trend during the crisis, albeit at slightly lower speed (see Figure 10b).

Figure 10a

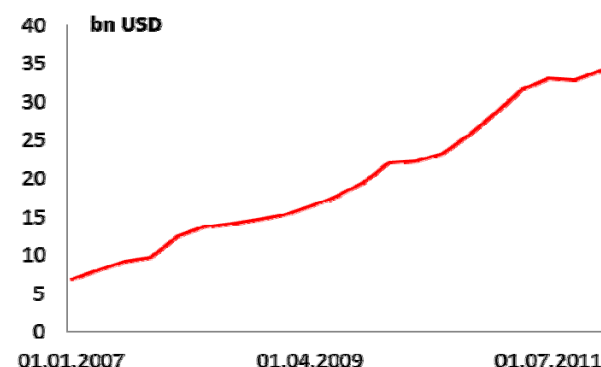
Public debt



Source: Ministry of Finance.

Figure 10b

External debt



Source: National Bank.

These developments have implications for ongoing and future government support to the banking sector if needed, be it directly (through future bank recapitalisations) and indirectly (through supporting state-owned enterprises that borrow under directed lending programs). The increase in public debt levels and the weakened credit profile of the sovereign clearly limits its future ability of supporting the banking sector and the economy, with negative implications.

Conclusion: A negative impact of the recent currency crisis on the situation in the banking system cannot be denied, even though a systemic banking crisis was fortunately avoided. A number of issues like an expected increase in NPLs will continue to put pressure on the system in the medium to longer-term. Coupled with less room for future state support, these developments pose significant challenges to the authorities.

4. Conclusion and policy recommendations

The fact that the current account crisis of 2011 did not result in a systemic banking crisis could lead to the misleading conclusion that the structure of the banking sector is healthy enough to fully withstand such a crisis. Further on, one might conclude that in case of a new crisis, banks will remain stable. The analysis has shown that both conclusions are wrong.

While there are some features which proved to stabilise the banking sector (e.g. the fact that private households are not allowed to take out foreign currency loans and the fact that most foreign currency loans were given to companies with corresponding foreign currency cash flows), the crisis has demonstrated that many banks were not able to compensate for the losses by their own means. Significant capital injections by their respective owners (in the case of the two largest banks this is the state) were necessary. This is the result of a rather unprofitable banking sector, which can be explained with the high influence of the state on the banking sector mainly via its directed lending programs. In addition, and most importantly, the directed lending programs mean that banks do not steer their loan portfolio by way of market signals. Even if a company (or a sector) is considered to be particularly risky, it would receive loans if it is included in one of the directed lending programs.

The important point to note is that if Belarus was hit once again by a similar crisis in the future, the impact could be much more severe than in 2011. This has, among other things, to do with the fact that this time around the financial support capacities of the state are much more restrained. This in turn means that the necessary adjustment would have to be borne mainly by the market participants in Belarus, thus non-financial companies and banks and at the end also private households. The banks would most probably experience much stronger foreign currency deposit withdrawals, putting their liquidity and solvency position at risk. In such a scenario, a run on foreign currency deposits could spread to local currency deposits, putting pressure on the central bank to provide massive liquidity support. Combined with a likely

strong depreciation of the BYR this would lead again to an inflation spike, which could easily surpass the levels seen in 2011.

In order to prevent such an adverse scenario from happening, a number of measures have to be taken at the macroeconomic level as well as at the microeconomic (banking) level.

Policy measures on the macroeconomic level

1. In the short-term, the National Bank should not be too hasty in bringing down interest rates, given that inflation and inflation expectations are still high. This means that real interest rates are low or even negative (depending on whether one looks at ex-ante, or ex-post rates) which could trigger again a resurgence of inflation with well-known negative consequences for the economy and the banking sector.
2. The gradual transition to a more flexible exchange rate system that started in September 2011 is very important and needs to continue. A floating exchange rate allows market forces to adjust swiftly to changes in the external environment, thereby shielding the domestic economy from external shocks.
3. In the medium-term, a new monetary policy strategy needs to be pursued. In line with our previous work, we recommend the adoption of an inflation targeting (IT) framework, which would give the National Bank the opportunity to achieve a low and stable rate of inflation in the medium term. Such a system, in which the BYR is allowed to move freely, but where the National Bank prevents excessive fluctuations, would be able to create a two-way exchange rate risk, discouraging dollarization in the banking sector and the economy more generally. This would further boost the credibility of the National Bank and confidence in the local currency, which is in turn important for sustainable banking and financial sector development. In this context, the independence and accountability of the National Bank should be strengthened.
4. Apart from monetary and exchange rate policy, also fiscal and income policies need to contribute to maintaining the recently regained macroeconomic stability. In particular, wage policy should take into consideration past productivity gains, and not lead them, given that Belarus has to compete on the global market. The negative consequences of excessive wage increases have become obvious during the latest crisis.

Policy measures on the microeconomic (banking) level

5. We strongly support the idea of consolidating the directed lending programs into a separate Development Bank, and curtail the new issuance of such loans. This would be an opportunity to relieve the banks involved from conducting such non-market driven activities and provide a first step to let commercial banks act much more in response to market developments. The removal of directed lending from the commercial banking sector needs to be stressed, as this has negative implications for the allocation of capital and investment efficiency. Relieved from this burden, commercial banks would become more efficient and profitable. This would in turn enable them to build up an adequate capital buffer. By this way banks and thus the whole sector could be made more robust to withstand future negative shocks without relying on support from the state. This would undoubtedly contribute to financial stability.
6. The dominance of state-owned banks in the banking sector should be diminished by increasing reliance on financial intermediation through private banks, and here in particular foreign ones. Such a move would allow the banking sector to allocate credit primarily according to market signals, increase efficiency and price and manage risks accordingly. This would have positive implications for the stability of the banking sector as well as the whole economy. One instrument to achieve this is through increased privatisations. The authorities have undertaken first steps in this direction, including the softening of respective restrictions regarding foreign ownership, which is a welcome move. This process, whose results are however not entirely dependent on domestic developments, needs to continue. Removing the burden of directed lending from state-owned commercial banks (see previous point) may be an additional incentive for a potential private investor.