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Economic Outlook

Second Quarter 2021

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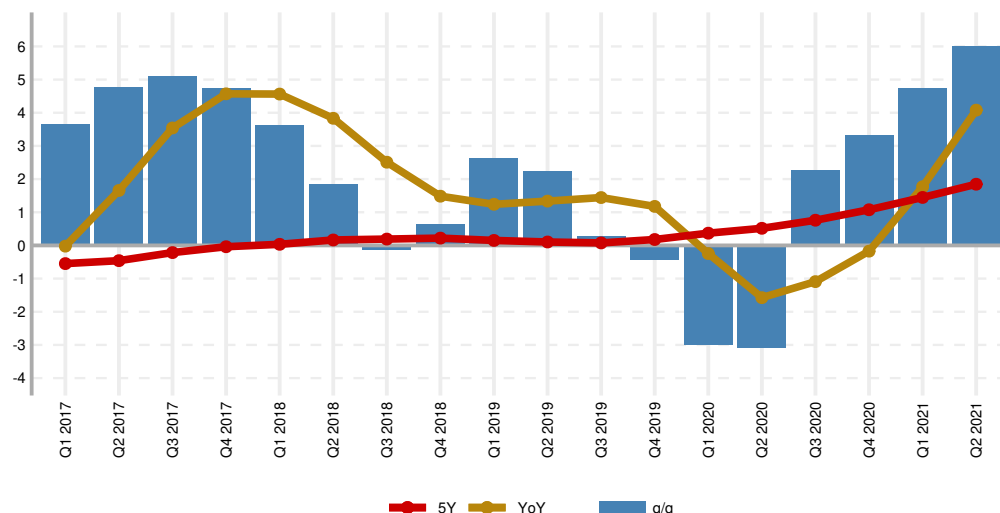
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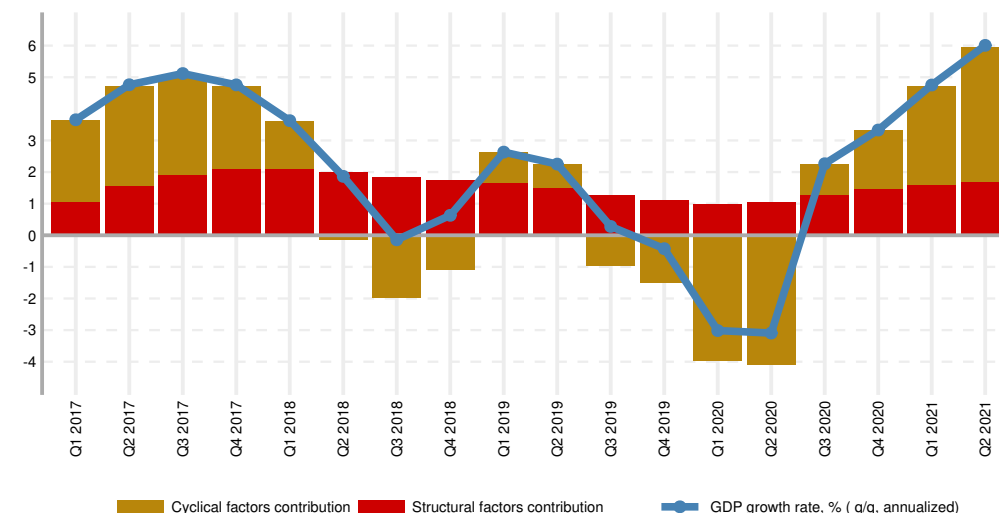
A jump in output growth on a backdrop of oppressive news and prospects

- The foreign trade miracle persisted
- Improved quality and balance of growth
- A belated increase in interest rates
- Inflation continued to gain momentum
- Discord in financial stability trends
- A new jump in wages as employment declines

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. **The data for the past quarter are estimate.**

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

Macroeconomic triumph... in the moment and out of context

In Q2, there was a significant jump in growth. Relative to “COVID” Q2 2020, the acceleration in growth was expected and predictable due to the low base effect. But beyond that, growth also accelerated significantly relative to Q1 2021, reaching an annual equivalent of 6%. Within a particular quarter, it was the highest since the Q4 2010. Moreover, the corresponding jump has only happened after the economy had reached its pre-COVID level (in Q1). That is, it cannot be identified with the recovery growth mechanics.

Growth acceleration had an impact on many macroeconomic indicators. For example, corporate and government debt burden indicators improved, as did the fiscal stance. Real wage growth accelerated again, with a decline in real unit labor costs and lower unemployment. There was also tangible progress in indicators of the quality of growth. Labor productivity reached a new historical peak, and the return on capital indicator reached a local four-year peak.

All of these trends, considered “in the moment,” give reason to state that Q2 was very successful. At the same time, for more meaningful judgments and assessments, from which we can judge the quality of growth and its prospects, it is important to consider the context. First and foremost, the reasons for the growth episode that occurred and their sustainability are important.

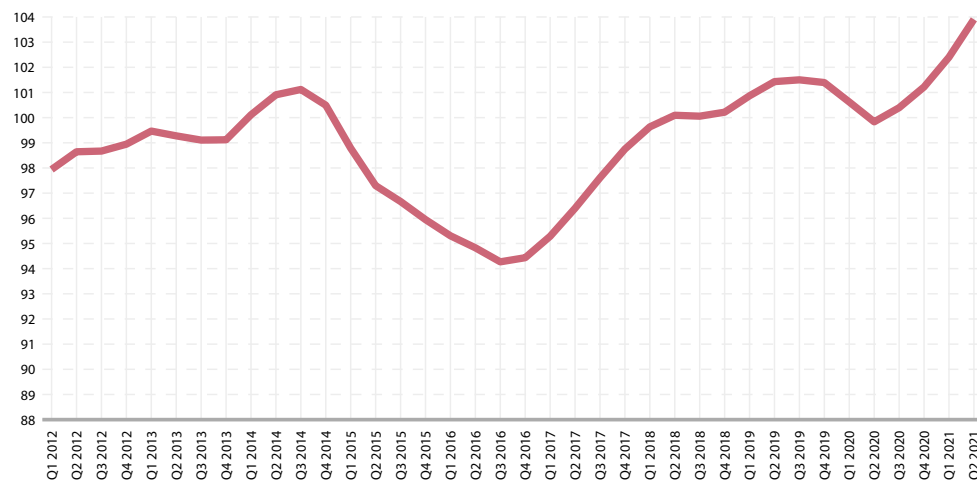
The key reason for the rapid growth was the reincarnation of the foreign trade miracle. In Q2, export growth continued, and its physical volume hit a new historical peak (exceeding the previously record high of Q2 2012). The export boom was due to a number of factors related to the peculiarities of the post-COVID macro-dynamics in the world. Imports in Q2 also showed steady growth, but so far it has only compensated for the slump during the pandemic.

If the foreign trade miracle could claim to be a new normal, the output growth it caused and the accompanying trends could be considered natural processes. However, so far there are more reasons to consider the foreign trade miracle as a transitory shock. It is unlikely that exports will be able to continue growing when the post-COVID dynamics in the world cools down. It is likely to be difficult even to hold the existing positions. And imports are likely to catch up with exports.

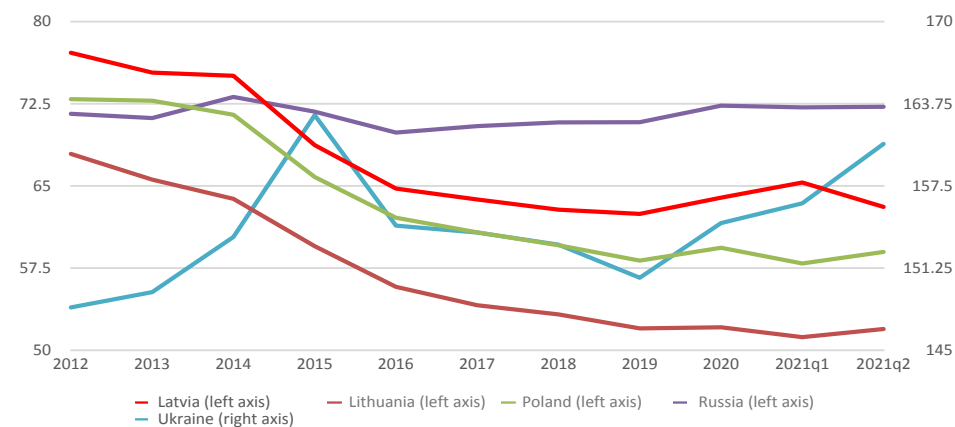
Therefore, the most likely scenario is that the foreign trade miracle will be exhausted in the second half of the year. In this scenario, the GDP growth will slow down and will be about 2.4% by the end of the year. Depending on the intensity of their impact already this year, the most probable range of the GDP growth rate for the year is 1.7-2.4%. By 2022, their impact threatens to become the main factor of macro dynamics, which will cause the country to enter recession on the cusp of 2021-2022.

Development trends

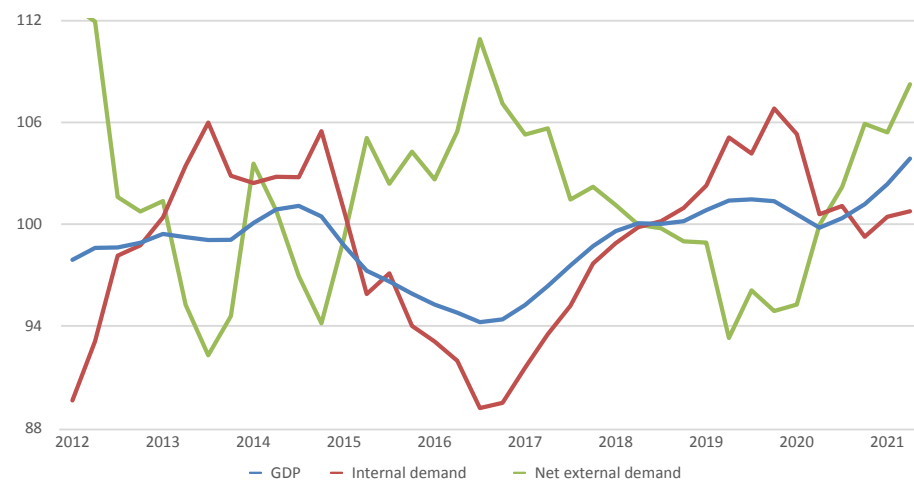
Level of output, 2018=100



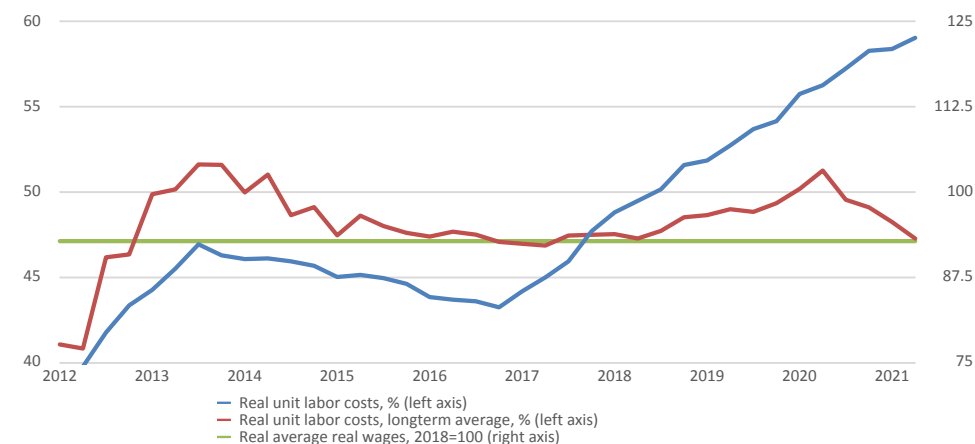
Relative well-being* in Belarus vs. neighbours, %



GDP, internal and net external demand**, 2018=100



Real wages and real unit labor costs.



* - Well-being here refers to GDP per capita at PPP in international dollars of 2017. Data from 2020 are estimates based on real GDP per capita growth rates in these. The indicator presented in the chart is the ratio of well-being in Belarus compared to one in the relevant neighboring countries, in percentages.

** - The indicator of net external demand is calculated as the difference between the export and import indices according to the SNA, in which 2018 is the base, that is, 2018 = 100. 100 is added to the resulting value for comparability with other indices in which 2018 is the base.

Institutional environment

A Sanctions loop for development prospects

Several new sanctions packages were adopted against Belarus in summer, some of which were formed based on the sectoral principle. The greatest macro effect can be expected from the UK and EU sanctions packages, which imply bans or restrictions on the export of Belarusian oil products, potash fertilizers, etc. Based on various interpretations of the original provisions, these sanctions affect from 10 to 13.5% of all Belarusian exports. According to the output scale, potential losses from them amount to about 6% of the GDP within 2-3 quarters after their activation. Subsequently, due to sectoral interrelations and restrictions in the use of exchange rate to smooth their effect, the losses will increase up to 10% of the GDP.

The EU, British, Swiss, and Canadian packages also include financial sanctions against state borrowers, including the three largest state banks – Belarusbank, Belagroprombank and Belinvestbank. These sanctions are not that critical in terms of rapid and tangible manifestation on a macro scale. But they will generate a number of permanent effects that undermine the already fragile financial stability in Belarus.

New USA sanctions have also been imposed on Belarus. Due to the special mechanism of their implementation and the provisions to be detailed, the potential macro effect from them is not yet directly obvious. But they certainly create large-scale barriers to the activities of individ-

uals and companies, including large state-owned enterprises. Moreover, because of their special mechanics, USA sanctions close many potential ways for circumventing UK and EU sanctions.

The potential losses described above could hypothetically be prevented or reduced by the authorities. The most effective way to do that seems to be redirecting “released” exports to other directions. In addition, it is possible to use instruments for localization of negative effects within the sanctioned industries. This may allow to even out the inter-branch and secondary effects of the shock spreading (a similar logic in the actions of the authorities took place during the pandemic). But the problem for the authorities is that the field for the appropriate actions is often beyond their control at all, or they are extremely limited in the tools and possibilities to influence it.

Hence, it seems realistic that the potential losses described above at the juncture of 2021-2022 (when the main sanctions provisions come into force) will gradually be transformed into actual losses. In this case, it is also important to take into account the inevitable interaction between the individual effects. A significant decline in GDP will also lead to financial stress, which, given the financial sanctions, is very likely to be transformed into a full-scale financial crisis. Such a development threatens to turn into a deep and prolonged economic depression.

Background information

Crackdown on civil society

On the eve of the announcement of sanctions, representatives of the current Belarusian authorities stated that it would result in “civil society ceasing to exist”. After the sanctions were adopted, the authorities decided to liquidate several dozens of NGOs, and their representatives were subjected to criminal cases, searches and arrests. In the comments of the authorities after the fact it was described as a crackdown. Probably, in the logic of the authorities, such a crackdown should contribute to the economic and political strengthening of the current regime.

Growing migration crisis

Soon after the adoption of sanctions, the EU neighboring countries of Belarus faced a rapid increase in the flow of illegal migration. This provoked a significant migration crisis for them, which they were nevertheless able to manage. The authorities of these countries and the general public directly link this crisis to the actions of the current Belarusian authorities. This creates preconditions for further escalation of the authorities’ relations with Western countries.

Belarus received SDRs as part of the general allocation

Within the framework of the general SDR allocation (the IMF mechanism to enhance global financial stability), Belarus received the equivalent of about USD 0.9 billion. These funds will replenish the country’s foreign exchange reserves and, at least temporarily, strengthen its fragile financial stability.

However, in the long run, it can result in big problems for the authorities. On the international agenda, the question of how logical it is to provide Belarus with aid assistance through international financial mechanisms has become topical. The collision is that the efficiency of such mechanisms is mainly ensured by the Western countries, which imposed sanctions on Belarus. Politically, this brings the issue of the legitimacy of the Belarusian authorities to the forefront. And this time in a broad sense, i.e. including the legitimacy of the representation of Belarus in international organizations by governmental actors.

New rating actions against Belarus

The sanctions against Belarusian state-owned banks were echoed by the withdrawal of their ratings by Fitch agency. This can be seen as a signal that the unpredictability of the future dynamics of the financial position of these banks is increasing.

The rate ceiling on foreign currency deposits is abolished

In view of the large-scale outflow of foreign currency deposits, the National Bank began to abandon the long-standing practice of artificial restrictions on interest rates on them. This will “free” these rates, cause their growth and eliminate some disproportions in the deposit market. But it is unlikely to at least partially mitigate the main problem – The growth of the rates that the banks can afford will not compensate for the large-scale risks, with which many depositors have started to associate deposits in Belarusian banks.

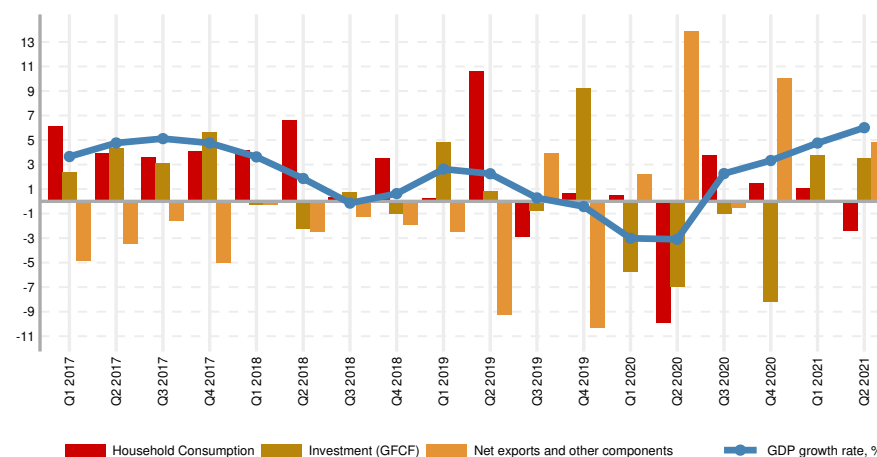
Output and demand

Metamorphosis of growth based on external demand

The key growth driver in Q2 on the demand side was net external demand. Its condition, after improving throughout the year, is close to its local 5-year peak (the level of mid-2016). In contrast to that period (in 2015-2016, the external position improved due to a contraction in domestic demand and increased price competitiveness based on lower wages and ruble depreciation), the improvement in the external position today is due to an autonomous (external favorable) shock. This, all other things being equal, should have caused internal adaptation. For example, strengthening of the exchange rate and intensification of domestic demand growth. However, accumulated risks and negative trends in the financial sector limit possibilities for strengthening the ruble and, along with negative expectations, repress domestic demand.

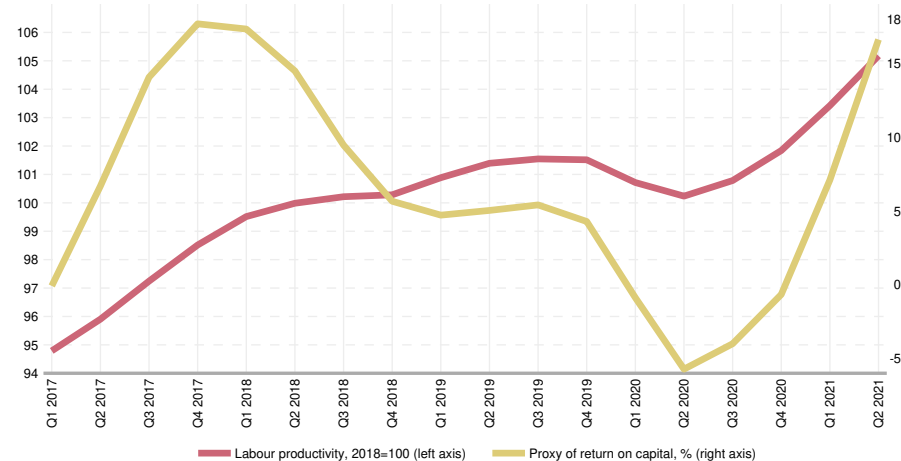
Blocking such adaptations leads to an accelerated growth of output, but macroeconomic disproportions arise and accumulate, and the structure of aggregate demand changes perceptibly. This distorts the cause-and-effect relationships between economic processes and the meaning of a number of economic indicators. If the initial shock and the accelerated growth based on it soon fade, all this is not a big problem. The accumulated disproportions in this case will turn into a margin of strength for the external position for the future. But if the external shock proves to be prolonged, it is fraught with non-standard internal adaptations.

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

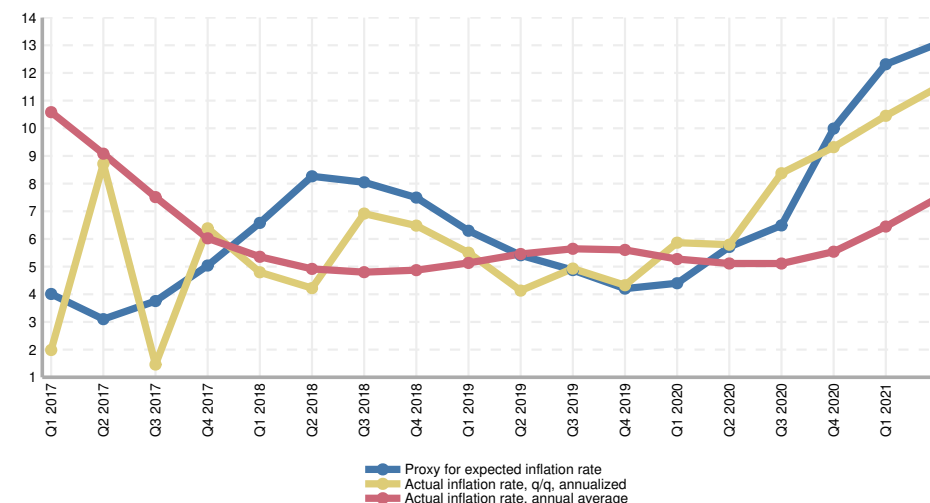
Inflation continued to gain momentum

The acceleration of inflation has become a steady trend. On the one hand, this can be taken rather calmly, with reference to the fact that such a trend has a regional and even global character. At the global level, it is caused by a combination of adaptations to post-COVID conditions on both the offer side (disruption of logistics and production chains) and the demand side (reaction to large-scale monetary and fiscal incentives). On the other hand, unlike countries with stable and predictable monetary environment, the ability of the National Bank of Belarus to bring inflation under control in the medium term is much more questionable.

A belated increase in interest rates

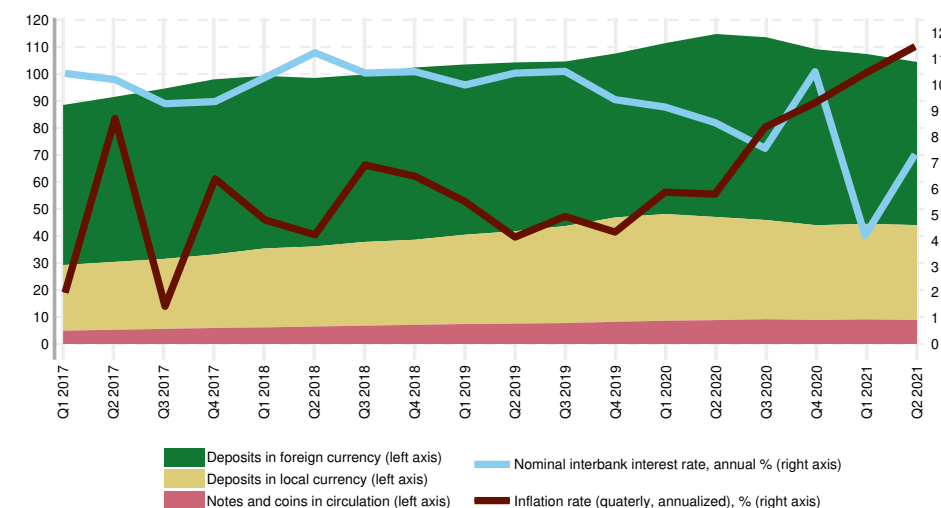
The accelerating inflation forced the National Bank to use additional instruments, as it became increasingly obvious that only money supply control measures were insufficient for this purpose. The refinancing rate was raised in two stages (by 1.5 percentage points up to 9.25% per year), and the rates on foreign currency deposits were “released”. However, such an increase in rates seems belated and probably already insufficient to curb inflation. The current inflationary surge has unwound inflation expectations, which leads to the entrenchment of “bad” behavior patterns of economic agents. This, especially given the current information background, strengthens the internal prerequisites for an inflationary spiral.

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

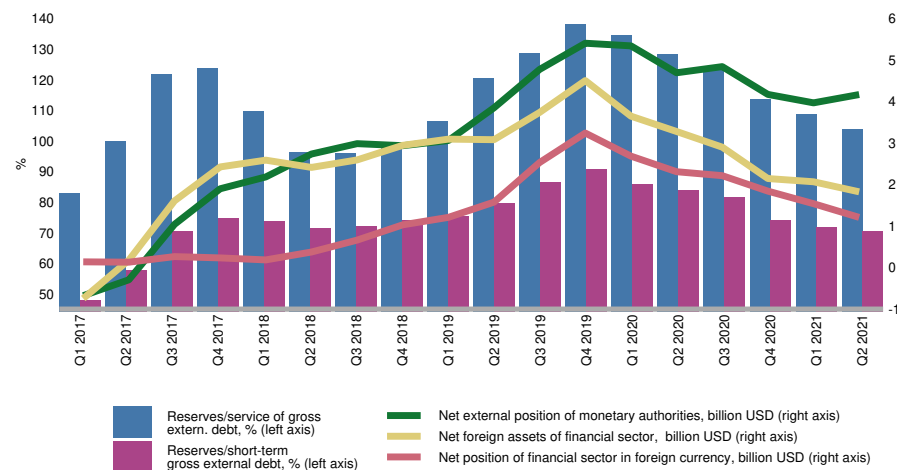
Liquidity in foreign currency remains the most vulnerable element of financial stability

The state of liquidity in foreign currency continues to weaken. This happens despite the ongoing export boom and strengthening of the foreign trade position. The main reason is an increased economic agents' distrust in the financial system. That is why foreign currency deposits continue to steadily flow out of the banks. The situation with foreign currency liquidity is expected to become even more acute in the future. It may be aggravated by the expected deterioration of the external position due to sanctions, along with limited access to external borrowing. The available foreign exchange reserves in this case are unlikely to be able to fully implement the protective function. First, their level is quite low (according to the most common criteria of their sufficiency). Second, the readiness of the authorities to use them in this capacity is not evident.

Private debt encumbrance is decreasing

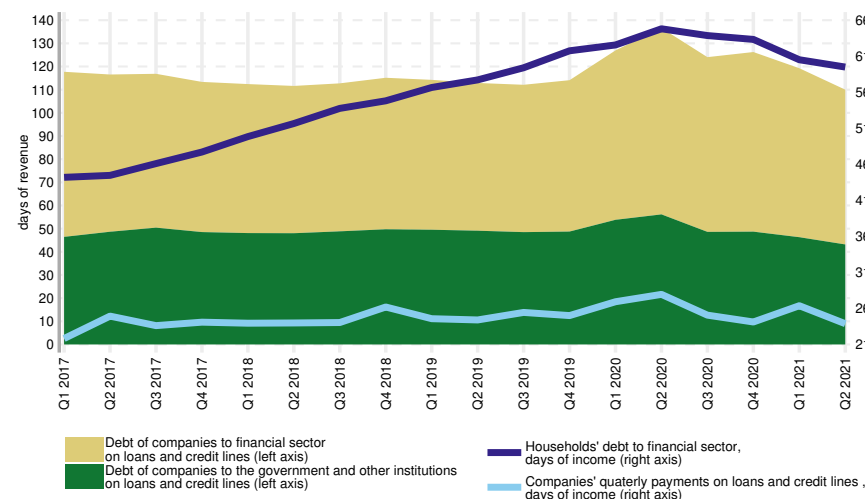
The downward trend in the private debt encumbrance has acquired the features of sustainability. Firstly, this is due to banks' forced compression of credit supply and growth of interest rates. Second, it is facilitated by the current surge in the indicators against which debt is weighed (output, revenues, income, etc.). However, if the credit compression lasts long, this in itself threatens the prospects for future growth. Therefore, in the future dynamics of the debt encumbrance, spikes are likely.

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

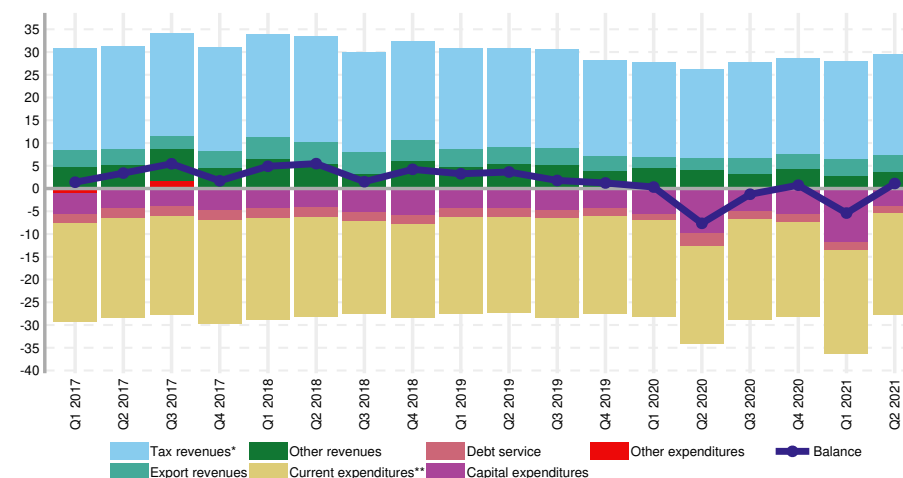
Improving the fiscal stance

In Q2, the consolidated budget was in surplus again (about 1.1% of GDP). The revenues part showed slight growth (by 1.2 percentage points up to 29.3% of GDP as compared to Q1 2021). The biggest contribution was made by VAT and income tax revenues. However, the growth of revenues should rather be regarded as a local surge. Their level remains significantly lower than, for example, on average for 2018-2020 (by 2.7 percentage points of GDP). Accordingly, spending cuts played a more important role in balancing the budget. Compared to Q1 2021, they decreased by 5.3 percentage points up to 28.2% of GDP (as compared to the 2018-2020 average of 2.7 percentage points of GDP). Capital expenditures accounted for almost all of the decline. From a fiscal perspective, a return to balancing tactics at the expense of capital expenditures is a perfectly acceptable move. But there are great fears that this will increasingly manifest itself and be visualized in problems of both technical infrastructure (condition of roads, bridges, etc.) and social infrastructure (condition of school buildings, hospitals, etc.).

Shifting trend in government debt encumbrance?

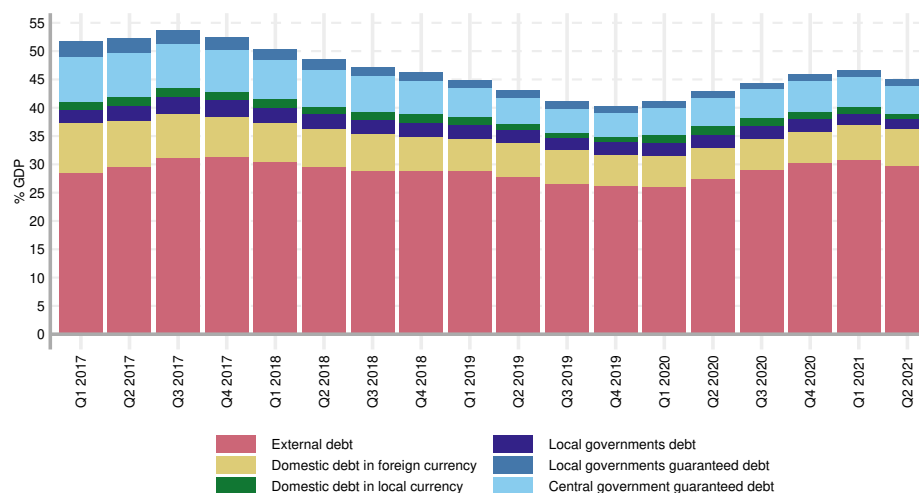
For the first time in 6 quarters, the government debt encumbrance decreased. This was a consequence of the jump in GDP, which counterbalanced the increase in government debt in nominal terms. Taking into account the limited opportunities for new borrowings, it may cause a change in the trend in the debt encumbrance dynamics for a certain period.

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

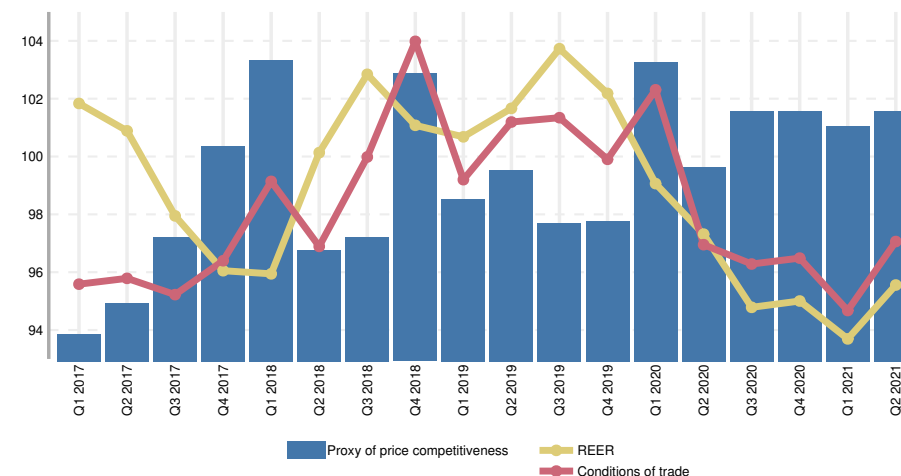
Stability in price competitiveness

Price competitiveness of Belarusian producers increased insignificantly in Q2. On the whole, it has been excessively stable over the last four quarters. This is largely seen as a consequence of the foreign trade miracle. The strengthened foreign trade position forms quite a comfortable situation in the foreign exchange market. Even taking into account the increased demand for foreign currency, caused by negative patterns of saving behavior, it allows providing its balance without significant fluctuations of the real exchange rate. Such fluctuations arise only with shifts in the terms of trade, levelling them out, which leads to the situation of a frozen price competitiveness index.

Shifting focus in the world: from growth to inflation

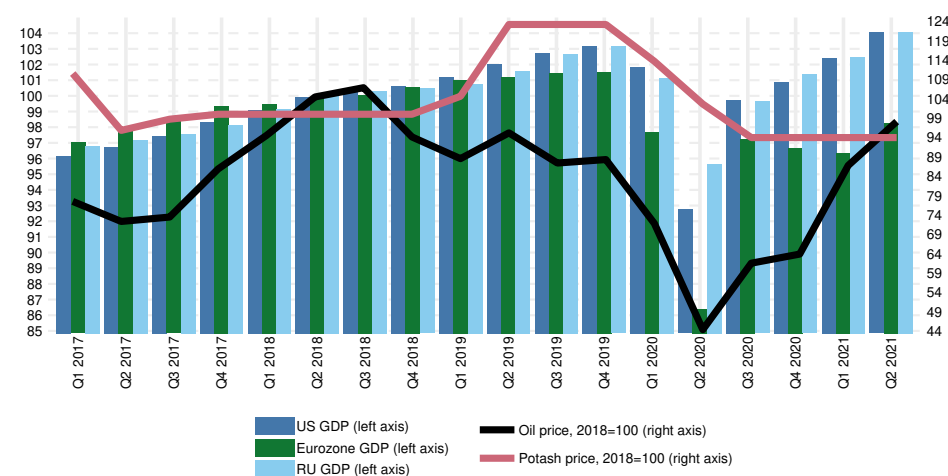
Most of the world's economies continued their rapid recovery growth in Q2. For many major economies, it marked a return to pre-COVID levels of output, while others approached or even exceeded it. Against this background, inflation, which accelerated in most developed countries, began to attract more and more attention. Perceptions of it began to change from “a desirable companion of recovery growth” to “a lesser evil” and, in some cases, “a key medium-term threat”. This has brought to the forefront a discussion of the timing of “normalization” (completion of rounds of quantitative easing and, possibly, rate raising) of monetary policy by the central banks of developed countries.

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

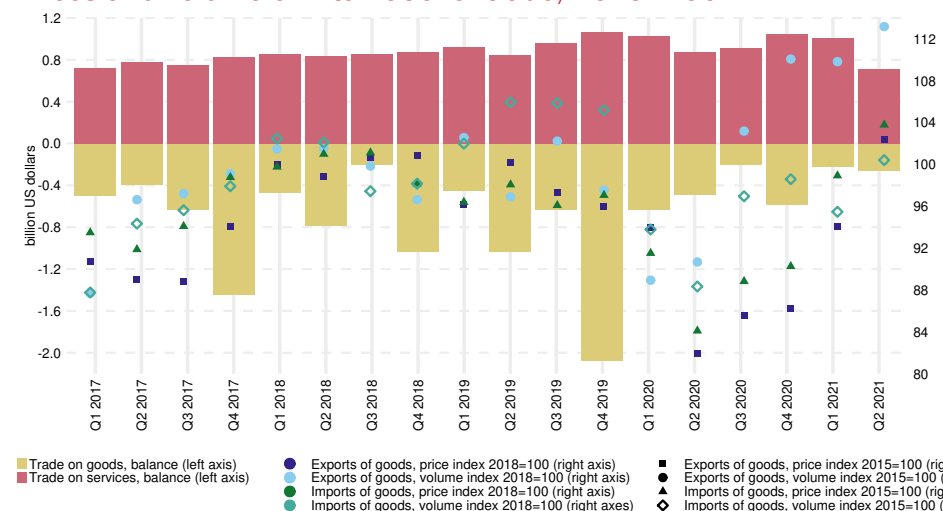
The foreign trade miracle still persists

The foreign trade miracle, which became the main driver of macrodynamics, consists of an export boom and lagging growth of imports. In Q2, the physical volume of exports hit a new historic maximum, and compared to the plateau it had been at in the pre-COVID period, its value increased by 14%. The physical volume of imports also grew considerably (by 5% compared to Q1), but its level was only close to the pre-COVID value.

There are several reasons for the export boom. First, against the background of worldwide price increases, Belarusian producers restrain them for their products, gaining a price advantage. This is relevant, for example, for woodworking products, ferrous metals, textiles, footwear, and tires. Second, the global food price shock has also created an increase in demand for the products of related industries. This effect affects Belarusian producers of, for example, mineral fertilizers, agricultural engineering, and others. Third, the most competitive producers were able to close the niches that emerged against the background of all sorts of offer failures due to COVID. This is relevant, for instance, in instrument making and furniture production. Fourth, the physical volumes of exports of oil products and potassium fertilizers have recovered to their normal level.

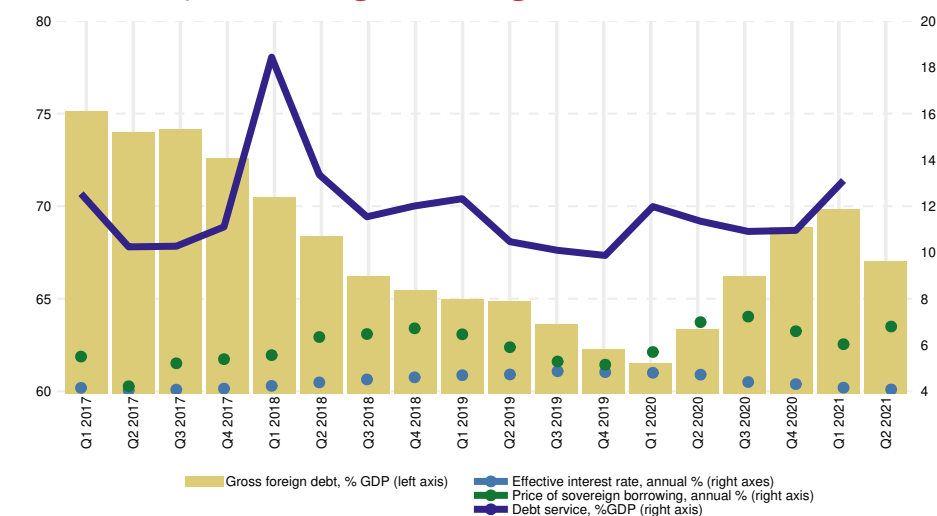
It is still not clear how sustainable these factors are and whether Belarusian exporters will be able to at least hold on to the gained positions later. And, in turn, the future macrodynamics largely depends on this.

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

A new jump in wages as employment declines

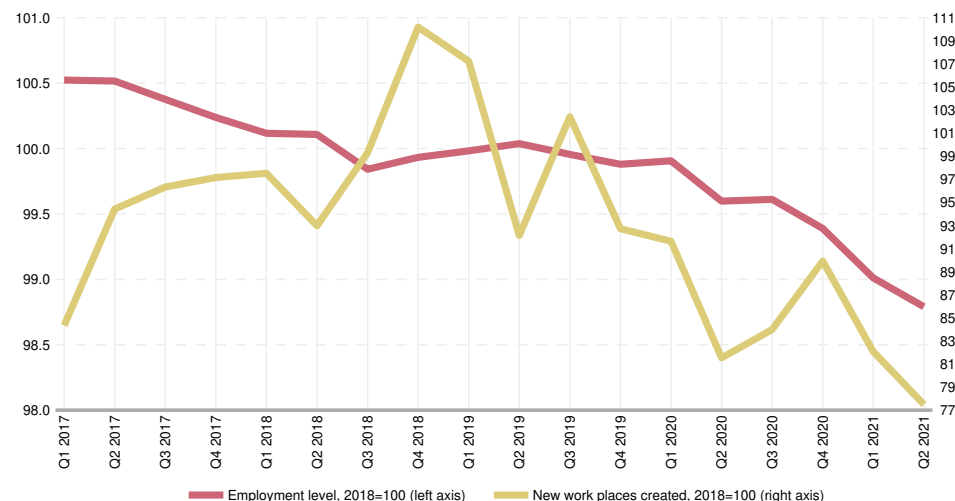
In Q2, the growth of average real wages accelerated again: up to 5.5% in annual equivalent (from 0.9% in Q1). This growth is associated with three circumstances. First, a jump in GDP and labor productivity contributed to this growth. Second, average wages are fueled by the growth in the public sector. Third, the falling employment background is also a contributing factor, both through market mechanisms (e.g., competition for workers) and through directive mechanisms (when employment is lower, directive wage targets are easier to achieve).

The jump in GDP growth with falling employment also eliminated the disparity between the current and equilibrium level of real unit labor costs. All else being equal, this points to opportunities for future organic wage growth alongside productivity growth. This again leads to the central question of today's agenda: how natural and organic is today's growth in GDP and labor productivity, and what are their prospects for the future?

Inflation leads to growing income disparities

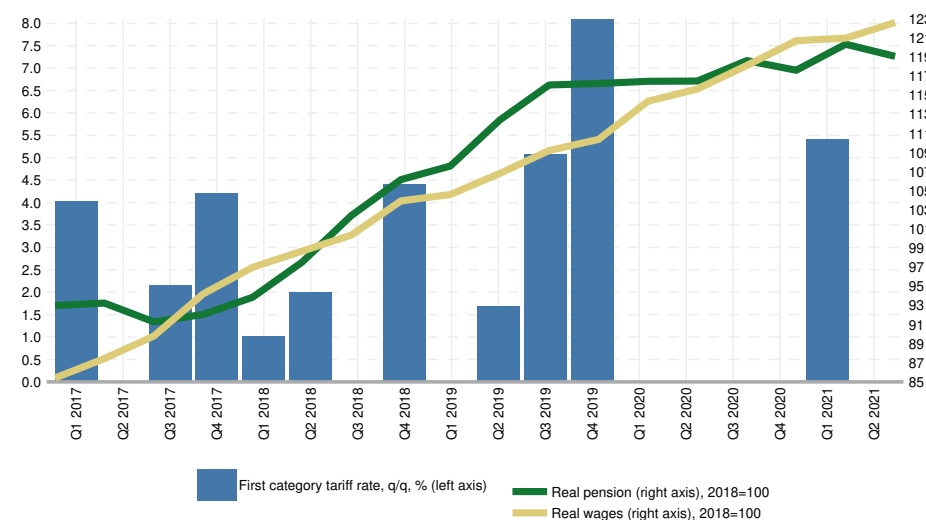
Real pensions (and other social transfers) shrank in Q2. In the context of high inflation, it is inflation that dominates their dynamics, as the nominal rates of social transfers are revised irregularly. Against the background of the limited room for maneuver in the Social Security Fund, this raises fears that the growth of disparities in income may again become a steady trend.

Employment and new jobs, 2015=100



Note: The indices are seasonally adjusted.

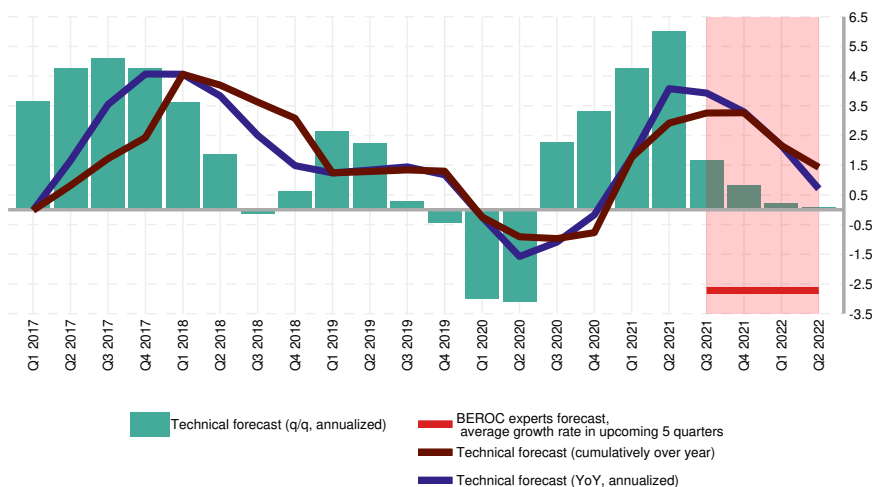
First category tariff rate and household income



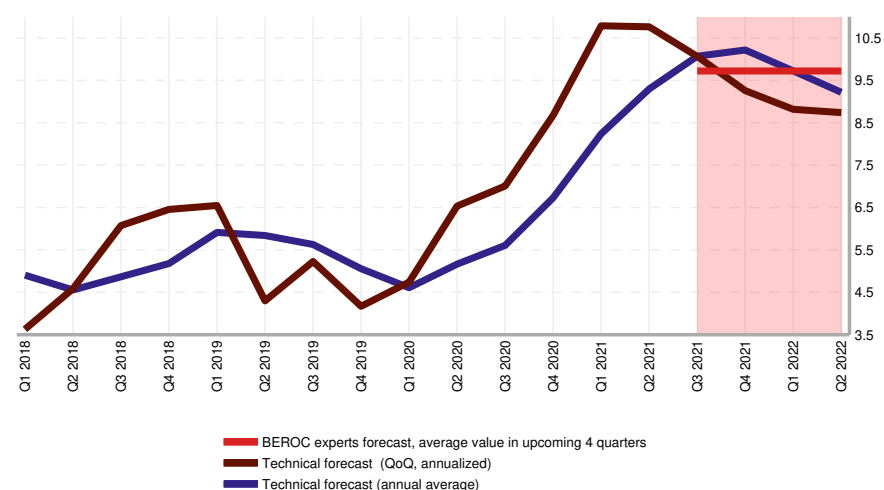
Note: The indices are seasonally adjusted.

Technical forecast

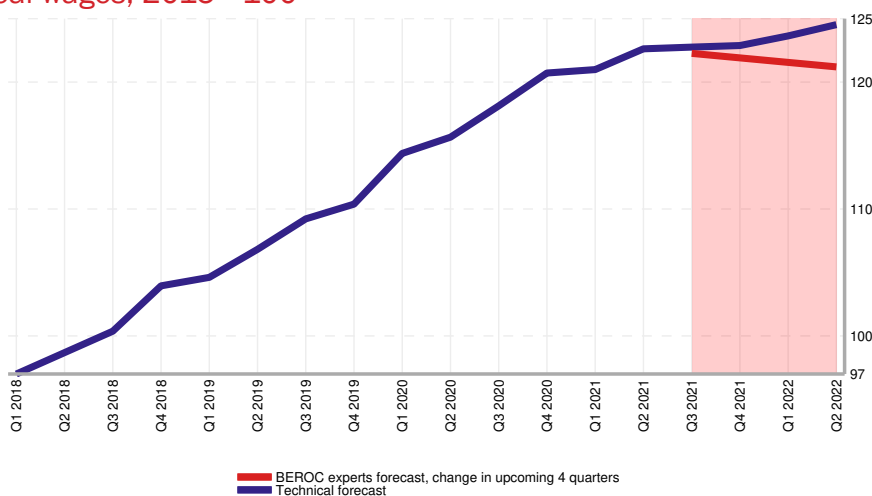
Output growth, quarter on quarter, % (annualized)



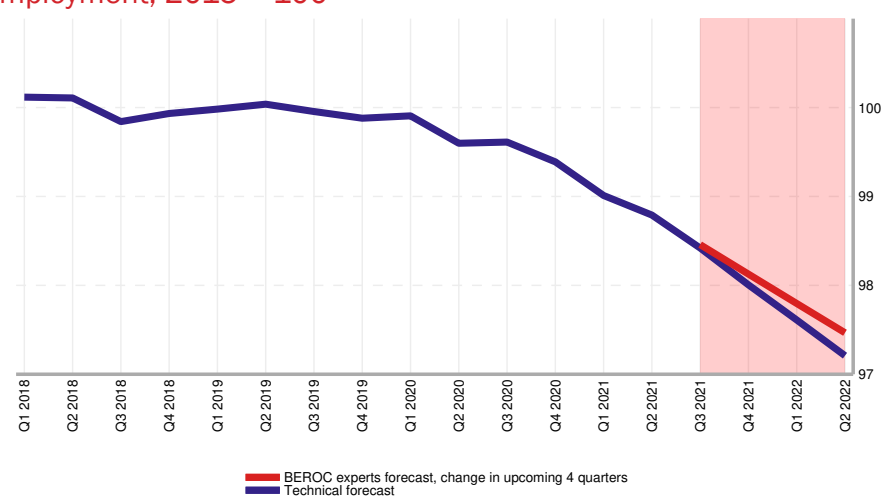
Inflation rate, annual average, %



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?" BERO'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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