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BEROC Economic
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Economic Outlook

Third and Fourth Quarters 2019

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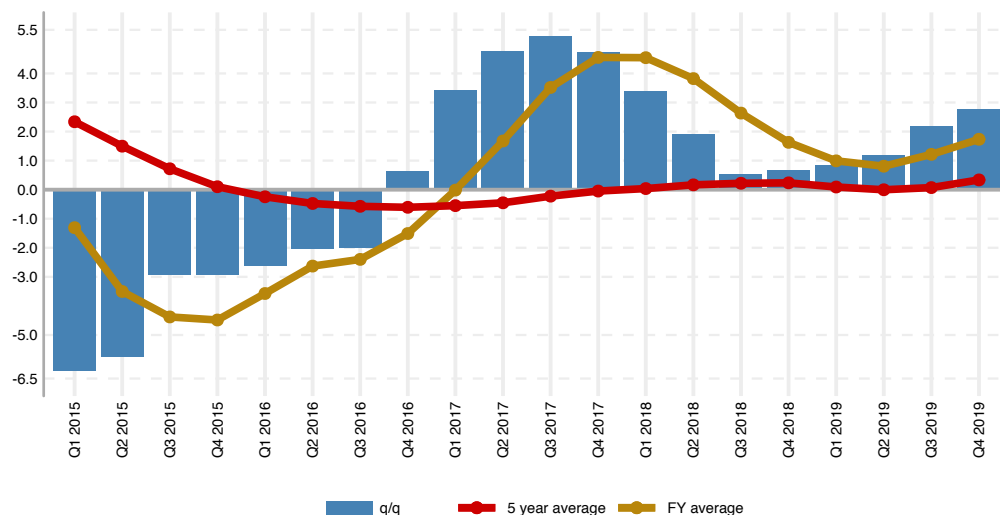
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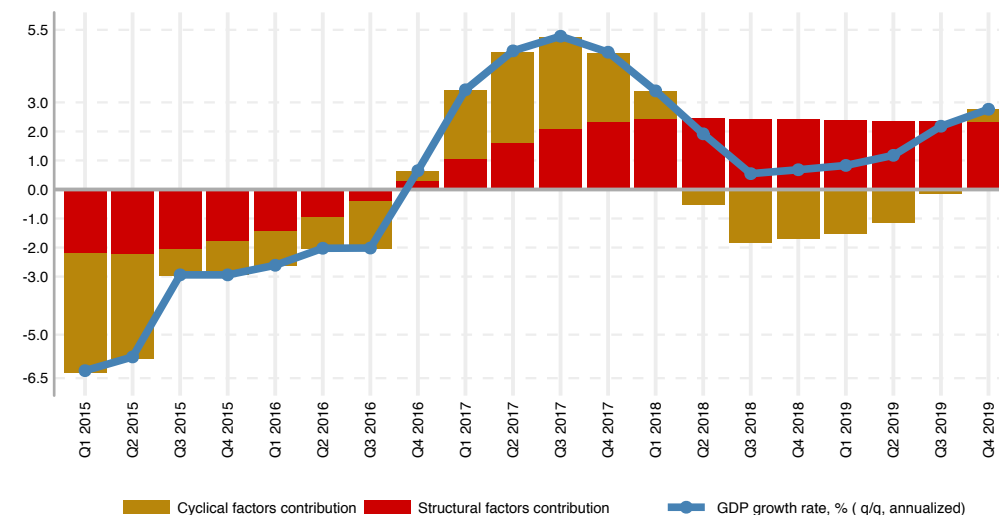
Systemic challenges suppress the weak cyclical growth

- Investment surge
- The National Bank is setting the trend of declining interest rates
- The physical volume of imports is growing, while that of exports is decreasing
- The inflation is below the targeted values
- The budget surplus is going down
- Real wages are growing, but the labor market is choppy

GDP growth rate, %
(seasonally adjusted, annualized)



Decomposition of GDP growth: the contribution of structural and cyclical factors, percentage points



1. By default Belstat reports GDP growth rates (i) on accrual basis and (ii) vs. the same period of a previous year. The series of such growth rates turn out to be flat, but it 'hides' new signals in output dynamics. In internationally accepted practice series of the annualized growth rates between two consecutive quarters (with a seasonal adjustment) are more frequently employed. Such growth rates reflect the tendencies of the output with respect to a particular quarter (including the last one). The series of annual average growth rates (not on accrual basis) allow to avoid high volatility of previously mentioned indicator and embeds the information about the last quarter to the previous year context. Finally, average annualized growth for last 5 years (not on accrual basis) could be viewed as indicator characterizing the environment of the long-run growth.

2. Decomposition of GDP to structural and cyclical component is made by means of univariate Kalman and Hodrick-Prescott filters. Final decomposition is a result of averaging of these two approaches. In terms of growth rates, such decomposition demonstrates contribution of structural and cyclical factors to growth rates of the output. However, it doesn't focus on the current state of the trend (potential) output and output gap (corresponding estimates of levels may differ significantly (than estimates of growth rates) in comparison to estimates based on another decomposition techniques).

Current trends

Inertia acceleration of growth vs. stronger signals of future deceleration

The output growth accelerated in Q3-4 2019. The upward output trend was a result of cyclical fluctuations. If their frequency and range were close to the “historical norm”, the end of 2019 could be expected to be roughly the midpoint of the growth acceleration phase. Moreover, there would be strong inertia growth in 2020 and the economy would continue “gaining the momentum” for most of the year.

However, despite its acceleration at end-2019, the de facto growth showed signs of weakness, fragility, and “directivity”. The dynamics of aggregate demand components was volatile. For example, the positive contribution of exports to the output growth in Q3 turned negative in Q4, and by contrast, the contribution of the final consumption expenditures turned from negative to positive. Moreover, there was no uniformity of the dynamics of domestic demand components traditionally inherent in periods of “natural” growth. All this points to contradictory incentives and behavior patterns of economic agents and, ultimately, to the weak growth inertia.

In Q4, the instability of the growth acceleration phase became more prominent, while the negative signals intensified. For example, the quarterly inflation slowed down, reaching a level significantly below the target. In part, this fact can be interpreted in a positive way and be associated with success of the monetary policy. However, it also signals that the demand is weak, which is in contrast with the growth acceleration phase. The challenge of weak demand has become increasingly urgent for firms, leading to a deterioration in their financial performance in Q4. Moreover, surveys of

firms at the end of the year recorded an increase in their expectations of future weakening of demand. This led to a sharp change in the behavior of firms in the labor market already in Q4. Firstly, a downward trend in employment reemerged following a long period of stabilization. Secondly, the number of new jobs decreased rapidly—this indicator moved to the range of values typical for the period of recession of 2015-2016.

The negative signals observed in Q4 were partly caused by the risks and uncertainties related to the energy import prices. Being overcautious about them, economic agents limited their output and demand, thus generating a deterrent effect on the economic activity.

If projected on to the subsequent periods, with a view to the realization of part of the risks, as well as the continued uncertainty about oil, this negative impact would strengthen. Therefore, in early 2020, the acceleration is almost certain to at least slow down, and is even likely to be replaced with a recession. Moreover, for the same reasons, the risk of recession becomes tangible for the whole 2020. But such a scenario is unlikely to be acceptable to the authorities. Therefore, the issue of fiscal and monetary stimuli can be expected to reemerge on the agenda.

Institutional environment

The oil-related systemic challenges remain unaddressed

At the turn of 2019-2020, being faced with diverging political and economic risk paths, the Belarusian authorities had to make a choice. Belarus did not follow the path of “deep integration” imposed by Russia in return for maintaining the status quo in the oil and gas sector. That path is fraught with massive political and institutional risks. In addition to the awareness of these risks, the decision taken may have been based on doubts as to whether the agreements on “deep integration”—“in excess” of Russia’s obligations within the framework of the EAEU—would be a reliable guarantee of maintaining the status quo in the oil and gas sector.

The new price offered by Russian suppliers in 2020 is about 4% higher than in 2019, reaching roughly 83% of the world price. In 2020, the key problem caused by such terms, if they were accepted, would be the refineries’ profitability declining to a level close to zero or even turning negative. However, that problem could be addressed partly at the expense of the budget and partly by raising prices in the domestic market. As a result, the shock would come to a relatively modest “loss” of output (down to 1.5% of GDP) and budget revenues (about USD 300 million).

However, in subsequent years (at further stages of the “tax maneuver”), it would become more difficult to address the oil- and gas-related problems in a similar way. In this case, Belarus would have to take steps no

later than in 2022, by either reducing the volume of oil refining or offering other systemic responses to the rising price of crude oil. However, it is difficult to resort to such responses because of the crucial role of the oil refining sector for the national economy. Although its direct share in the GDP is less than 1%, due to extensive sector linkages, as well as the multiplier effects on demand, this sector would affect at least 8.5% of GDP. It also plays an important role in ensuring the external, fiscal, as well as financial stability throughout the economy.

If the consequences of the tax maneuver were accepted in 2020—the year when Russia starts subsidizing its refineries—that would de facto mean the acceptance of Russia’s interpretation of the EAEU agreements and the loss of opportunity to appeal to them as a basis for claims of the Belarusian authorities to special conditions in the energy trade. Therefore, the refusal of the Belarusian authorities to accept the conditions offered by Russia today is a logical step in upholding their interpretation of the EAEU agreements, as well as an attempt to preserve and protect their economic model in the medium term.

However, with this move, the Belarusian authorities have already triggered the systemic challenges for the national economy, being still unable to offer appropriate systemic responses. So far, it has generated mainly short-term losses, a significant part of which can be “rolled back”. However, if “put on hold” for a long time, this situation is fraught with negative consequences of a systemic nature.

Background information

The authorities adopted a strategy to strengthen the confidence in the local currency

In early 2020, a joint resolution of the Government and the National Bank adopted a strategy to strengthen the confidence in the local currency. It postulates that the excessive dollarization has become a barrier to long-term growth, as well as to ensuring the macroeconomic and financial stability.

To change the situation, the authorities declare their readiness to implement institutional transformations, as well as to improve the quality of their economic policy. For example, they declare the adoption of a wide range of measures to “create a business environment based on the rule of law and rules of market competition”, ensure the equality of different forms of ownership, “introduce principles and behavior standards based on transparent and open... economic policies.”

The contents of this document can be highly praised. It identifies the key causes and consequences of dollarization—without avoiding institutional challenges—and proposes adequate and realistic measures to achieve dedollarization.

However, the likelihood of full implementation of this strategy in the current environment seems to be not so high. Many of the measures proposed in the strategy imply a change in a number of established institutional standards and practices. Therefore, the implementation of this strategy will require political will, the presence of which is at least not obvious today.

New episodes of “unconventional” government support

The last day of 2019 was marked by the adoption of a range of Decrees on providing government support to a number of distressed state-owned enterprises. The tools to provide such support were: restructuring of previously granted loans, non-competitive provision of new budget loans, tax relief/deferral, selective exemption from compliance with a number of legal requirements to business processes. Such government support can be called “unconventional”, since its tools are not aligned with the list of admissible arrangements designated in the framework Decree on the provision of government support (No. 106 of 23 March 2016).

Although the volume of government support is not excessive (especially in the scale of the entire economy), this case seems significant and alarming for a number of reasons. Firstly, it clearly demonstrates the ineffectiveness and inconsistency of the “half-hearted reforms”. The attempt to support distressed state-owned enterprises was ineffective and forces the authorities to “bypass” the standards of financial discipline formulated for state-owned enterprises. Secondly, this could become a signal for state-owned enterprises to ease their financial discipline. Moreover, this can also be interpreted as an additional indication of the authorities’ willingness to “shelve” the problem of bad debts, without authorizing them in principle.

Output and demand

Investment surge, net export downfall

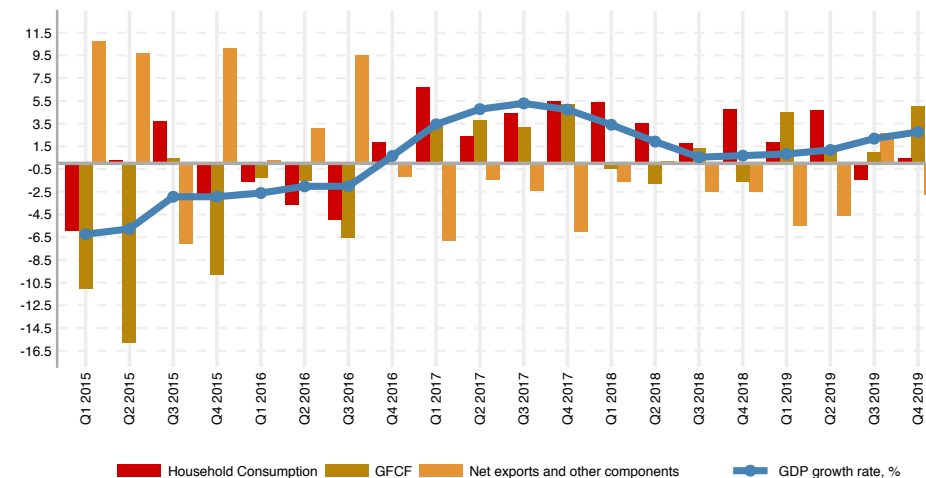
The key component of domestic demand—household final consumption—generated a weak positive contribution to the output growth in Q4, following a downfall in Q3. In general, during the second half of the year, the contribution of consumption to the output dynamics was close to zero. This testifies to the fact that consumer demand, which had been the “engine” of growth since 2017, reached a certain ceiling. In other words, the share of consumption in the composition of demand became so high that its further growth was difficult and inefficient. Against this background, the key positive contribution to the output dynamics from the demand side was generated by the gross fixed capital formation. A significant part of this increase was related to investments in the nuclear power plant.

The net exports had a deterrent effect on the output in Q4: exports were slowing down, while imports continued to grow.

The qualitative indicators indicate that there is a reserve of inertia growth

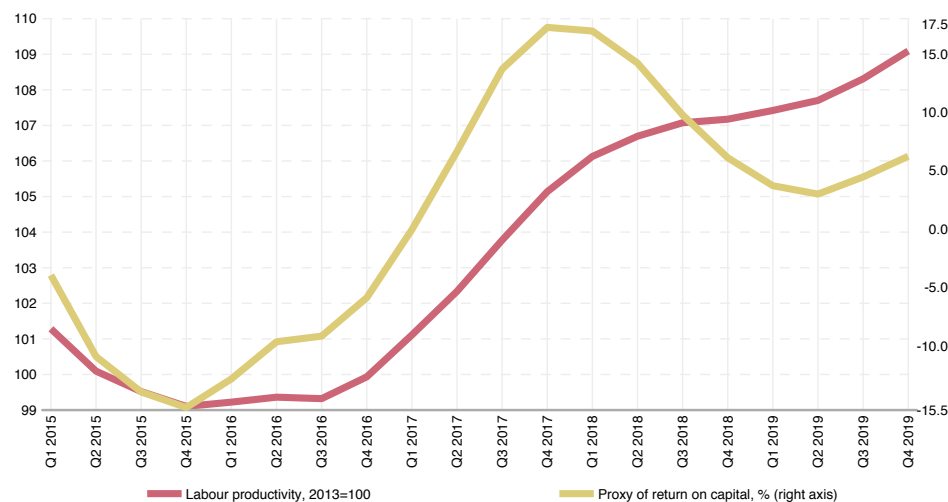
The qualitative indicators of growth improved in Q3 and Q4. This shows that the growth in those periods was intensive and at least partly “natural”. Moreover, the growth of those indicators can also be interpreted as an indication that the economy was characterized then by inertia and strength to sustain growth in subsequent periods.

Contribution to output growth, percentage points



Note: The rate of the GDP growth and the relevant contribution of demand components are annualized quarter on quarter (with a seasonal adjustment); GFCF is gross fixed capital formation.

Quality growth indicators



Note: The proxy for the return on capital is calculated as a ratio of the annual average output growth to the share of GFCF in GDP.

Monetary sector

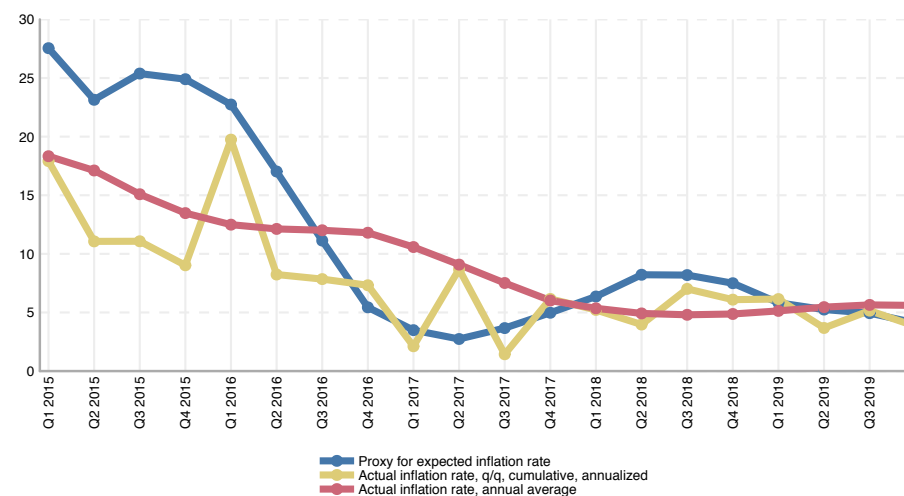
The inflation and inflation expectations are below the targeted values

The situation in the monetary sector was quite favorable in Q3 and Q4. The values of the inflation accumulated for the quarter, as well as those of the inflation expectations, were initially close to the target (5%) and later on went even significantly below it. On the one hand, such results can be attributed to “achievements” of the monetary policy. But, at the same time, it is worth noting the negative signals associated with the inflation slowdown. Traditionally, the weakness of inflation reflects the weakness and fragility of demand. This concern is particularly relevant, given that the core inflation (calculated based on freely formed prices) was below 2% (annualized) in Q4, and the main contributor to the price dynamics were regulated prices, which respond late to changes in the market.

The National Bank is setting the trend of declining interest rates

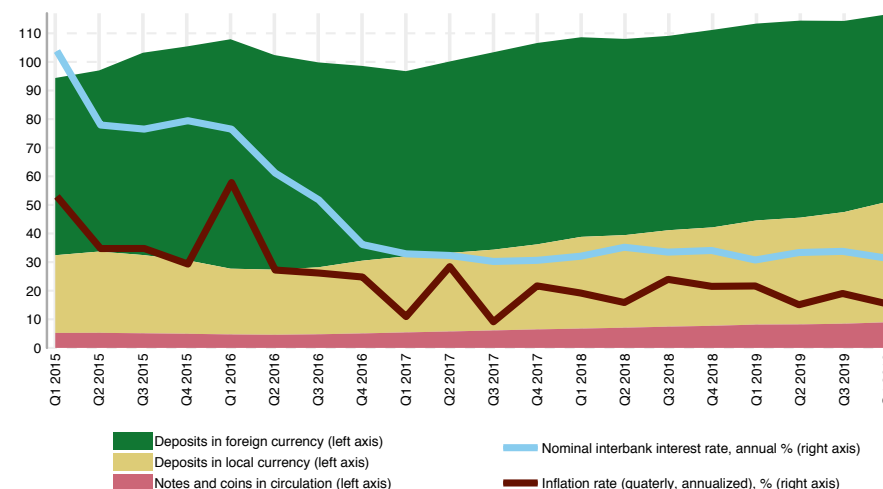
The tangible slowdown in inflation expanded the opportunities for the monetary policy. In Q4, the refinancing rate of the National Bank was reduced by 0.5 p.p. to 9% per annum, which became one of the factors of a revival in the credit market. As a result, the growth of the monetary aggregates recovered and the market interest rates declined slightly (albeit to a lesser extent compared to the refinancing rate). Subsequently, in February 2020, based on the above trends, the National Bank reduced the interest rate by another 0.25 p.p. to 8.75% per annum.

Inflation and inflation expectations %



Note: The inflation expectations are calculated on the basis of the methodology developed by Kruk (2016). All the indicators are annualized in percent. The quarterly inflation is seasonally adjusted.

Interbank interest rate and monetary aggregates



Note: M3 components correspond to the scale M3 2015=100. All the indicators are seasonally adjusted in real terms.

Financial stability

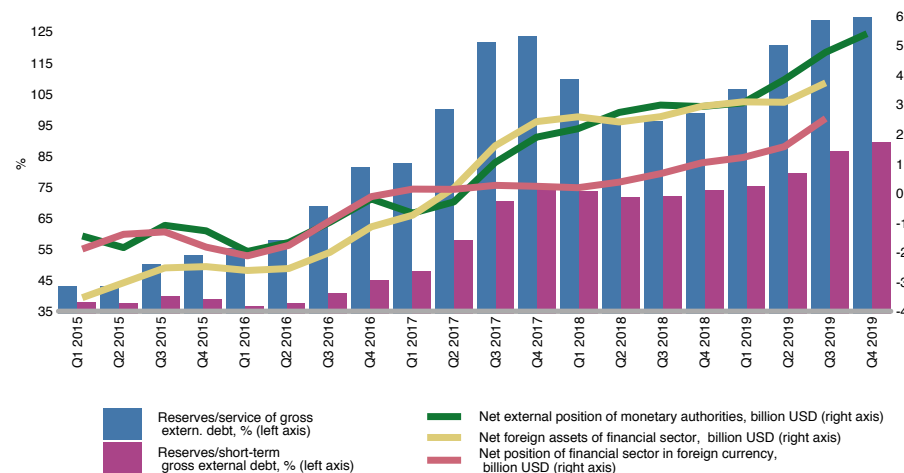
The foreign currency liquidity continued to strengthen

The foreign currency liquidity continued to improve. The key reason for this was the continued net supply of foreign exchange in the domestic foreign exchange market. However, there were changes among its suppliers in the second half of the year: individuals reduced their net supply of foreign exchange, while firms increased theirs—this trend was particularly stable among non-residents. In Q4, there was another “failure”: against the backdrop of the growing trade deficit, resident firms became net buyers of foreign exchange. This fact, as well as the impact of the oil-related shock, suggests that the medium-term trend of the liquidity in foreign currency strengthening will change in 2020.

The corporate lending revived

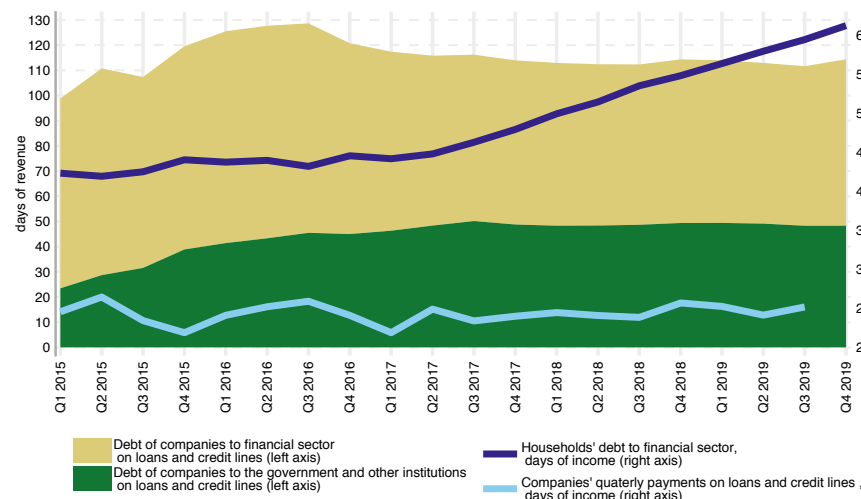
Following a long period of tranquility, the corporate lending market visibly revived in the second half of the year, and especially in Q4—the corresponding credit exposure grew by 12.6% yoy in Q4. This was a result of a whole set of factors: the reduction of interest rates by the National Bank, the cyclical economic growth, banks’ excess liquidity, the pressure created by the National Bank through its macroprudential and administrative tools to redirect the supply of loans from the retail to the corporate segment.

Foreign exchange liquidity indicators



Note: The indicators of reserve assets are as of the beginning of the quarter. The gross external debt service includes interest and principal payments for the previous 12 months. The net external position of the monetary authorities is calculated as the difference between the reserve assets and the costs associated with them over the coming 12 months.

Size and quality of private debt



Note: Companies’ liabilities to the government etc. under loans are calculated as the difference between the total amount of companies’ liabilities under loans and their liabilities under loans provided by the financial sector.

Fiscal sector

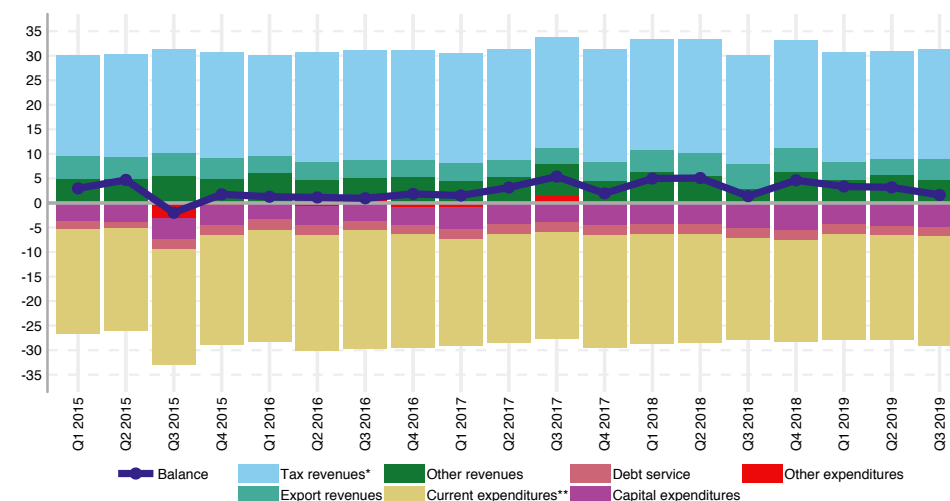
The budget surplus is going down

The key fiscal trend of 2019 was a progressive decline of the consolidated budget surplus. In the first half of the year, it was close to the level of 3.2% of GDP, while in Q3, it dropped to 1.6% of GDP. The decrease of the surplus in Q3 was mainly due to higher budget expenditures, while the main revenue items were relatively stable compared to the previous periods. Most of the increase in expenditures was attributed to the current expenditures, primarily wages and salaries and charges on the payroll, as well as the current budget transfers.

The trend in the dynamics of the debt burden is likely to change

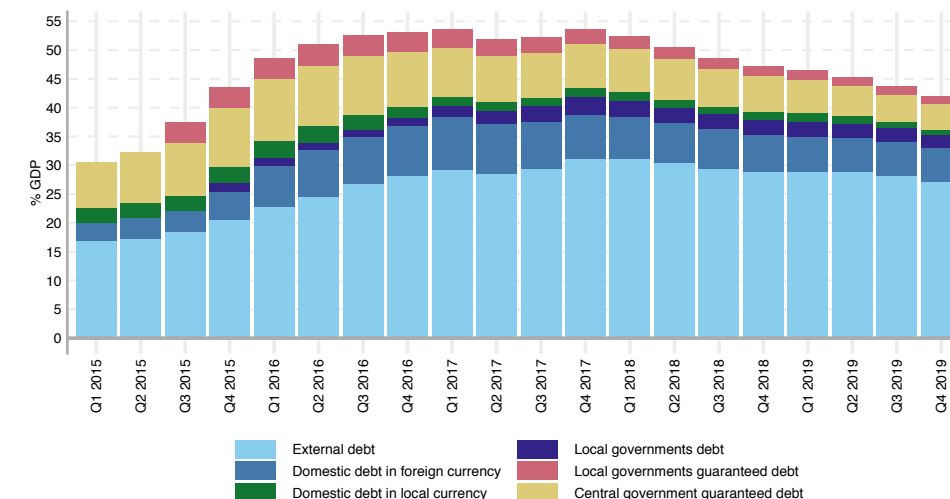
The authorities are adjusting their approaches to the public debt management amid the expected future deterioration of the fiscal position. Despite the available reserves—in early 2020, about USD 5.5 billion and BYN 8.5 billion were accumulated in the government accounts—and the declared intention to repay 25% of liabilities on the net basis, the de facto pace of net repayments was lower in 2019. Moreover, at end-2019, the public debt even increased on the net basis (by USD 132 million). Against the backdrop of the GDP growth and the nominal exchange rate stability, this facilitated a reduction in the debt burden. However, the situation is most likely to change starting from 2020, at least, because of the GDP in the dollar equivalent getting an impetus to decline.

Consolidated budget performance, % GDP



Note: * - without taxes on foreign trade; ** - without public debt service. % GDP values are seasonally adjusted quarterly flows.

Public debt, %GDP



Note: Quarter average.

External sector

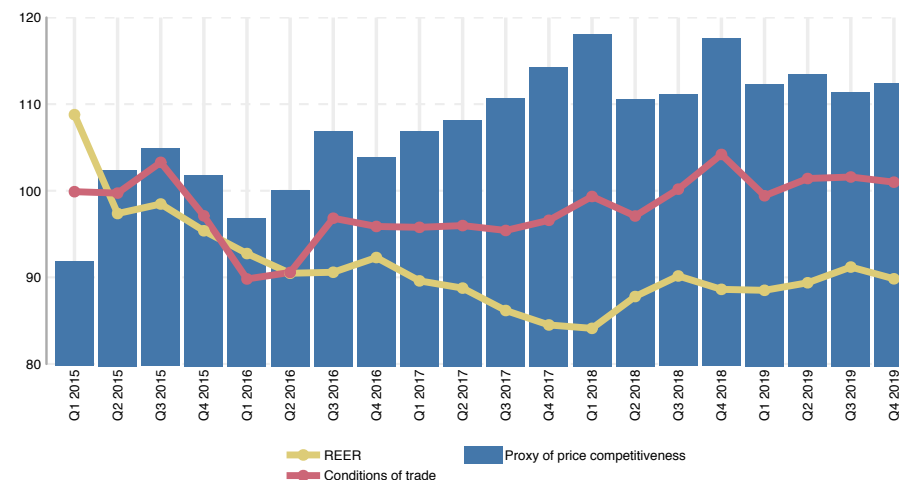
The terms of trade are relatively stable, BYN began to depreciate

In Q3-4, there were relatively minor fluctuations in the producer price competitiveness index. They were mainly caused by the real exchange rate dynamics, while the terms of trade were fairly stable. In the first three quarters of 2019, BYN appreciated in real terms because of the developments with the current account, which was stable and close to being balanced. However, the foreign trade indicators deteriorated in Q4, necessitating additional fueling of the producer price competitiveness. This gave an impulse to the depreciation of the real effective exchange rate and improved the market conditions for producers.

The global growth has stabilized, but risks remain

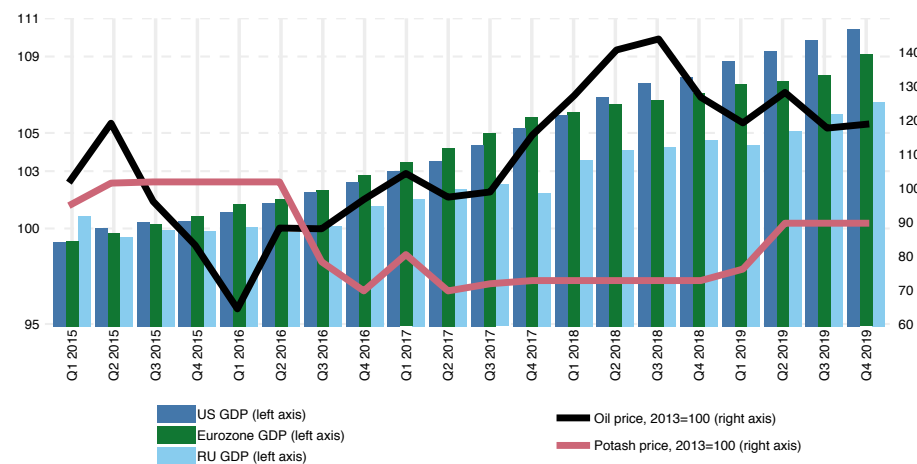
In Q4, the output growth in most of the major economies of the world stabilized or showed signs of forthcoming stabilization. An important contributor to the stabilization of growth and mitigation of concerns about a global recession/shocks was another reduction of the US Federal Reserve rate (by 0.25 p.p. to the band of 1.50-1.75% per annum). Against this background, expectations of stabilization/acceleration of growth in 2020 became prevalent in the global economy. However, a wide range of risks remains relevant, which implies a significant probability of a negative scenario.

External price competitiveness indices, 2015=100



Note: The price competitiveness index is calculated as the product of the terms of trade index and the reverse REER index, multiplied by 100.

Global economic indicators, 2015=100



Note: All the GDP series are seasonally adjusted. The commodity price indices are calculated based on the World Bank data.

External operations

The physical volume of imports is growing, while that of exports is decreasing

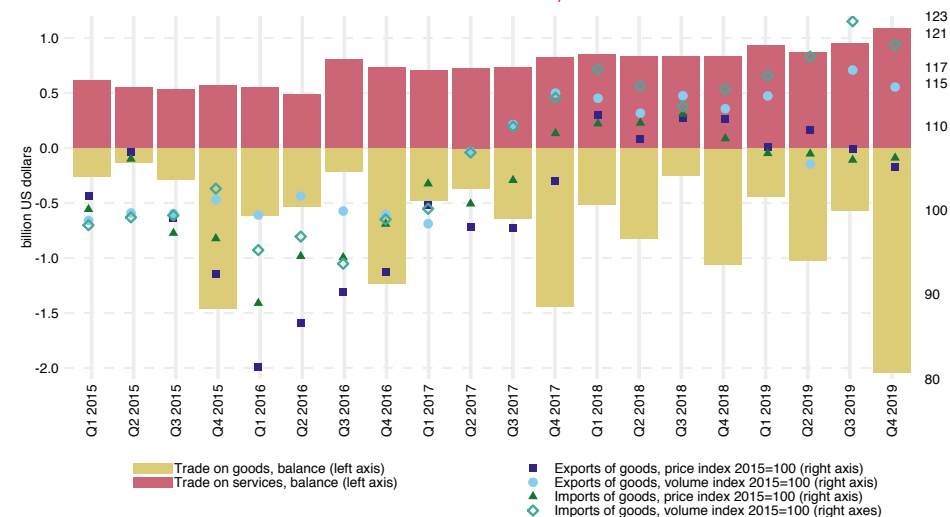
The key trend of Q3-4 was that of a steady increase in the volume of imports for almost all product groups. The highest rates were typical of imports of investment and non-food consumer goods, which reflects a link between imports and domestic demand, as well as the significant appreciation of the real exchange rate in Q1-3 2019.

The dynamics of exports in Q3 and Q4 differed significantly. In Q3, there was a significant surge in exports of most goods. As to intermediate goods, this became a certain compensation for “losses” associated with the “dirty oil” incident. In terms of investment and consumer goods, the growth momentum was associated with a recovery of growth in Russia. However, the trend changed in Q4 and the physical volume of exports dropped noticeably again. That was mostly due to a decrease in sales of potash fertilizers. But the volume of exports of consumer non-food goods also declined.

Improved market environment for external loans

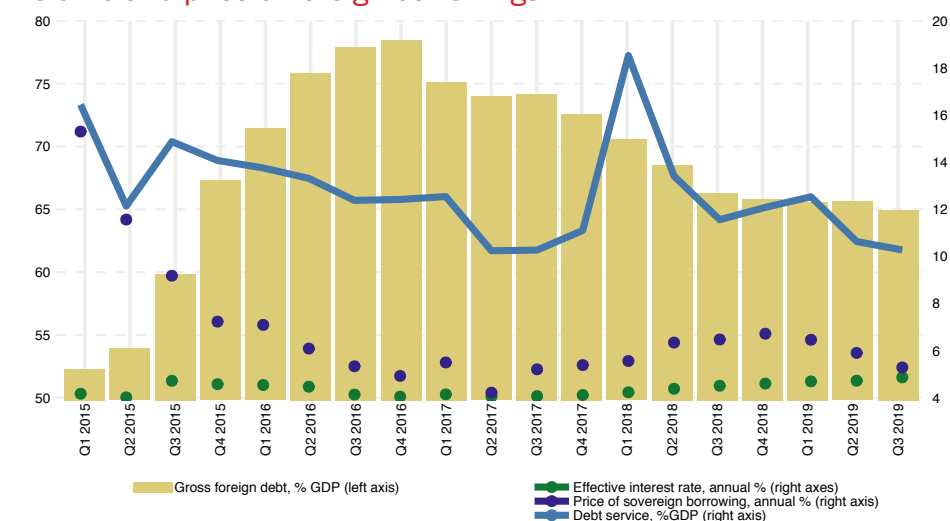
In Q3, the cost of new sovereign borrowings decreased for Belarus, reaching the actual cost of the public debt service. This means that the conditions for new sovereign borrowings by Belarus improved. In the context of the new public debt management environment, this may become an incentive for the authorities to issue new Eurobonds in 2020.

Prices and volume of international trade, 2015=100



Note: PI – price index; PVI – physical volume index. The indices are seasonally adjusted. The balance of trade is not.

Volume and price of foreign borrowings



Note: Debt service data in % of GDP include both interest payments and principal repayments. The effective interest rate is calculated as a ratio of public debt interest payments over the last 4 quarters to the average public debt size over that period. The cost of sovereign borrowings is an estimate calculated as the average yield to maturity for all sovereign Eurobonds outstanding at the time of calculation.

Social sphere

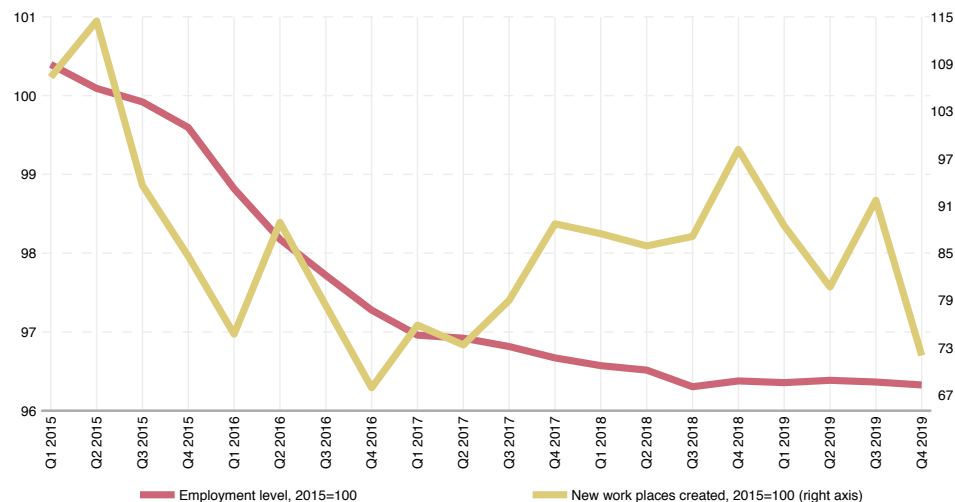
Wages are growing, but the labor market is choppy

In Q3-4, following its deceleration in the first half of the year, the real wage growth accelerated: the growth rates were 8.5% and 8.1% (annualized) and significantly exceeded the output growth rate. The faster growth of real wages led to an increase in real unit labor costs, which negatively affects the price competitiveness and/or financial sustainability of firms. Against this background, and combined with negative expectations growing, firms adjusted their labor market behavior in terms of job creation. In Q4, the number of new jobs declined sharply, reaching a level comparable to that of the recession of 2015-2016. In this environment, for the first time in a long period, the unemployment rate increased from 3.9% in Q3 to 4.0% in Q4.

Has the impact on income distribution weakened?

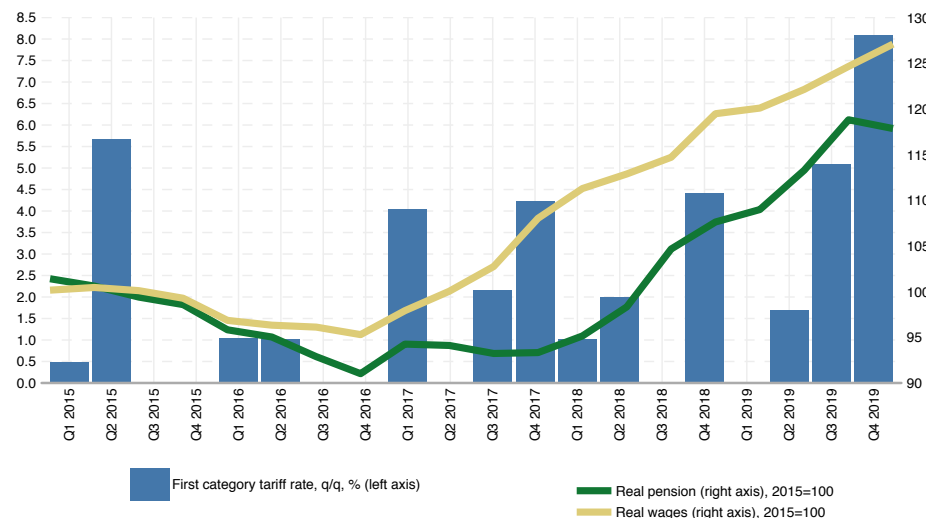
In Q4, the real amount of social transfers decreased for the first time in a long period. This might signal adjustments in the social policy. The authorities could interpret the real amount of social transfers achieved after a period of their rapid growth as socially acceptable. For example, they brought the poverty rate to its historical lows – close to 3.5%. Therefore, against the backdrop of shrinking fiscal opportunities, the policy of raising social transfers and smoothing imbalances in income distribution is likely to weaken.

Employment and new jobs, 2015=100



Note: The indices are seasonally adjusted.

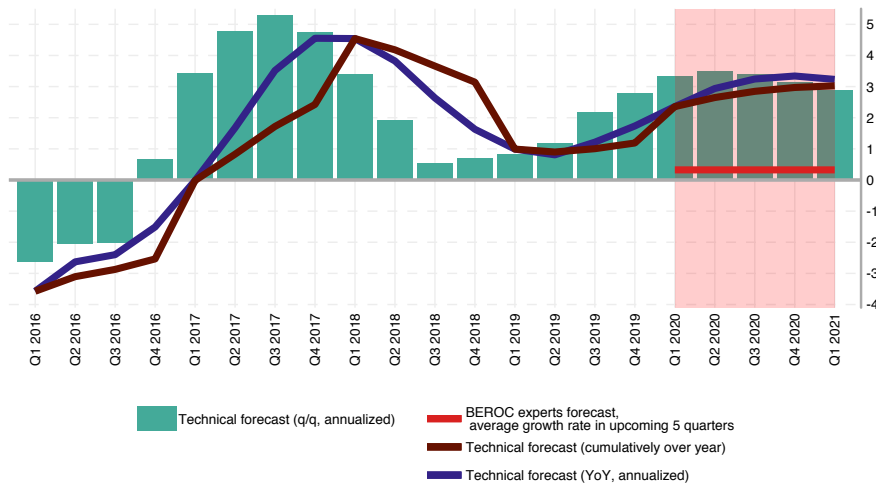
First category tariff rate and household income



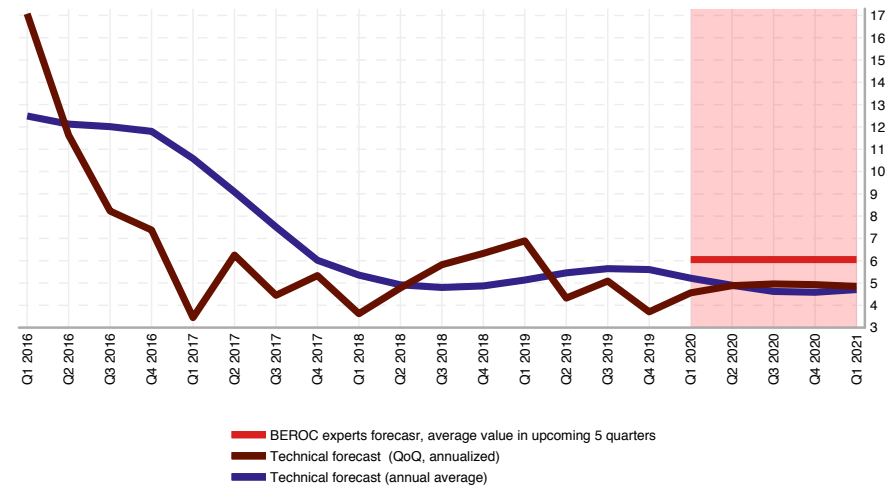
Note: The indices are seasonally adjusted.

Technical forecast

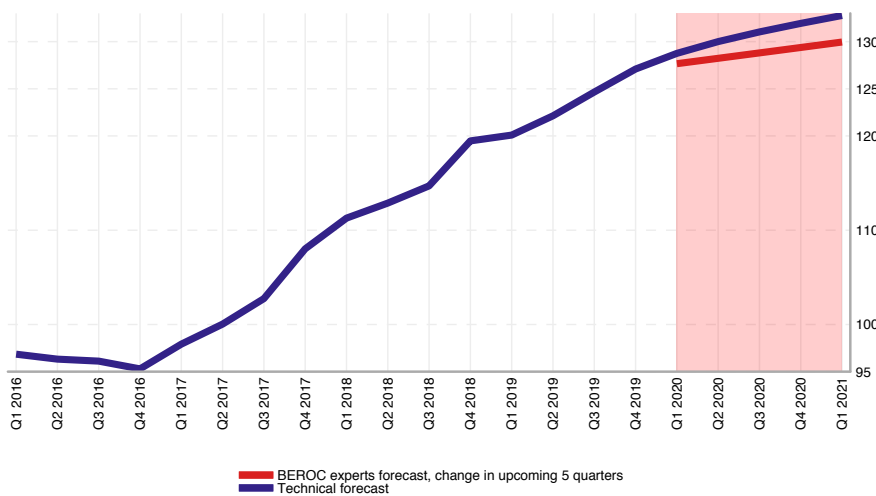
Output growth, quarter on quarter, % (annualized)



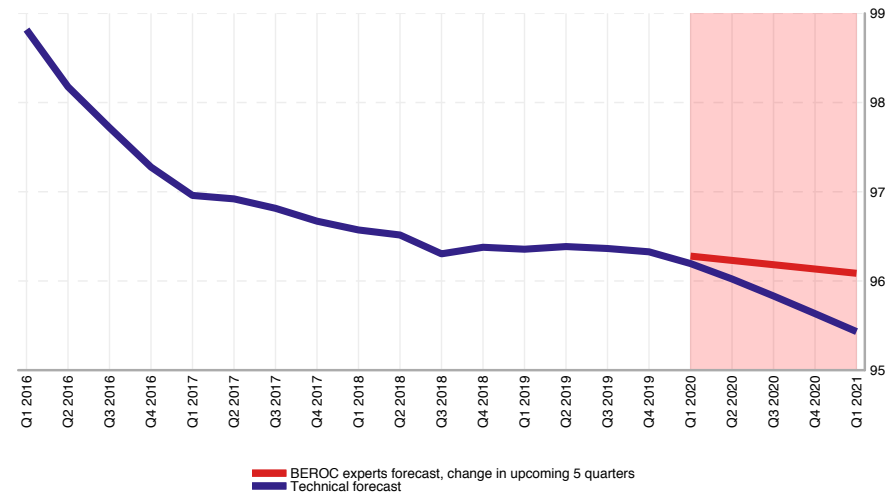
Inflation rate, annual average, %



Real wages, 2015 = 100



Employment, 2015 = 100



The technical forecast is an automated procedure that selects the best specification of ARIMA model for a certain dataset based on the Akaike information criterion and employs this model for forecasting for 5 upcoming quarters. An ARIMA-based forecast just takes into account past trends of the selected indicator and doesn't consider other economic variables, either in the past or in the future. The term "technical forecast" means that it doesn't include any linkages between economic indicators and is fully based on statistical methods. To correctly interpret this type of forecast one should use it as an answer to the following question: "What would happen to a particular indicator in the short-run, provided that the baseline scenario is applied, i.e. in case the fundamental parameters of the economic environment don't change, no exogenous shocks impact the economy, and fiscal and monetary policies remain unchanged compared to the current period?" BEROC's judgmental forecast shows the medium-term equilibrium of a relevant indicator, to which the latter would gravitate in the coming 5 quarters.

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International Monetary Fund (www.imf.org)

R Core Team (2017). R: A language and environment for statistical computing. R Foundation for Statistical Computing, Vienna, Austria. URL <https://www.R-project.org/>.

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