THE WORLD BANK

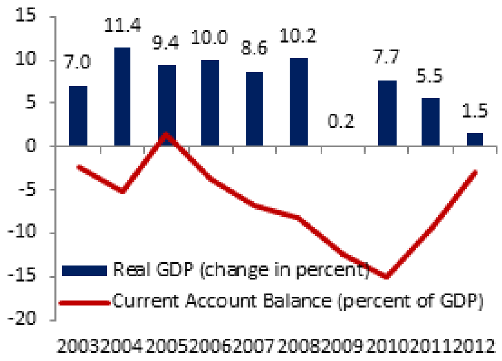
BELARUS Economic Update

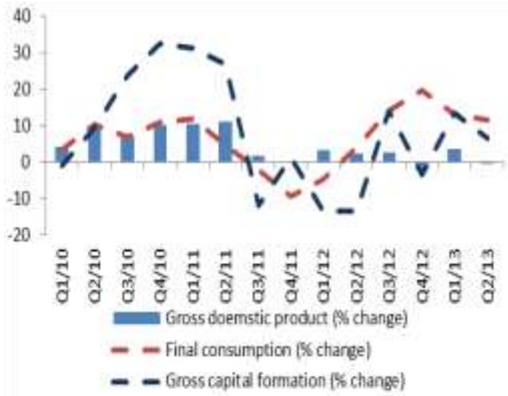
October 2013

- ***Real GDP growth is projected to decelerate in 2013 because of a weak external environment and slowing domestic demand.***
- ***External imbalances have reemerged and foreign exchange reserves are coming under pressure.***
- ***Consistent macroeconomic policies and structural reforms are needed to overcome external imbalances and achieve sustainable growth.***

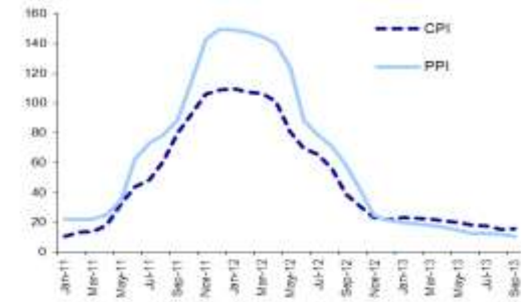
Recent Economic Developments

Over Jan-Sept 2013, real GDP grew by 1.1 percent, down from 3.2 percent during the same period of 2012. Many sectors saw declines in output, including industry (-4.6 percent) and agriculture (-2.2 percent). This was partially offset by growth in retail trade (18.6 percent), which was boosted by real wage increases and construction (5.9 percent), which was fuelled by credit growth, including under government programs. The decline in net exports – already rapid during the first quarter – accelerated in the second quarter because of a slowdown in Russia and falling prices for potash exports after the cartel between Belaruskali and Uralkali was dissolved. Domestic demand continued to expand, driven by wage and credit growth, but the pace of investment and consumption growth has been slowing and the economy contracted during the second quarter of 2013.

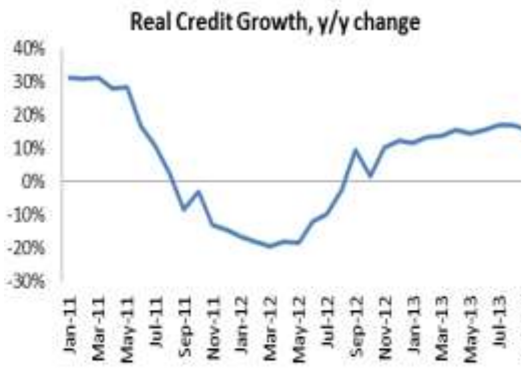




Inflationary pressures persist, exacerbated by a stop and go monetary policy. Reacting to slower than expected economic performance in early 2013 the NBRB cut the refinancing rate from 30 percent at the beginning of 2013 to 23.5 percent in June. Inflationary pressures, while continuing to subside, remained in double digits at 15.4 percent (Sept'13, y/y) and above the inflation in main trading partners. As a result, the real exchange rate continues to appreciate (by 4.6 percent since Dec'12), despite nominal currency depreciation. Meanwhile, devaluation expectations remain high, as evidenced by growing demand for foreign cash (net purchases of foreign currency were close to 1 billion USD over July-Sept) and a high share of foreign currency deposits (about 60 percent).



Current account pressures have re-emerged as a result of a sharp contraction of net exports. In Jan-Aug 2013, a rapid decline in exports (-22.7 percent, in fob prices) outpaced the decline in imports (-10.4 percent), resulting in a merchandize trade deficit of almost US$ 2 billion (down from a US$ 2.3 billion surplus a year ago), equal to 2.8 percent of annualized GDP. The widening trade deficit together with negative net transfers of custom duties on oil exports remained the major drag on the current account deficit, which exceeded US$ 3 billion (or 4.6 percent of annualized GDP) during the first half of 2013. Foreign reserves (excl. Monetary Gold) have been declining since the beginning of the year, dropping to US$ 5.5 billion or about 1.6 months of imports. Balance of Payment pressures are exacerbated by large external debt repayment needs, including to the IMF.



The economic slowdown dampened fiscal revenues, but expenditure cuts led to a fiscal surplus. In Jan-Aug 2013, revenues from profit taxes and taxes on international trade declined in real terms by 5.9 and 18.4 percent, y/y, respectively, being partially offset by strong growth in excise taxes (38.1 percent). On the expenditure side, measures were taken to contain growth of capital expenditures, while employment cuts in the civil service also eased the pressure. As a result, GG budget surplus was around 1.1 percent of annualized GDP.

Medium Term Outlook

Looking ahead, Belarus is facing substantial headwinds. Our forecast is based on the expectation that external pressures, including the commitments made under EURASEC Anti-Crisis Fund, would accentuate macroeconomic policies to contain domestic demand for the remainder of Q4'13 and throughout 2014. As a result, growth is expected to decelerate to around 1 percent in 2013, accelerating slightly to 1.5 percent in 2014. Despite this slowdown, we expect inflation to remain above 15 percent (eop) through the projection period, due to expected tariff increases and continued nominal rubel depreciation. The current account deficit is expected to widen to 8.9 percent of GDP in 2013 and adjust moderately to 8.1 percent of GDP as a result of domestic demand containment in 2014. Gross external financing needs are exacerbated by significant external repayment obligations on long term external debt (including IMF), which put significant pressure on the sustainability of the BOP. With lower than expected FDI inflows, meeting these financing needs will be challenging, especially in an environment of liquidity tightening at global financial markets. Shallow fiscal deficits are expected to emerge, as weak economic performance will continue to dampen fiscal revenues while higher than expected interest rate subsidies and external debt service payments (due to rubel weakening) will put upward pressure on expenditures. Over the medium term, we expect growth rates to accelerate moderately, driven by a recovery of both external demand (with strengthening growth in Russia and the EU) and domestic demand (with a return to looser macroeconomic policies especially in 2015 which is an election year).

Given Belarus' precarious external position, consistent, stabilization oriented macroeconomic policies are needed to prevent a further deterioration of its balance of payments. The key parameters of this policy framework should pertain to (i) maintaining the flexible exchange rate regime; (ii) tightening monetary policy, namely containment of credit growth, including under government directed lending programs; (iii) balancing real wage growth with labor productivity growth; and (iv) further tightening of fiscal policy through reduction of expenditures, especially of subsidies in order to maintain a balanced budget over the medium term (v) deep and comprehensive structural reforms to strengthen competitiveness and productivity led growth (more detailed structural policy options are included in the special focus note attached).

	2011	2012	2013	2014	2015
Nominal GDP, BRB billion	297158	527385	612558	715008	838704
Real GDP, % growth	5.5	1.5	1.0	1.5	2.0
Consumption, % growth	1.0	8.2	11.6	0.5	3.1
Investment, % growth	13.9	-9.8	5.8	-2.8	2.0
Export of Goods and Services, % growth	30.4	10.1	-6.5	2.5	1.6
Import of Goods and Services, % growth	18.5	11.2	1.3	-0.3	2.5
CPI, % eop growth	108.7	21.8	15.6	15.2	16.2
Current Account Balance, % GDP	-10.6	-2.9	-8.9	-8.1	-9.2
General Government Revenues, % GDP	38.7	40.7	39.6	39.3	39.0
General Government Expenditures, % GDP	35.9	40.0	40.3	40.8	41.1
General Government Balance, % GDP	2.8	0.7	-0.7	-1.5	-2.1
External debt, % GDP	57.9	53.5	56.7	63.0	62.7
PPG debt, % GDP	31.6	31.5	31.5	31.5	31.6

Source: World Bank Staff Estimates.

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BELARUS

Special Focus: An Agenda for Structural Reforms

October 2013

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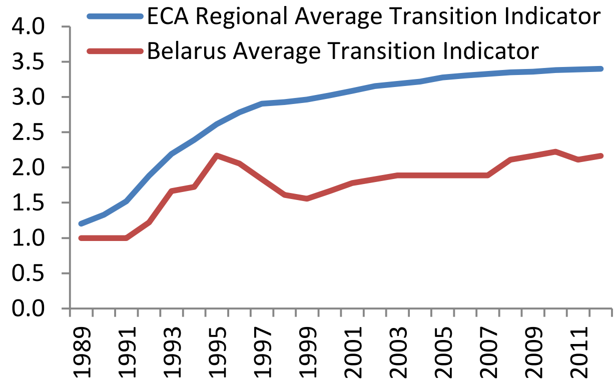
- ***Growing macroeconomic imbalances reflect deep-rooted structural problems in Belarus.***
- ***Comprehensive and sustained structural reforms are needed for enhancing productivity and competitiveness.***

Structural roots of macroeconomic imbalances

Figure 1: Lagging Structural Reforms in Belarus



Source: *EBRD Transition Indicators*
Note: *Transition Economies Average includes values of 28 transition economies, tracked in the EBRD transition indicators. Indicator reflects an average of sub-indicators on enterprise restructuring, privatization, competition policy, price liberalization and trade liberalization.*

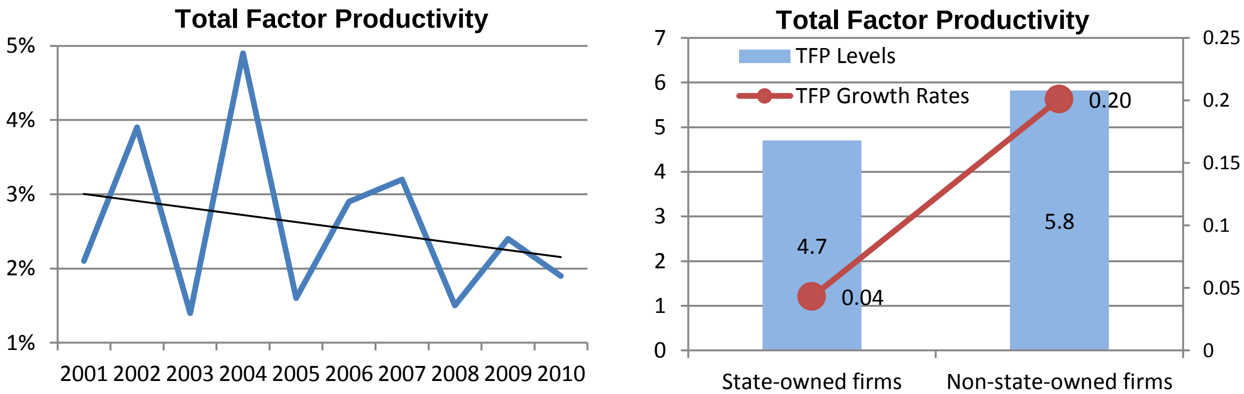
Structural reforms in Belarus have been gradual compared to other transition economies (**Figure 1**). State owned enterprises (SOEs) – accounting for over 50 percent of output and 2/3rds of employment – are governed by centralized administrative controls and enjoy an extensive system of state support. This system has softened budget constraints and delayed restructuring. The financial sector is dominated by state-owned banks (70 percent of bank assets), which channel money to less productive parts of the economy, including through state-directed lending programs. The government also continues to regulate prices for socially important goods and services (including foodstuff and communication services). These policies have left a large proportion of productive resources locked in an inefficient SOEs sector, and restricted private sector development.

While macroeconomic imbalances are exacerbated by the global economic slowdown, they have deep structural roots in a state-driven economic model.

(i) *Energy dependence:* Mineral imports (including crude oil and natural gas at below world prices from Russia) account for 38.3 percent of imports (2012). While underpriced energy imports have spurred economic growth, they expose Belarus to risks associated with the negotiation of energy trade agreements. On the export side, mineral exports – mainly refined oil products – account for around 36 percent of exports (2012) thus making Belarus vulnerable to commodity price fluctuations.

(ii) *Slowing productivity growth:* Productivity growth in non-energy sectors has been stagnating, especially in the state-owned sector. Aggregate productivity growth has been declining since 2004 (**Figure 2**). While productivity growth contributed over half of GDP growth in 2000–04, it represented only 24 percent of overall growth in 2010. Moreover, SOEs not only have lower levels of total factor productivity, their productivity also increased at a slower pace than comparable private sector enterprises, reflecting less efficient use of factors of production.

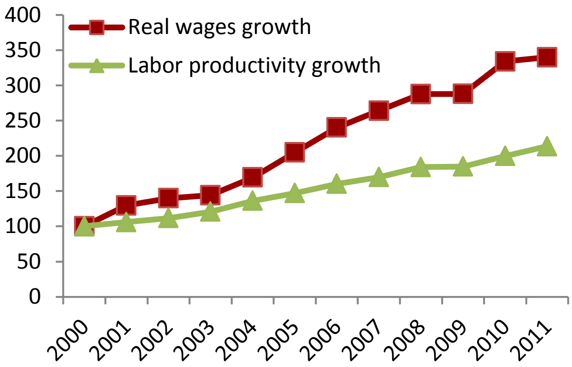
Figure 2:Slowing Productivity Growth, Especially in State-Owned Enterprises



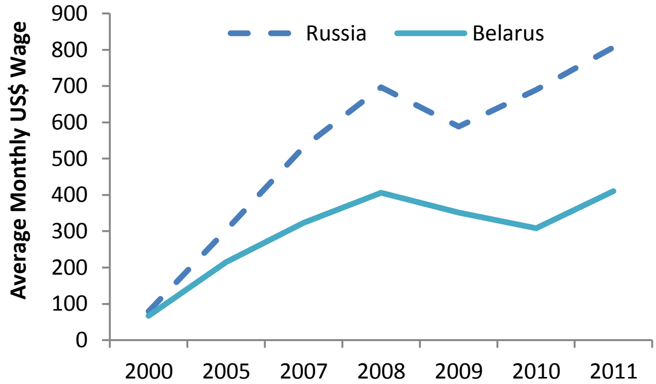
Source: World Bank Staff based on Belstat and NBRB data.

(iii) *Loss in competitiveness*: Rapid growth in real wages (more than tripling during 2000-11) outpaced growth in labor productivity, creating cost pressures and undermining competitiveness. These internal cost pressures were compounded by the fixed exchange rate regime which prevailed until 2011 and which was associated with a steady real exchange rate appreciation. At the same time, the wage gap between Belarus and Russia is widening (**Figure 3**). With the free movement of labor within the single economic space, persistent wage differentials will likely induce migration, especially of skilled workers.

Figure 3: Real Wages Outpaced Labor Productivity Growth…



…but the Wage Gap with Russia is Expanding



Source: *World Bank Staff, based on Belstat and Rosstat data.*

Correcting economic imbalances and lifting growth potential through structural reforms

Overcoming balance of payment problems in Belarus require a structural transformation of the economy to strengthen competitiveness, in particular of the tradable sector. Increasing competitiveness requires productivity-led growth, which implies reallocating of labor and capital to high productivity segments, restructuring of the SOEs sector, and implementing reforms to support the private sector. The main elements of such a structural modernization program would comprise:

(i) *Further liberalization of product and factor markets*: Remaining price regulations in both factor and product markets should be removed.

(ii) *Transformation and modernization of SOEs sector*: Budget constraints for SOEs should be hardened to expose them to market discipline. They should face the same credit, tax, energy, raw material, labor pricing, and procurement norms faced by private corporations. At the same time, corporate governance arrangements for SOEs should be strengthened. Managers of SOEs should be empowered to make decisions regarding the appropriate mix of inputs (labor, capital, materials) in production, as well as the level of prices of all outputs. This will require the elimination of the system of quantitative targets in the economy.

(iii) *Competitive and transparent privatization*: Privatization should be transparent (through the National Agency for Investment and Privatization) and used strategically to attract quality FDI. Agriculture, food processing, pharmaceuticals, and light manufacturing are suitable sectors for competitive and transparent privatization. New private investors should not be required to maintain recommended levels of employment or carry on social responsibilities.

(iv) Business environment: Streamlining of the licensing regime will help business entry and operation. An exit mechanism is needed to preserve the value of distressed but viable businesses. Reducing the burden of taxation, controls and inspections on businesses, strengthening the framework for competition; strengthening property and investor rights; legal frameworks (land and real estate, Intellectual Property Rights); and court enforcement will lower the costs of operations.

(v) *Integration in the global economy and competitiveness:* Lifting sector-specific constraints for products/sub-sectors with export potential, advancing WTO accession and adoption of EU harmonized standards across the board, including sanitary and phyto-sanitary standards would help Belarus increase the range of exported products and the discovery of new markets.

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