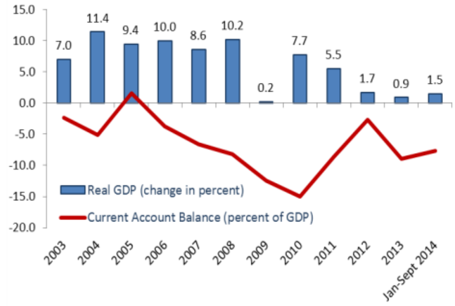
WORLD BANK GROUP

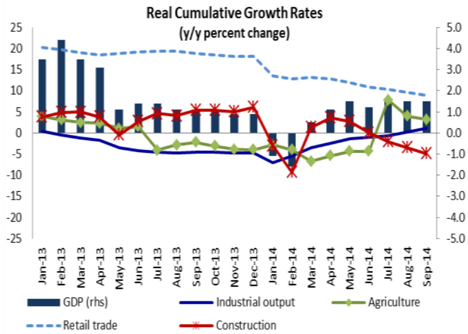
BELARUS Economic Update
November 2014

- ***Real GDP growth is expected to accelerate modestly to 1.5% in 2014 due to growth in domestic demand and improving net exports.***
- ***While external imbalances persist, financial support from Russia and a new favorable deal on oil trade have eased immediate balance of payment pressures.***
- ***The growth outlook for 2015 is clouded by weak growth in Russia and Ukraine – key export destinations.***
- ***Macroeconomic stabilization and comprehensive structural reforms are needed to reduce Belarus' dependence on external support and spark sustainable, productivity led growth.***

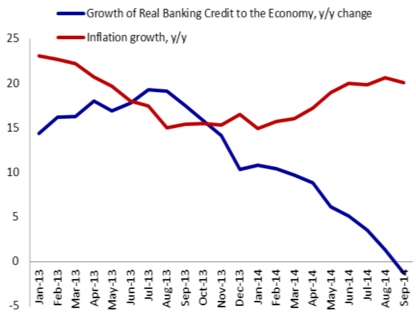


Recent Economic Developments

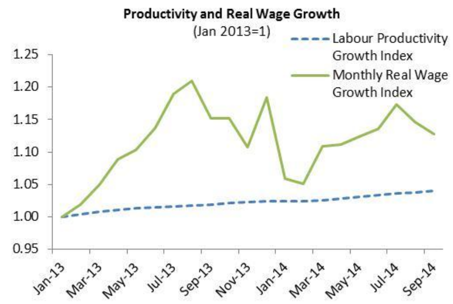
Real GDP growth accelerated to 1.5% in Jan-Sept. 2014, slightly up from 1.1% growth during the same period a year ago. Expansion of domestic demand remains the main source of growth, which is still increasing but at a reduced pace due to more moderate wage (0.8% y/y) and credit growth (-1.3% y/y). Retail (9.0%) and wholesale trade (10.2%) growth rates remain high but are decelerating consistently. Construction activities picked up in April by 3.6% (ahead of the World Hockey Championship in May 2014), but have since dropped by -4.9% y/y. The slowdown in non-tradable sectors was offset by improving performance in tradable sectors. After declining consecutively for 21 months, industrial output rose moderately by 1.2% y/y in Jan-Sept'14, driven by a revival of mining and chemical industries (including potash which is rebounding from a low base last year). However, stocks of unsold goods remain high at 77% of average monthly output, indicating sluggish demand for industrial goods. Agricultural output rebounded strongly to 3.2% y/y in Jan-Sept'14 due to favorable weather conditions.



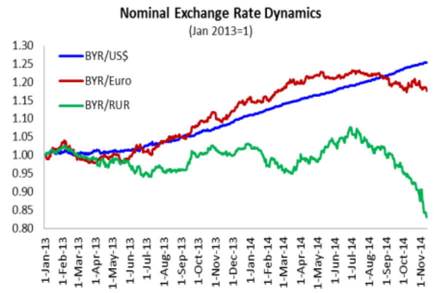
Monetary policy was eased despite accelerating inflation. CPI increased by 13.4% (eop) by September compared to 10% a year ago. Consumer inflation was fed by rises in transport and utility tariffs (19.7%, eop) and food prices (16.6% (eop). Meanwhile, real credit growth slowed down markedly since the beginning of the year from 17.5% y/y in Sept'13 to -1.3% y/y in Sept'14, thus dampening investment in the economy. This prompted the National Bank to ease credit conditions despite rising inflationary pressures. The refinancing rate was slashed by 2 pp to 20%, followed by a cut in overnight deposit and credit interest rates by 11 pp and 3 pp, to 24% and 17%.



External imbalances narrowed, but exchange rate pressures persist and reserves remain low. In the first half of 2014 merchandise imports contracted sharply by 6.7%, y/y as the BYR continued to decline steadily against the US$. A modest recovery of industrial and agricultural exports contained the fall in exports (1.6%, y/y), narrowing the merchandise trade deficit to 0.7% of GDP (compared to 3.9% a year ago). A surplus in the service trade account of 2.1% of GDP resulted in an overall trade surplus of 1.4%. In the first half of 2014, a large deficit in the income balance (9% of GDP) related to the repatriation of customs duties on oil exports remained a major drag on the current account which recorded a deficit of 7.7% of GDP (compared to 9.2% deficit in H1'2013). This and large external debt repayment obligations, including to the IMF, continue to exert downward pressure on the exchange rate which depreciated by a cumulative 9.1% to US$ since the beginning of the year. Forex reserves (excl. gold) declined by 9.3% to 1.2 months of imports of goods and services in September, despite disbursement of a US$ 2 billion concessional (intergovernmental) loan from Russia.



Fiscal discipline has been sustained, despite weak revenue performance. Weak economic activity and decline in exports resulted in contraction of profit and foreign trade tax revenues in real terms (by -47.6% and -37.5%, respectively), only partially offset by increases in revenue from excise (7.4%), property (7.6%), VAT (2.3%) and income (1.0%) taxes. Total tax revenue dropped by 9.3% y/y. At the same time, capital expenditures were cut by 15.8% y/y, helping to decrease real consolidated budget expenditures by 5% y/y resulting in a General Government budget surplus of 1.2% of GDP.



Source: World Bank Staff Estimates, based on official statistics.

Medium-term Outlook

Looking ahead, growth prospects are dampened by a weak external environment and domestic reform inertia. After slowing for three consecutive years, economic growth is expected to recover modestly to 1.5% during 2014, driven by domestic demand and some improvement in net exports (mainly due to sharply declining imports). Geopolitical tensions in Russia and Ukraine, which have resulted in slower growth and accelerated currency depreciation in both countries, are weakening external demand in key export markets. Emerging opportunities for Belarusian agricultural and food exporters on the Russian market (related to sanctions), a rebound of potash trade and prospects of larger oil exports (related to a new favorable energy agreement with Russia) only partially offset this generally negative outlook, especially since global commodity prices, including for oil and potash fertilizer, are expected to decline. Nevertheless, we expect growth to continue to accelerate slightly to 1.8% in 2015 mostly due to domestic demand growth fuelled by a return of looser wage and credit policies. Over the medium term, growth is likely to continue to fluctuate at around 2%, reliant mostly on domestic consumption and investment growth alongside a modest external pickup. Inflationary pressures are expected to remain strong, given nominal BYR depreciation and announced decisions to increase utilities tariffs by 2017 (see special focus note).

External financing constraints are eased by a new oil trade deal with Russia, but the gains will erode over time. According to the Eurasian Economic Union agreement signed in late May, Russia made commitments to increase crude oil supplies to Belarussian refineries (from currently 20m tons to 24m tons). In addition, the agreement stipulates that Belarus will receive a larger cut of the customs duties on oil products (USD 1.5 b, annually, until 2024, and extra USD 1.029 b in 2015). This will boost foreign currency proceeds, contain external imbalances and alleviate balance of payment pressures, related to the redemption of Eurobonds in 2014/15. Mainly due to the retention of oil duties, we expect the current account to narrow further to -6.3% of GDP, but deteriorate in the outer years as faster economic growth and wages push up imports and the relative value of the US$ 1.5bn customs duty transfer is eroded. Persistent inflation and rising unit labor costs, related to wage growth consistently exceeding slow productivity growth, will continue to impair export competiveness while exerting downward pressure on the BYR, especially if currency depreciation in main trading partners, most importantly Russia, continues.

Relief of immediate external pressures has opened a window of opportunity to address structural constraints in the economy to reduce dependence on external support and escape the current low growth trap. Challenges are serious, but appropriate policy decisions taken now could reshape the long-term trajectory of the economy. While the immediate threat of another balance of payment crisis may have subsided for now, macroeconomic policies should aim to contain inflationary and exchange rate pressures mainly through sustained moderation in wage and credit growth. Prudent macroeconomic policies should be linked with a comprehensive and consistent plan of structural reforms to boost productivity and make non-commodity exports more competitive. Imposing market discipline and incentives on the state-owned sector, while reducing state support and implementing a gradual, consistent and transparent privatization program would help unlock productivity growth and strengthen competitiveness. The most critical measures are: (i) adopt a new approach to directed lending and state aid to reduce significantly subsidized credit (below the refinancing rate) which is undermining the impact of monetary tightening while necessitating prevailing high interest rates in the rest of the economy, (ii) initiate restructuring of unprofitable SOEs, but couple this process with broadening of social insurance and social protection measures; (iii) improve corporate governance of SOEs and (iv) improve the business climate in order to enable the development of a dynamic private sector, in particular SMEs.

Medium-term Macroeconomic Outlook

		Estimate		Projection	
	2013	2014	2015	2016	2017
Nominal GDP, BRB billion	636784	749750	915894	1111713	1326718
Real GDP,% growth	0.9	1.5	1.8	2.0	2.0
Consumption,% growth	9.2	4.7	3.2	1.9	1.4
Investment,% growth	7.5	-4.0	1.7	3.4	1.9
CPI,% e.o.p growth	16.5	19.9	20.8	18.8	18.0
Export of Goods and Services,% growth	-16.0	-1.0	2.2	1.6	2.4
Import of Goods and Services,% growth	-4.2	-3.7	3.6	2.2	1.7
Current Account Balance,% GDP	-10.2	-8.1	-6.3	-8.5	-8.8
General Government Revenues,% GDP	41.9	43.3	42.9	43.0	43.4
General Government Expenditures,% GDP	41.7	42.5	43.6	43.1	42.9
General Government Balance,% GDP	0.2	0.9	-0.7	-0.1	0.6
External Debt,% GDP	53.2	59.0	58.4	60.6	63.5
Public & Publicly Guaranteed Debt,% GDP	32.5	32.5	29.0	27.2	25.8

Source: World Bank Staff projections

.**Contact info:** *Sebastian Eckardt* *Kiryl Haiduk* *Maryna Sidarenka*
SEckardt@worldbank.org *KHaiduk@worldbank.org* *MSidarenka@worldbank.org*
+375 (17) 359-19-50 ● www.worldbank.org/belarus