Periodical Part

Economic outlook / Belaruski Ėkanamičny Dasledča-Adukacyjny Centr ; 2019

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Belarusian Economic Research and Outreach Center (BEROC), Minsk

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Economic Outlook

Second and Third Quarters 2019

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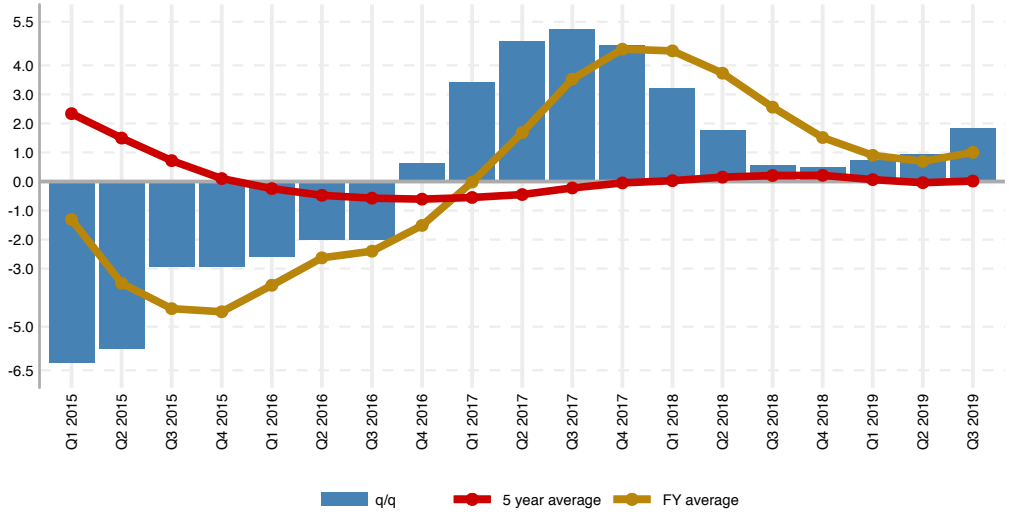
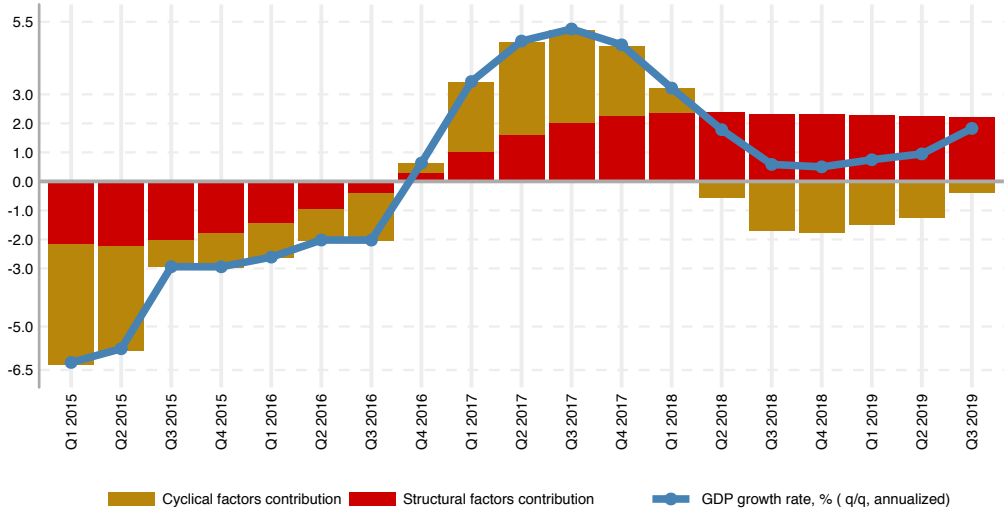
Controversial Growth Recovery

- The domestic demand has slowed down
- BYN has appreciated in real terms
- The physical volume of imports is growing, exports are see-sawing
- Stabilization of inflation and inflation expectations
- The budget surplus goes down
- Wages have risen, the unemployment has decreased

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

The output growth has accelerated, but remains weak and unsustainable

The output growth accelerated in Q2-Q3 2019. When taken on its own, this output pattern may be called positive. The premature and partly artificial recovery observed in Q1—owing to wage stimuli and favorable external shocks—kept the "maturation" of the economy for its full transition to this stage of the cycle in question. Therefore, the probability of a reversal of the business cycle and a new wave of growth deceleration persisted in Q2-Q3. This was further supported by negative external shocks, such as the "dirty oil" incident and the resulting drop in exports, the weaker external demand in Russia amid the local currency appreciation in real terms. Finally, the growth acceleration observed in Q2-Q3 was not backed by a significant strengthening of the fiscal/monetary stimuli, although this could have been expected based on the declared intention of the authorities to notably boost the economic activity.

Against the background of these trends, the economic growth accelerated, but remained weak and unsustainable, as well as controversial in its quality. For example, the transformations registered in the output composition—a significant deceleration of the domestic demand combined with the see-sawing net exports—are usually inherent in the stage of growth deceleration. A number of trends, more common for this stage, were also observed in the credit and labor markets. At the same time, some indicators of the quality of growth, such as labor productivity and return on capital, improved slightly, which can be interpreted as the economy's readiness for further growth strengthening.

In terms of projections for subsequent periods, the scenario of accelerated, although still slow and weak, growth looks most realistic. Under this scenario, the output growth would be close to 1.5 per cent in 2019, rising to about 2.0 per cent in 2020. However, the probability of alternative scenarios for 2020 is also quite high.

On the one hand, the risk of growth deceleration against the background of its fragility continues to persist. The prerequisites for this scenario are the weak domestic demand, decelerating export growth combined with a significant BYN appreciation in recent periods, as well as probable negative external shocks. These could include, for example, an increase in gas prices, disturbances in oil trade arrangements, deteriorating terms of trade, and a slowdown of the global growth. Moreover, the high probability of these shocks in itself has a shackling effect on the economic activity.

On the other hand, the economic growth in 2020 may be slightly above 2 per cent due to voluntaristic policy decisions. The importance of macroeconomic stabilization has become increasingly questioned recently as it supposedly inhibits the output growth. If this position is strengthened and the economic authorities significantly intensify the economic stimuli, that would result in a short-term surge in growth at the price of new risks and threats to the price and financial stability.

Institutional environment

Pressure from Russia and a stalemate situation for Belarus

The potential new deal with Russia remains a key topic for the national agenda. In anticipation of the announced date of signing a package of new agreements, uncertainty remains as to both the contents of the package and the probability of these agreements being signed at all. This background is largely created owing to the stalemate situation faced by Belarus in connection with this package of agreements, as well as the attempt of the authorities to find any acceptable way out of it.

Over the past year, the authorities have been engaged in negotiations with Russia in the format proposed by the latter – "a compensation for the tax maneuver in exchange for deeper integration". At the initial stage of the negotiations, the Belarusian authorities probably assumed that the failure to achieve the desired results would have mainly short-term negative consequences: a progressive decline in fiscal revenues, a deterioration of the financial position of the oil refineries, and a corresponding output decline.

However, the adoption of the negotiation format set by Russia has resulted in the risk of the rejection of the deal now potentially turning into a systemic shock for the national economy and worsened prospects for its long-term growth. It has happened because Russia gradually "raised the stakes" and a wide range of issues was tied to "deeper integration". These include the gas price and the so-called "re-clearance" of oil, removal of non-tariff barriers, and access to credit resources.

If the "big deal" is rejected, the risk of a systemic shock would force the authorities to look for ways to address new unwanted issues. For example, the problems of the budget revenue shortfall, as well as lower profitability of the oil refineries would call for a systemic response. The way the authorities respond to the issues would have an impact on the prospects for long-term growth. At present, the most obvious options of such a response are to minimize tax benefits, cut budget expenditures, as well as significantly reduce the volume of oil refining. However, such responses would reduce the degree of "political convenience" of the economy for the authorities and/or risk undermining its viability in the absence of further systemic changes.

In turn, an agreement on the "big deal", into which Russia is dragging Belarus, may result in a limitation/loss of certain elements of at least economic and institutional sovereignty of the country. Even judging by the scarce official information, the requirements imposed by Russia in terms of "deeper integration" are often "unacceptable".

Such a dilemma leaves little chance for any favorable resolution of the issue for Belarus, as well as the Belarusian authorities. Therefore, it is increasingly likely that the authorities would seek to leave the situation in limbo, looking/waiting for a more favorable moment to address it. However, it also means that conceptual risks will remain relevant for the country.

Background information

The 2020 budget is adopted with a deficit: the role of fiscal policies and public debt management is greater

For the first time in recent years, the consolidated budget for 2020 has been adopted with a deficit—about BYN 1 billion or about 0.7 per cent of GDP. It reflects the pessimistic scenario of the "energy negotiations" with Russia used in the budget plan. It is expected that the inertial growth of the "standard" revenues will be offset by a shortfall (of about BYN 1.9 billion) in revenues associated with energy trade. As a result, the total revenues would remain practically unchanged in absolute terms compared to 2019 but would decrease in relative terms (by about 2 per cent of GDP).

Consolidated expenditures are planned to remain at the level of 2019 in relative terms (about 28.5 per cent of GDP), which is equivalent to an increase of about 8 per cent in absolute terms. According to the budget plan, the main contributor to the total expenditure growth will be wages—on average, the public sector wages are expected to increase by about 11 per cent.

In these new realities, the role of the fiscal policies and public debt management increases substantially. The accumulated reserves will help finance the planned deficit in 2020, as well as maintain the rule of net repayment of about 25 per cent of the public debt obligations. However, in the medium term, this status quo would not be maintained under a conservative scenario. The authorities are likely to increasingly face a dilemma of fiscal stability/debt sustainability considerations and the challenge of ensuring a countercyclical effect of fiscal policies and public debt.

Is the commitment to macro stability in question?

In the second half of 2019, a number of events signal a potential weakening of the role of macro stabilization in the economic policy design. Firstly, following a two-year break, the authorities stepped up the use of methods of "financial engineering" to support state-owned enterprises. The most striking example of this was the support of cement enterprises. Secondly, there was some revision of the policy of curtailing the directed lending, which had been consistently implemented since 2015. In particular, the initially approved limits of such lending for 2019 were increased, and its complete elimination was postponed until 2021 (previously planned for 2020). Thirdly, a number of top officials have increasingly referred to more proactive policies of supporting short-term growth.

If this trend is strengthened and the economic policies are eased, Belarus may again face the risk of macro and financial destabilization. New and partly sound justifications for policy easing suggest that the economy is in a dire need of an "injection" of growth, while the fiscal and monetary policies supposedly have a restrictive impact on the output. However, while somewhat logical, such justifications ignore the structural sources of the weak growth and the sensitivity of the price and financial stability to the macroeconomic policy design.

Output and demand

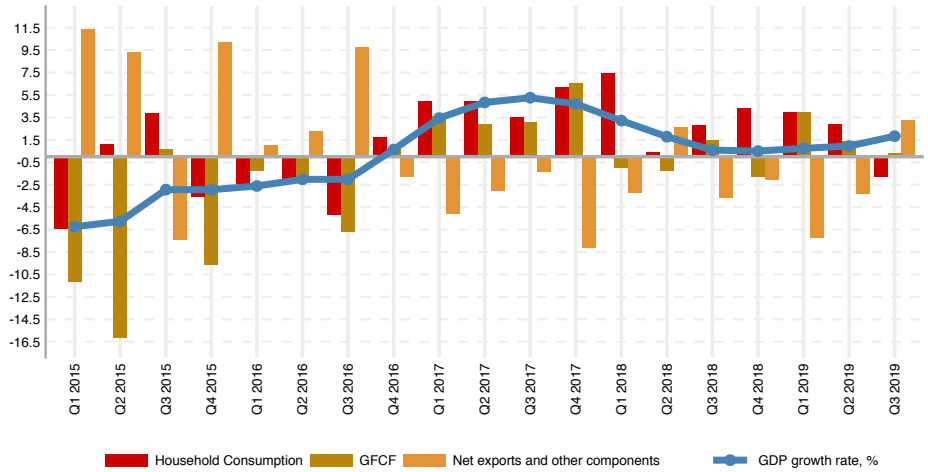
The domestic demand has slowed down

The main trend in the output dynamics on the demand side was the slowdown and the subsequent fading out of the domestic demand growth. It demonstrates that, following the rapid growth in the previous periods, the domestic demand has hit its "ceiling" and needs additional impulses to grow further. The pattern of net exports was unstable and was largely influenced by fluctuations in exports—which were largely related to the "dirty oil" incident—while imports showed rather stable growth. In subsequent periods, the net exports are most likely to be determined more by the condition of imports, as the latter is sensitive to the domestic demand. If the authorities do not resort to active stimulation of domestic demand and it stagnates for several periods, there will be a high probability of decelerating/declining import growth. With expansionary policies in place, the domestic demand would rise again, leading to further growth in imports and deterioration of net exports.

Are the improving quality indicators a background for accelerating growth?

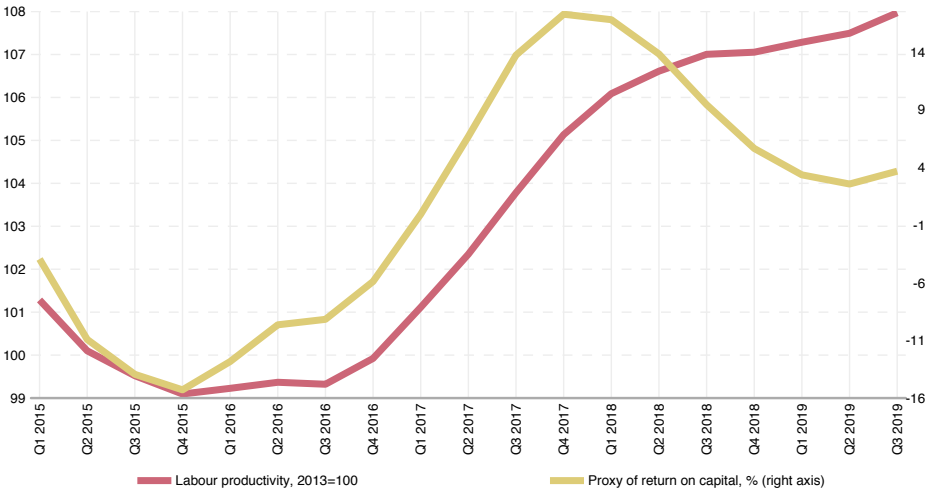
The quality growth indicators improved in Q3. On the one hand, this gives reason to speak about a background for growth recovery. On the other hand, this trend is still weak and may simply reflect the de facto weakening of the domestic demand.

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

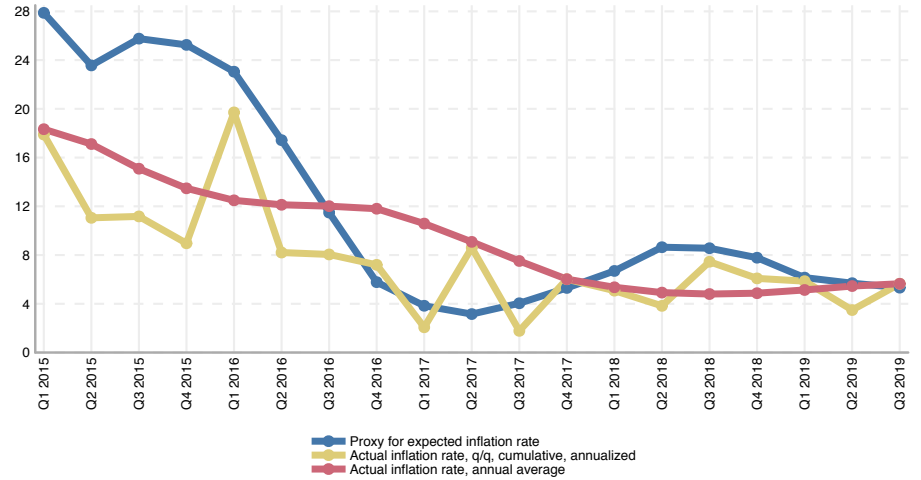
Inflation and inflation expectations have stabilized

Around the mid-year point, the inflationary surge that occurred in the previous few quarters was neutralized. This was facilitated, first of all, by the inertial damping of the domestic demand. Secondly, both the monetary and the fiscal policies constrained the money supply growth. The National Bank maintained the refinancing rate unchanged at the level of 10 per cent (until August), which resulted in persistent (and even somewhat growing) excess liquidity of banks (because they are short of attractive borrowers), which they "froze" in bonds of the National Bank. The Ministry of Finance continued to accumulate resources in its accounts with the National Bank, also constraining the money supply. This background contributed to lower inflationary expectations, to some increase in demand for instruments of savings in the local currency (and therefore to appreciation of the latter).

The space for maneuver in the monetary sphere has expanded

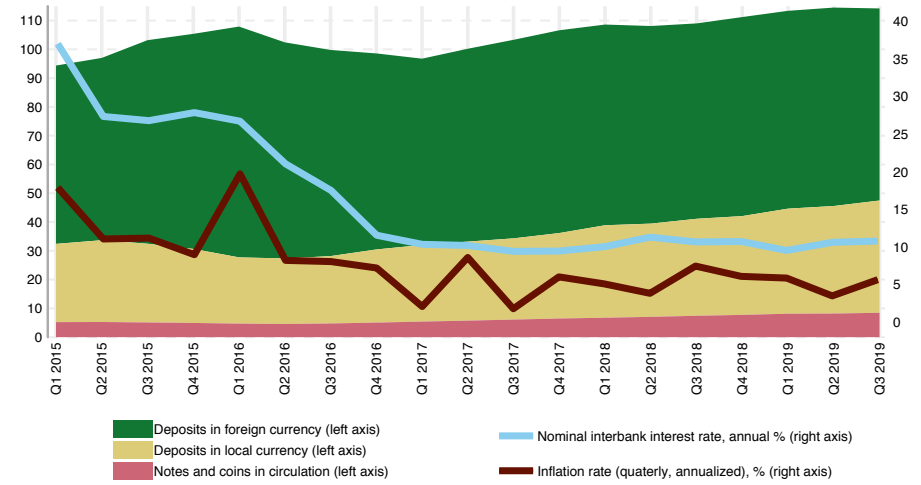
The deceleration of inflation resulted in some growth of real interest rates in the credit and deposit markets at the turn of Q2-Q3, while the nominal interest rates remained stable. Amid improvements in the monetary sphere, the National Bank's space for maneuver expanded. Therefore, after a one-year break, it again resorted to reducing the refinancing rate: in two rounds (in August and November) it was brought down by 1 p.p. to 9 per cent per annum. This interest rate brought the monetary policies back to a nearly neutral state in terms of their impact on the output.

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

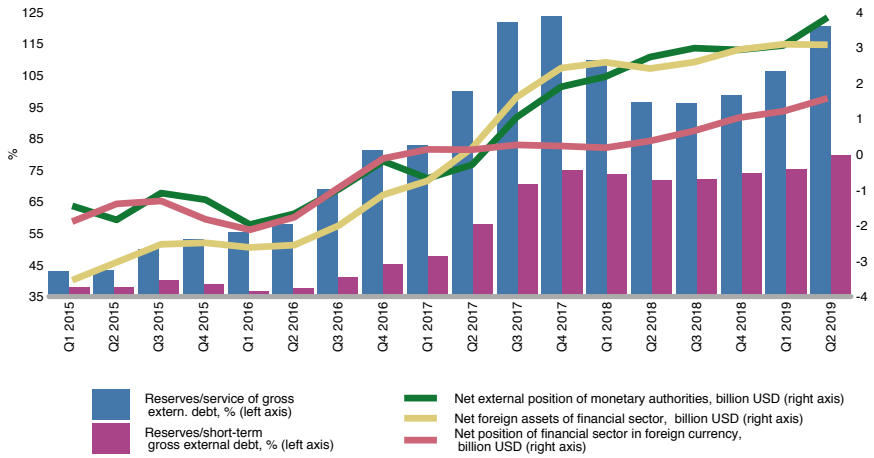
The foreign currency liquidity continues to strengthen

The foreign currency liquidity continued to strengthen. The main reason for this were the net sales of foreign exchange by households. Their volume remains very significant (about USD 600 million for three quarters of 2019), although it is decreasing compared to previous periods (about USD 1.1 billion for three quarters of 2018). The external position also had a stabilizing effect: a moderate current account deficit was almost entirely covered by net inflows under the financial account. The latter was influenced by the behavior of the government: it was repaying the public debt on the net basis in small “portions”, although it had accumulated resources for more active net repayments.

The retail lending boom is fading out

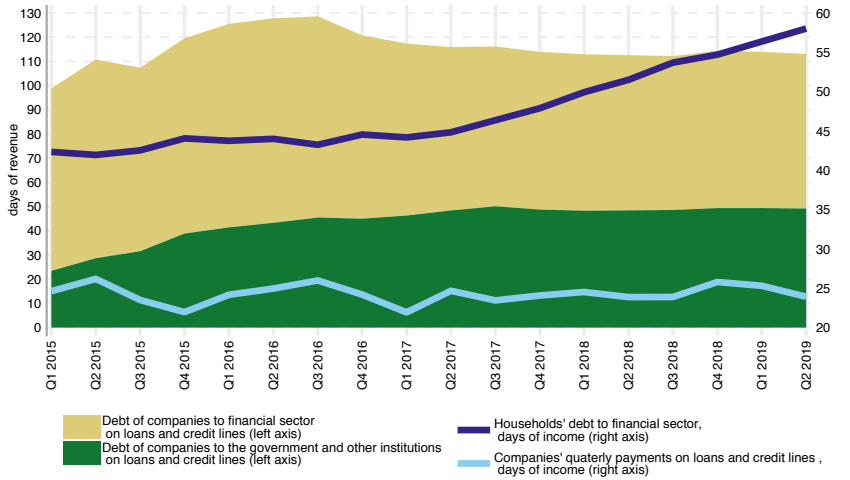
The corporate segment of the credit market remained dormant: outstanding corporate loans grew moderately in nominal terms, while declining in real terms. The key reason for this is still the shortage of corporate borrowers attractive for banks. Therefore, banks continued to be more active in the retail segment. The growth of outstanding retail loans was still high in nominal and real terms. However, this growth began to slow down, signaling the likely soon termination of the consumer lending boom.

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

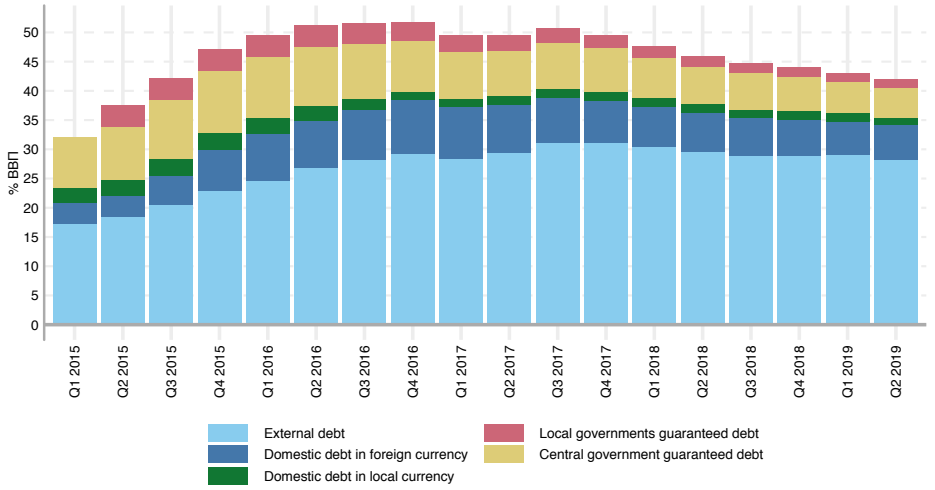
The budget surplus is decreasing

The key trend of 2019 in the fiscal sphere is a progressive decline in the consolidated budget surplus. In the first half of the year, it gravitated to the level of 3.2 per cent of GDP, and it is most likely to be within the range of 2.5-3.0 per cent of GDP in 2019 (3.8 per cent of GDP in 2018). The key reason for the decline of the surplus is the drop of revenues from foreign trade—by about 1.3 per cent of GDP in Q2 against the average annual level of 2018. Amid the weak economic environment, revenues from most tax items also decreased—in total by about 0.4 per cent of GDP against the average annual level of 2018. Expenditures in relative terms also decreased slightly—by about 0.8 per cent of GDP—although less than revenues. Expenditure cuts were quite evenly distributed across the main items.

The authorities repay the public debt in “small portions”

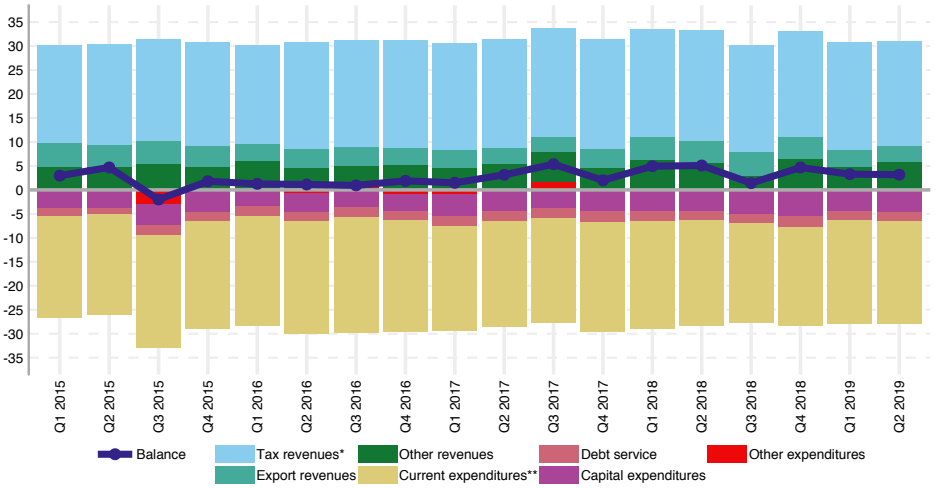
The authorities are adjusting their approaches to the public debt management in the context of the expected deterioration of the fiscal position in future. Despite the available reserves—about USD 5.0 billion and BYN 7.8 billion held in government accounts—and the declared intention to repay 25 per cent of liabilities on the net basis, the de facto net repayment rate is lower. About USD 180 million (about 14 per cent of the total volume of public debt repayments) were repaid on the net basis in three quarters. But due to the GDP growth, it helps maintain the downward trend of the debt burden.

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

BYN has appreciated in real terms

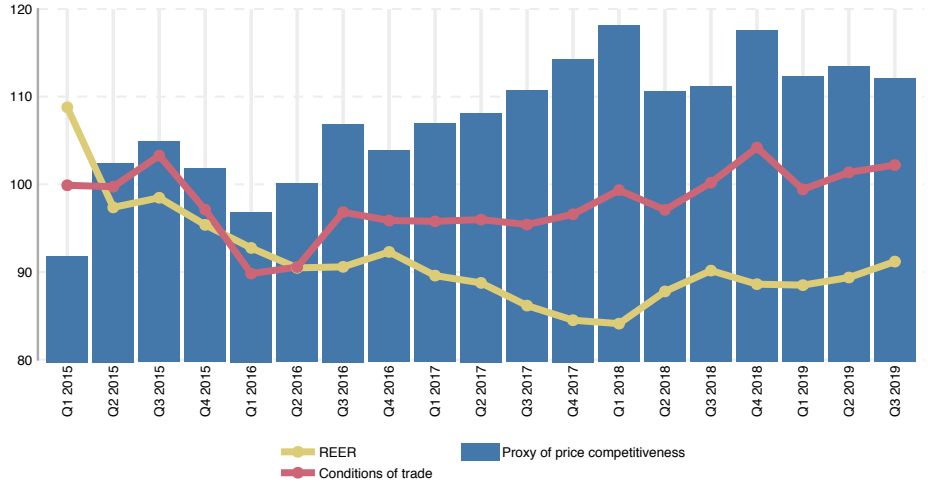
The price competitiveness index did not change significantly in Q2-Q3. But this result was backed by divergent trends. Firstly, the terms of trade improved slightly. But this trend was determined by trade in energy goods, while the terms of trade for non-energy goods even deteriorated somewhat. Secondly, BYN appreciated in real terms in Q2-Q3—as a result of the trends observed in the domestic foreign exchange market—that weakened the price competitiveness of all producers. Therefore, despite the fact that the average price competitiveness in the economy did not change significantly, its variation depending on activities could be quite large in Q2-Q3.

The global growth is decelerating, while Russia's growth is accelerating

The growth of most major economies of the world (USA, EU, Japan) continued to weaken in Q2-Q3. The main reasons for this include the cyclical deceleration, as well as political barriers generating economic risks (trade wars, Brexit). Against this background, a significant acceleration of the growth in Russia in Q2-Q3 turned to be an unexpected development, the prospects of which are still controversial.

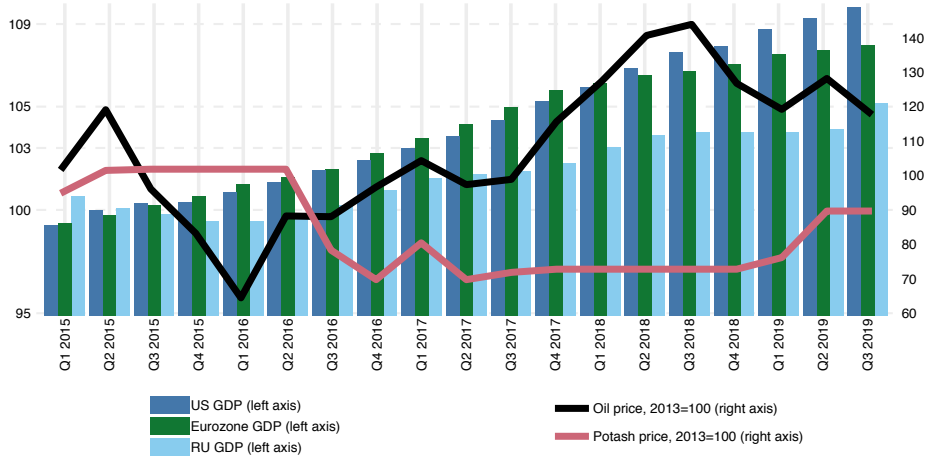
The entire global economy tends to face the preconditions for a rapid change of the phase of the economic cycle. In particular, most of the forecasts for the global economy—assuming easing of the political barriers—posit a slight acceleration of growth in most countries of the world in 2020.

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

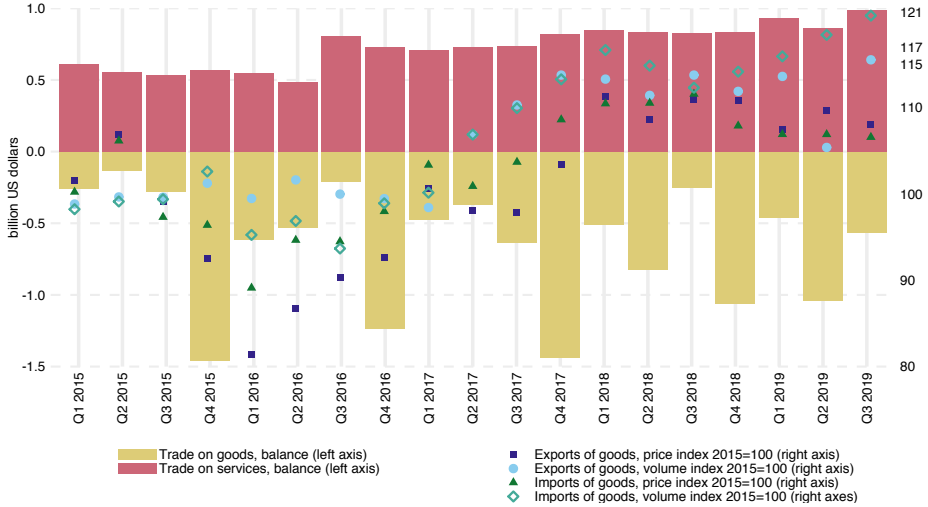
The physical volume of imports is growing, exports are see-sawing

The main trend of Q2-Q3 was a steady increase in the volume of imports for almost all product groups. Imports of investment and non-food consumer goods were growing at the fastest pace, implicitly indicating that the growth of imports was largely a result of the domestic demand stimulation in the previous periods. The dynamics of exports differed greatly in Q2 and Q3. In this regard, Q2 became one of the most unsuccessful in recent years, with the volume of exports dropping significantly. The largest decline occurred in exports of energy products, mainly due to the "dirty" oil issue. However, the physical volume of exports declined for other product groups as well. In Q3, there was a significant surge in exports of most goods. In terms of intermediate goods, it became a kind of compensation for losses in the previous quarter. In terms of investment and consumer goods, the growth momentum was associated with a recovery of the growth in Russia.

The cost of external borrowings decreases

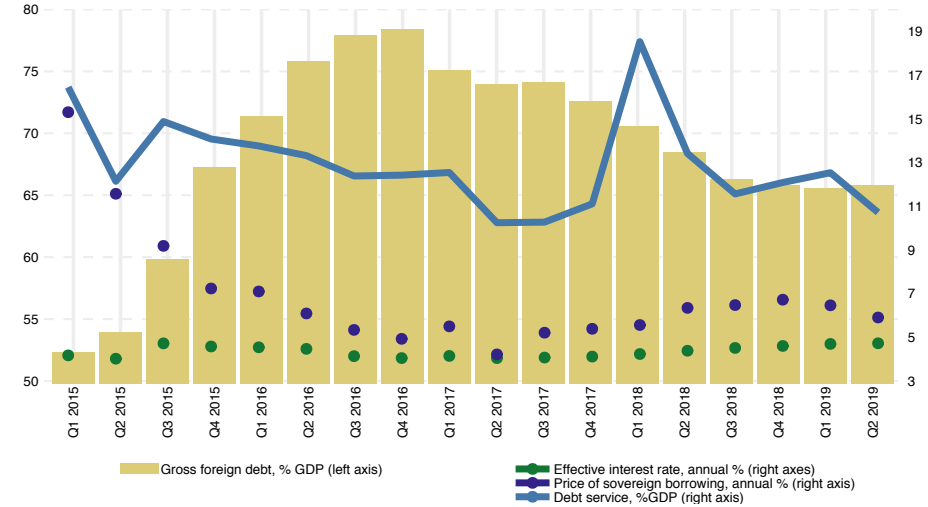
The trend in the cost of foreign borrowings for Belarus changed in Q2-Q3: after a few quarters of growth, the cost began to decline again. The new trend is explained by changes in the environment in the global capital market due to changes in the interest rate policy of the US Federal Reserve, which headed for lower interest rates starting from the middle of the year.

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

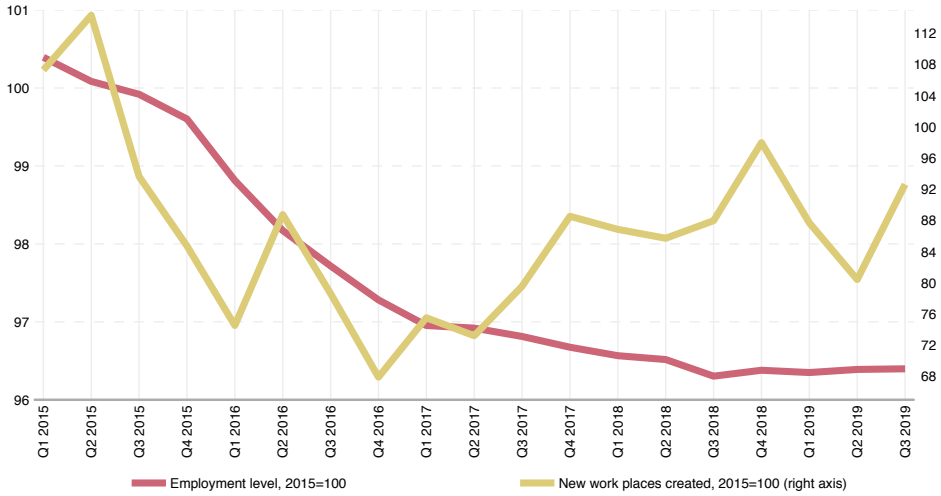
Wages have risen, the unemployment has decreased

Following a slowdown at the beginning of the year, the real wage growth accelerated in Q2-Q3. The quarterly growth rates were not so high (7.2 per cent and 3.5 per cent, annualized, in Q2 and Q3 respectively), but significantly exceeded the output growth rate. This was largely associated with the measures taken by the economic authorities to achieve the relevant targets. The faster growth of real wages has led to an increase in real unit labor costs, which negatively affects companies' price competitiveness and/or financial sustainability. In this environment, companies adjusted their labor market behavior in terms of new jobs. However, owing to fluctuations in the labor force participation, the unemployment rate was declining steadily: from 4.6 per cent in Q1 to 4.4 per cent and 3.9 per cent respectively in Q2 and Q3.

The growth of social transfers accelerated

Against the background of the existing margin of fiscal strength, the economic authorities again resorted to increases in social transfers. For example, in nominal terms, the average pension was raised steadily by 6.2 per cent in Q2 and then by 6.7 per cent in Q3. This led to significant real growth (17.1 per cent and 14.1 per cent, annualized, respectively) and to smoothing the accumulated imbalances in the income distribution. Against this background, the poverty reduction trend strengthened: the poverty rate fell to 3.5 per cent in Q3 (from 3.6 per cent and 3.7 per cent in Q2 and Q1 respectively).

Employment and new jobs, 2015=100



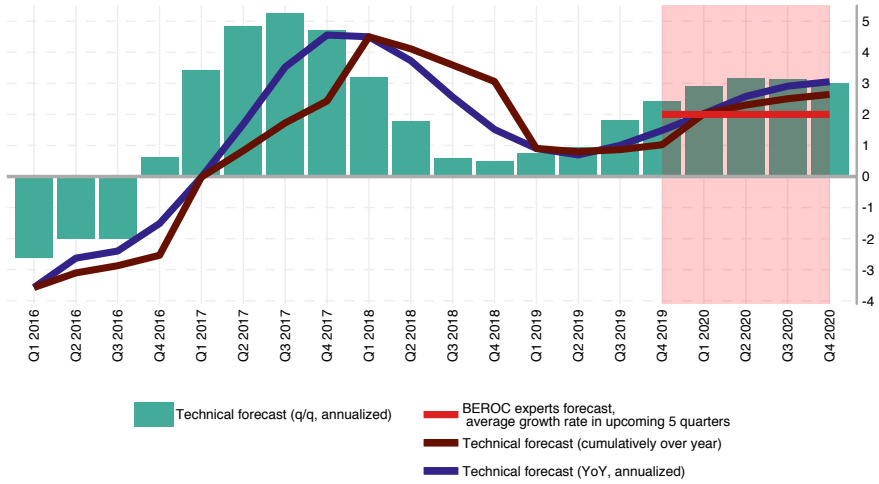
Note: The indices are seasonally adjusted.

First category tariff rate and household income

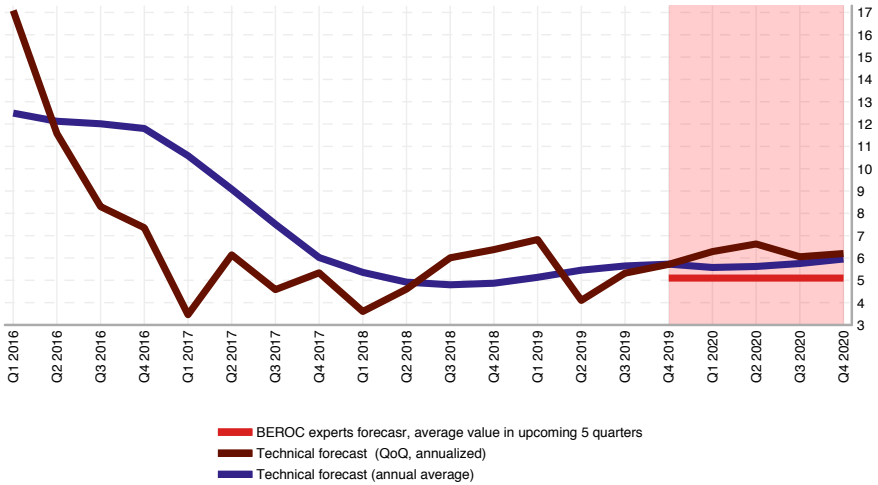
Note: The indices are seasonally adjusted.

Technical forecast

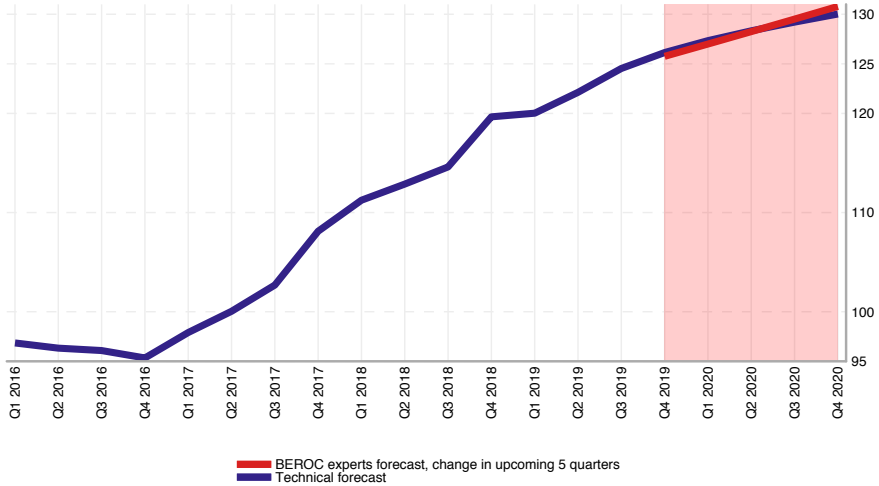
Output growth, quarter on quarter, % (annualized)



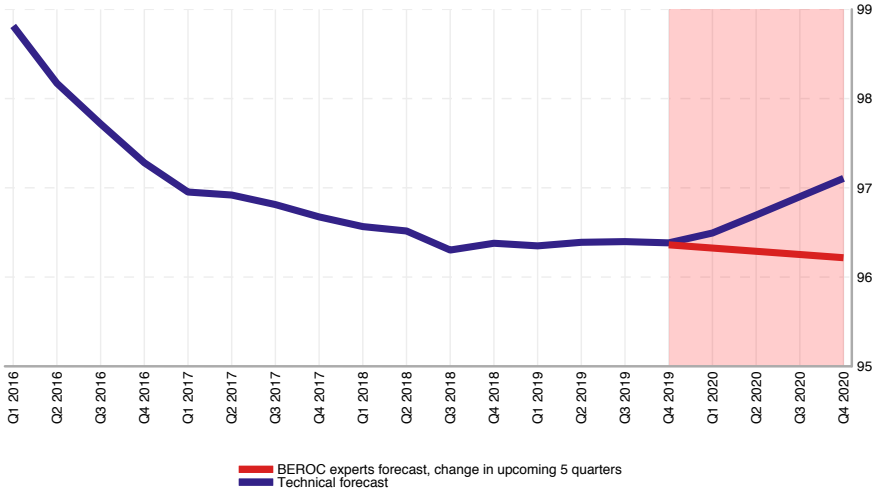
Inflation rate, annual average, %



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.

This publication is published under the editorial responsibility of **Dzmitry Kruk** and **Dzmitry Kolkin**.

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The publication draws upon information and data of the following:

National Statistical Committee of the Republic of Belarus (www.belstat.gov.by)

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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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