

Belarusian Economic Research
and Outreach Center



Economic Outlook

Fourth Quarter 2016

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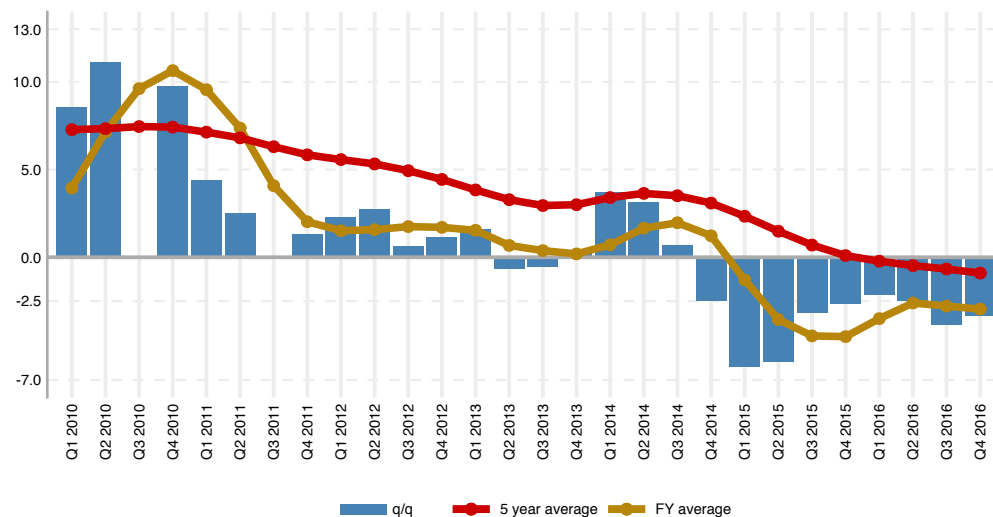
Social sphere

Technical forecast

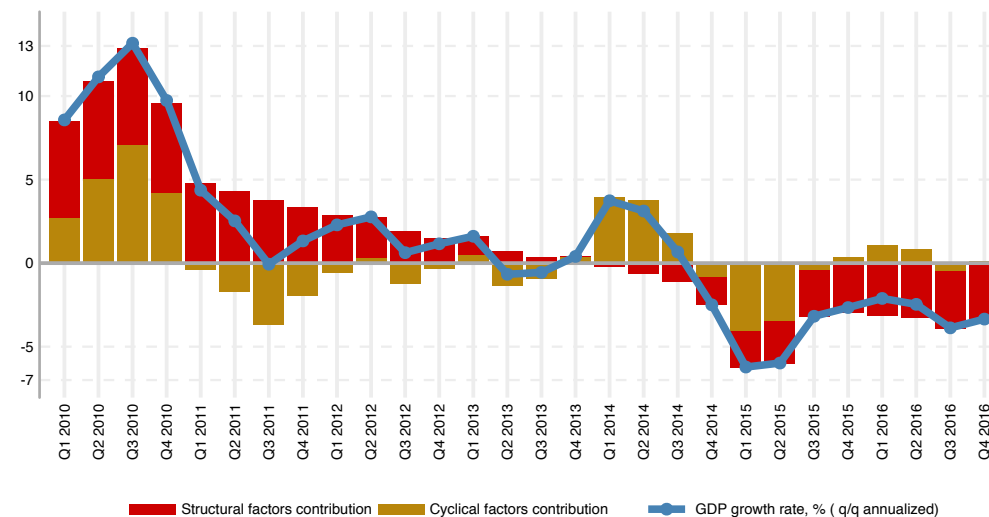
Adjustment to structural recession

- Structural adjustment is in progress
- Debt challenges vitalize
- Households have to cut consumer expenditures more actively
- First signals of monetary environment stabilization
- New steady-state in external environment?
- Real wages flattened out, but employment is shrinking

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).

Main trends

Eliminating structural distortions is not over yet.
Structural contraction of the economy is still on the way.

Output dynamics in the 4th quarter was driven by structural factors only. According to our estimates, the recession in the 4th quarter could be interpreted as a pure structural contraction of output. The latter reflects so called 'overhang of inefficiency' closely related to the national economy and a very slow process of its reduction. In some cases, the latter is closely linked to activities of economic authorities. For instance, for certain industries and even companies procedures of financial restructuring or even liquidation bankruptcy are applied in case their business models are considered nonviable anymore. However, in most cases the authorities procrastinate, delay and postpone making crucial decisions. If this is the case, correction of structural distortions sometimes happens automatically. Nonviable firms face unbearable losses that drive them to decrease capital investments, employment and output, and in some cases completely phasing them out. At the same time, structural adjustment is partially postponed until 'tomorrow'. That is why structural distortions are maintained and may even become wider meaning that abolishing them tomorrow will be even more painful. Furthermore, maintaining the 'overhang of inefficiency' generates negative externalities for the entire economy. For instance, finan-

cial contagion may spread out because of expanding non-payments and erosion of financial credibility. The latter turns out into cases of credit rationing and formation of systemic excess of liquidity in the banking sector. From the economic dynamics perspective it means that the 'price' for structural weaknesses has not been fully paid yet and structural adjustments will continue in 2017.

Contribution of cyclical factors to the output growth rate was close to zero. It means the bottom of cyclical slowdown has already been passed, although the phase of cyclical slowdown itself has not been passed yet, but its end might be approached soon. However, one should understand that approaching recovery is considered as an outcome of structural contraction: the stance which 'yesterday' was classified as a deep cyclical slowdown has become close to neutral in a new reality. This environment suggests that forthcoming transition of the cyclical component of the growth rate to the positive spectrum should not be interpreted as a 'true recovery'. The economy remains 'unhealthy and depressed' until major structural distortions have been abolished.

Informational background

First steps towards resolving the debt crisis

In the 4th quarter, the authorities made first actions to resolve the crisis of non-performing loans in agricultural sector. Belagroprombank and Development bank transferred claims on 270 agricultural firms in the total amount of around BYN 600 million (around 10% of the total volume of non-performing loans in the banking system) to the Assets management agency. The scheme of this deal is not fully transparent, but most probably assumed de-facto exchange of these assets at face value for state (or municipal) bonds. Lack of transparency and use of face value for assets exchange (not market value and corresponding discounting) seem to be rather disturbing signals meaning this procedure is focused on hiding 'the symptoms of the disease', but not 'curing the causes of the disease'. The latter assumes that the inefficiency and loss-making of the borrowers should be overcome. In this respect the government provided a positive signal as well (although weak): they made a segmentation of 425 loss-making agricultural firms. In accordance with this procedure, they approved 102 and 323 enterprises to be qualified for bankruptcy with liquidation and pre-trial financial restructuring correspondingly. In general, the steps towards solving the debt crisis are still far from being systemic and coherent. While the scope of the problem is still not evident, and 'curing' the debt crisis may cause a new wave of slowdown, the way of solving it becomes too slow and contradictory.

Authorities cut directed lending and search for new forms of state-owned enterprises support

The government keeps on cutting new injections of directed loans into the economy. Corresponding limits that were approved for 2017 assume such injections will be at least 30% lower than in 2016 (new loans will not exceed BYN 1.9 billion). However, it should be emphasized that such an approach leads to a very slow reduction of outstanding directed loans, and share of such loans in banking assets remains too high (around 44% as of the beginning of 2017). But even such a moderate regime of directed lending cuts leads to financial challenges for the beneficiaries. Through this, one may feel a forming trend of searching new – both formal and informal – methods of state-owned enterprises support. New pieces of legislation aiming at deregulation in specific industries and fields are considered to be formal support. As for informal way of support, accumulation of non-payments and arrears (for energy resources, taxes, etc.) seems to be expanding in the economy.

Tensions with Russia in the sphere of energy supplies and foreign trade

During the 4th quarter Belarus and Russia didn't resolve contradictions in gas price. Gradually these contradictions expanded to other spheres of the foreign trade: from oil to food. The depth of the conflict and its circuit directly dampened the output and in the future it might also have indirect effect as a financial turbulence trigger.

Output and demand

Capital investments depression persists

Investment demand remains in a deep depressed stance and contracted 13th quarter at a run. During this whole period, it has contracted by roughly 40%. It is very likely that already in 2017 the economy will face with a postponed effect of the investment depression – shrinking output because of lower production capacities.

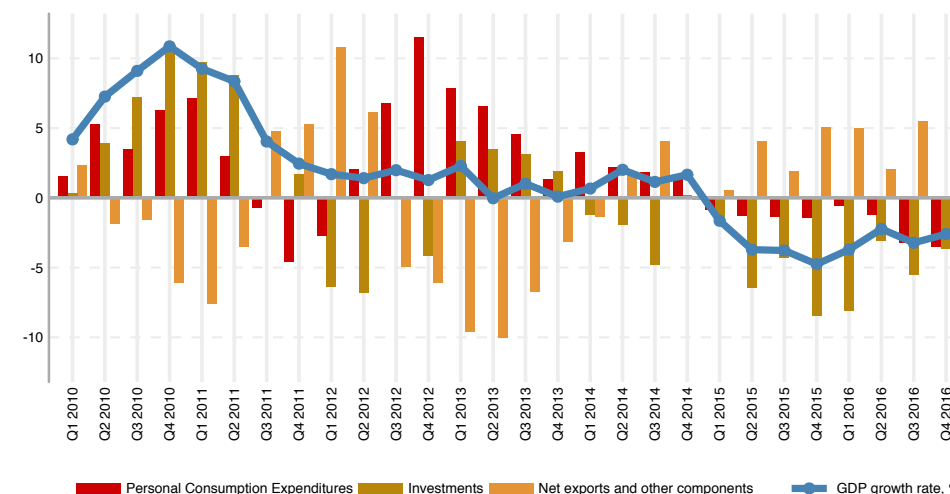
Households have to cut consumer expenses more actively

The possibilities and willingness of households to smooth their consumption at the expense of savings are going down. This determines deepening recession in consumer expenses. The first half of 2017 is very likely to be the period of the most sensitive cuts in consumer expenses.

The quality of growth continues to deteriorate

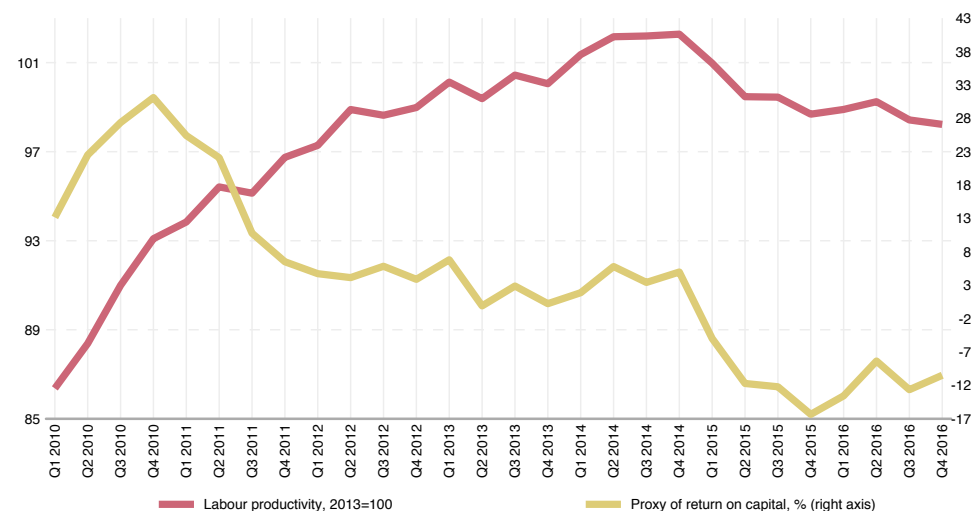
The quality growth indicators do not display any features of recovery in the economy and form expectations that the structural contraction of the economy will persist in near future.

Contribution to output growth, percentage points



Note: The growth rate of GDP is provided on annualized quarter on quarter basis with a seasonal adjustment; GFCF – gross fixed capital formation.

Quality growth indicators



Note: The proxy for the return on capital is calculated as the relationship between annual average output growth and share of GFCF in GDP.

Monetary sector

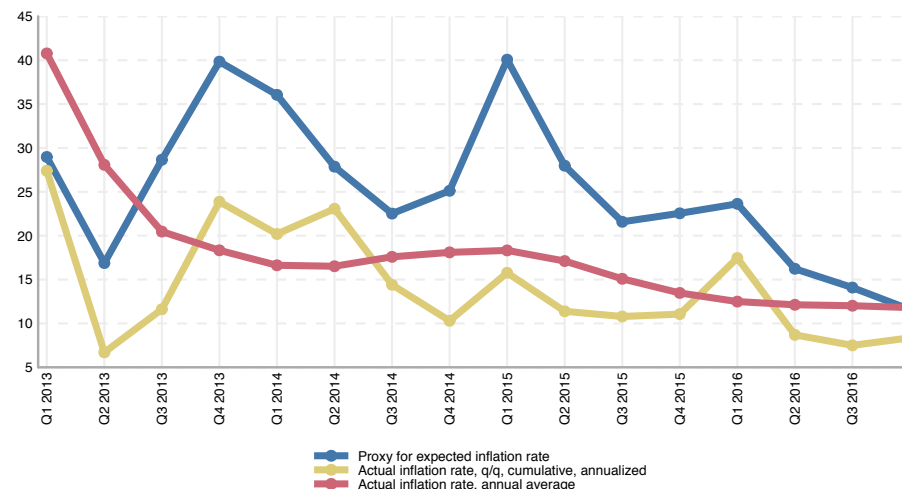
Signals of the monetary environment stabilization

For the first time in the last 5 years (after financial crisis), there are first signs of recovery of the monetary environment in Q4 2016.

Has time come to soften monetary policy?

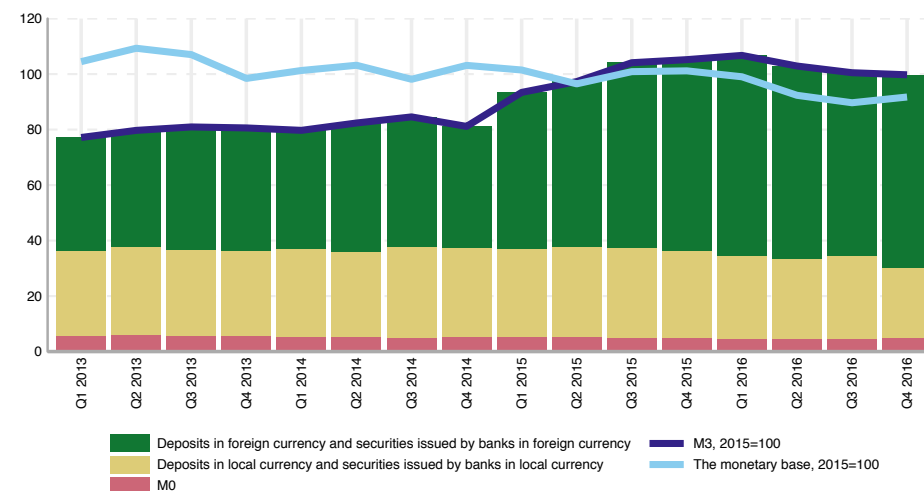
Signs of stabilization are supposed to change the status-quo with respect to the degree of tightness of monetary policy. The view assuming that monetary policy softening will result in a rapid inflation spike (because of overstated expectations) is likely to become less vital. With this in mind the National Bank catches more flexibility for providing monetary stimuli (for instance, reduction of interest rate). At the same time, structural contraction of the national economy levels down the role of cyclical component in the output dynamics, which results in a shrinking need of monetary stimulation. Besides, there is a chance of return of “expectations cliff”, as there is uncertainty about the nature of the monetary environment stabilization and the degree of its sustainability.

Inflation and inflation expectations %



Note: Inflation expectation proxy is calculated as difference between interest rates of new savings deposits and call deposits for individuals.

Monetary aggregates



Note: The components of Broad money (M3) correspond to the scale M3 in 2015=100. All the components are seasonally adjusted.

Fiscal sector

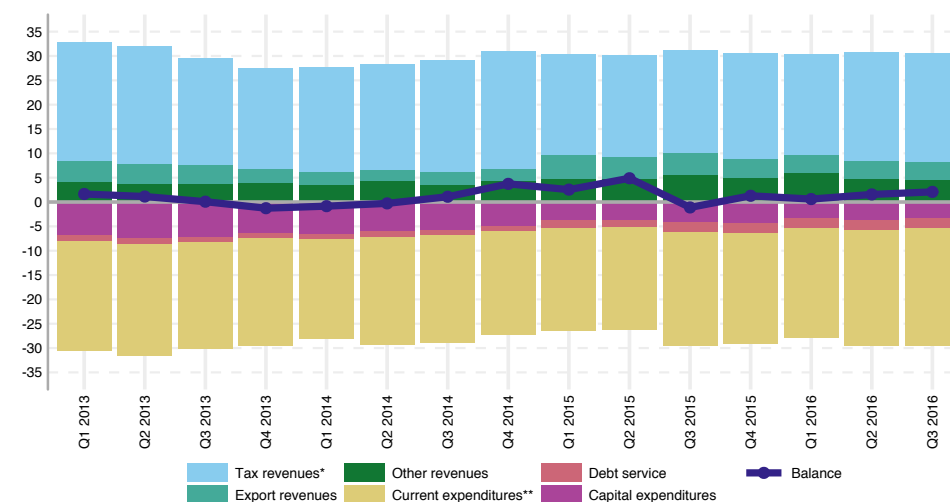
Fiscal policy remains procyclical

Significant principal payments influence unofficial commitment of the Ministry of finance to hold budget surplus. At the same time, in real terms budget revenues shrank because of a recession (although revenues remain relatively stable as a share of GDP). This is the reason of expenditures restraint of the government. Capital expenditures decrease the most. As a result, fiscal policy became persistently procyclical.

Debt sustainability tends to become the highest risk for the national economy

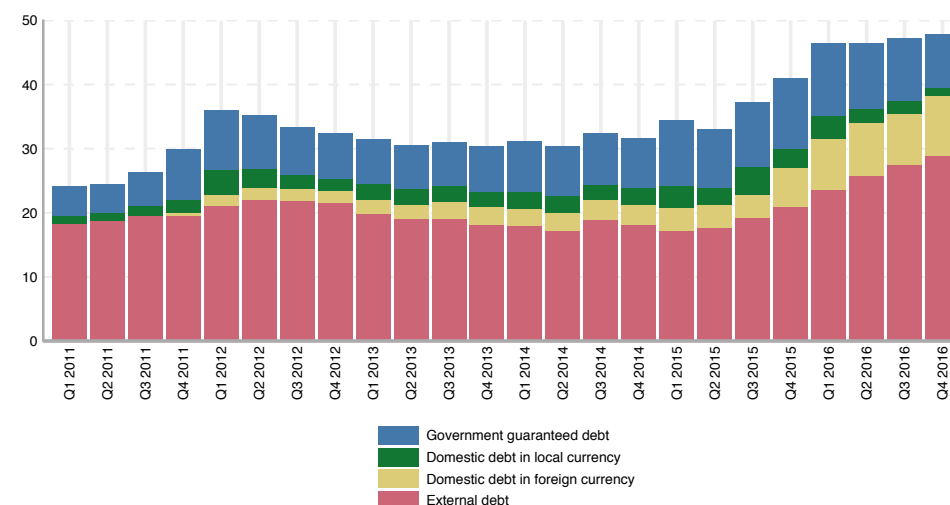
The sustainability of the public debt service in future causes concerns since the debt burden increased to new high values. Moreover, there is a wide range of other disturbing factors that may negatively affect debt sustainability: the prevalence of foreign currency debt in total debt structure, decreased budget incomes in foreign currency, limited options to refinance public debt, and uncertainty in output growth.

Consolidated budget performance, % GDP



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

Public debt, %GDP



Note: as of the beginning of the quarter.

External sector

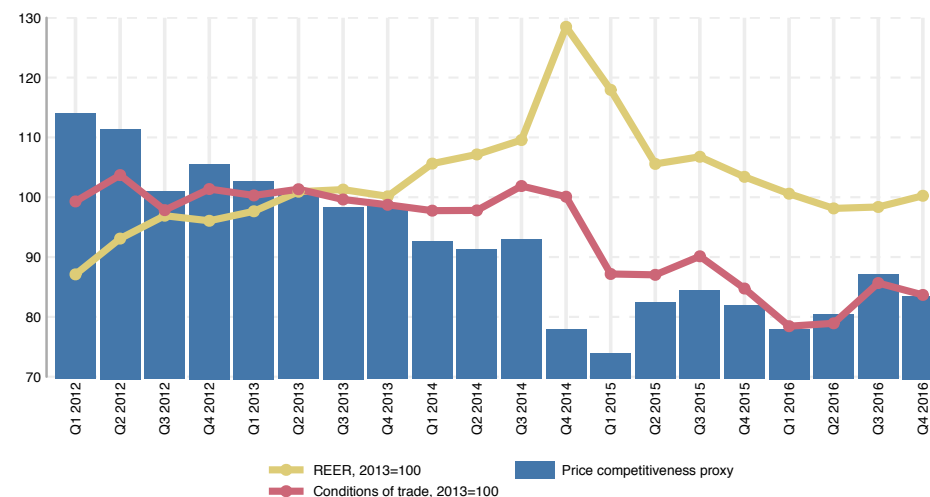
Price competitiveness indices stabilized

Positive signals of price competitiveness of domestic producers in 2-3Q of 2016 did not transmit to 4Q. Both indices of trade conditions and REER worsened. Taking into account their development in the past several years, this might be a signal of stabilization in external environment. That is, current price conditions are likely to be equal to corresponding equilibrium range.

Rise of economic growth in the US is seen as a new driver of global growth

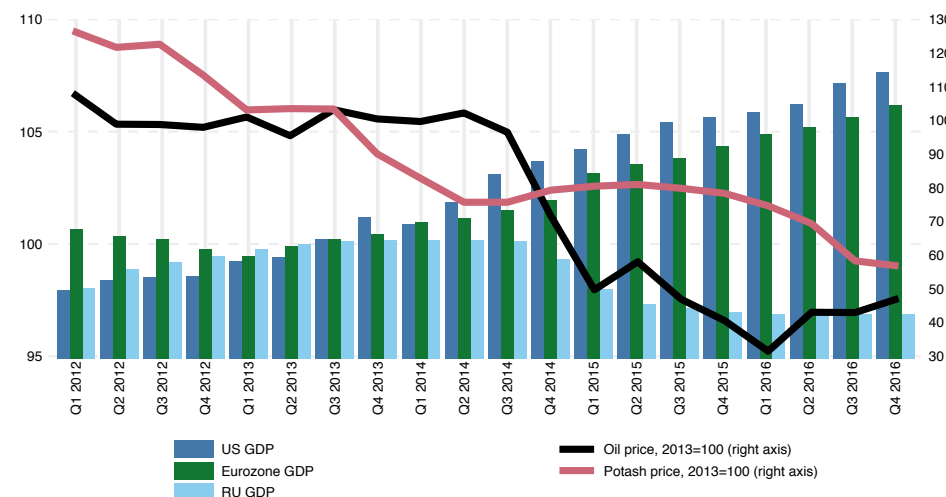
World's biggest economy – the US – has been demonstrating descent signals of recovery for the several running periods. In current environment the US Fed increased interest rate to the range of 0.5-0.75%, indicating a high probability of further economic growth in 2017. These steps might generate a trend towards US dollar appreciation and restrain the prices of commodities at the global market.

External price competitiveness indices, 2013 = 100



Note: Price competitiveness index is calculated as the product of trade conditions index and reversed REER index multiplied by 100.

Global economic indicators, 2013=100



Note: All GDP indicators are seasonally adjusted. Potash and oil price indices are calculated based on corresponding data in the IMF IFS database.

External operations

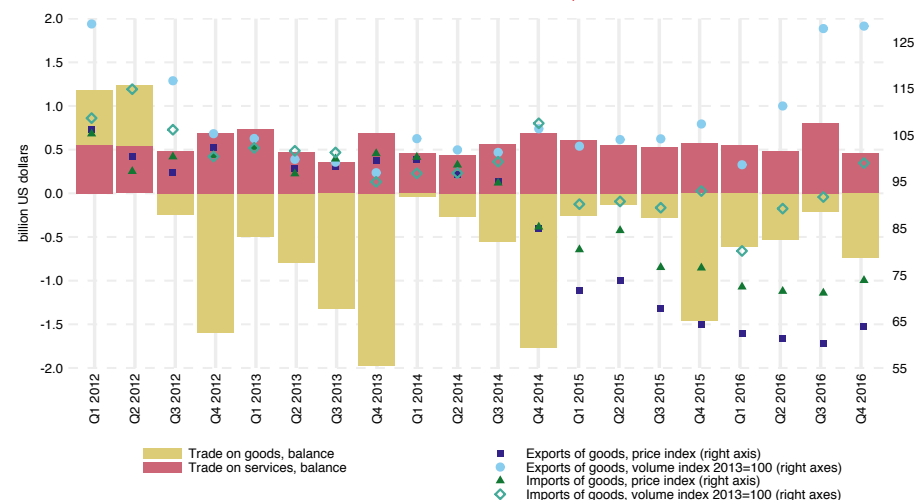
Physical volumes of foreign trade perform strong growth

In the 4th quarter of 2016, foreign trade results aggravated. As for merchandize trade, partially it worsened because of seasonal factors and partially because of worse trade conditions and increased imports in physical terms. The latter might be treated negatively from the trade balance view. However, from the view of the entire economy, it might be a positive signal encompassing some progress in economic activity.

Debt burden keeps on growing

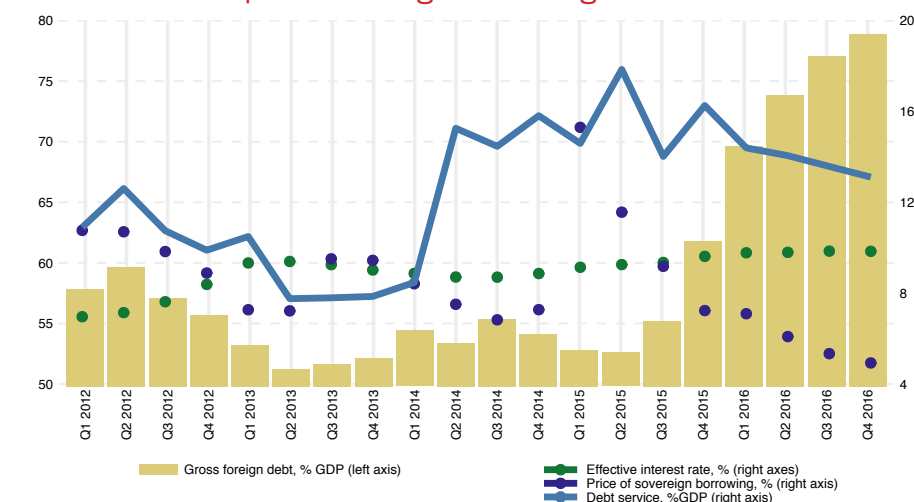
The debt burden (debt as the percentage of GDP) of the national economy proceeds growing at the background of structural contraction. The basic contribution to this growth is due to public sector and non-financial firms (mainly state-owned), whose ability of generating hard currency revenues has shrunk. Hence, a broad issue of the debt sustainability for the national economy has shrunk to the issues of public debt sustainability and overall growth perspectives.

Prices and volume of international trade, 2013=100



Note: PI – price index; PVI – physical volume index. Indices are seasonally adjusted. Balance of trade in goods and services are not.

The volume and price of foreign borrowings



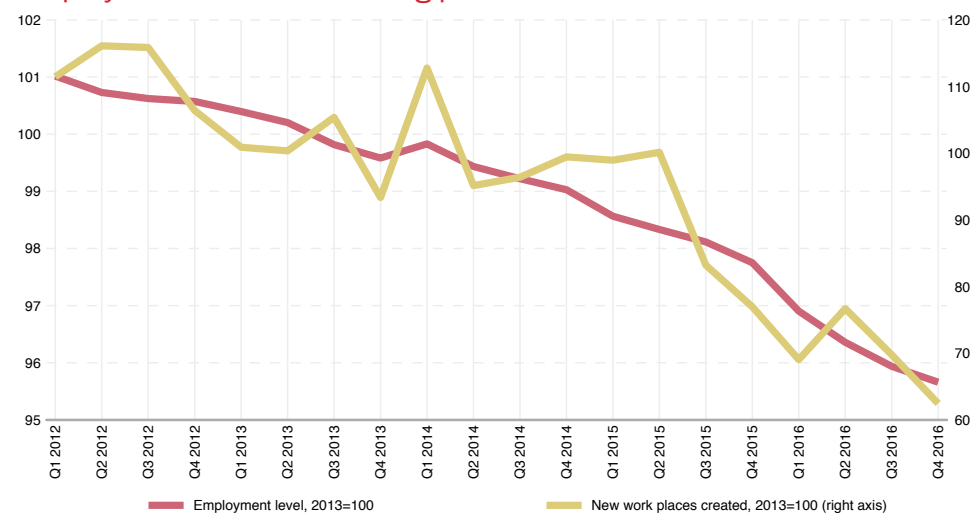
Note: debt service includes interest and principal payments. Effective interest rate is calculated as a ratio of interest paid during past 4 quarters and average amount of debt in this period. Price of sovereign borrowing - an estimate of the yield to maturity on Belarusian Eurobonds 2018.

Social sphere

Labour market keeps on shrinking

The indicators of employment and new working places kept on declining in the 4th quarter. Unemployment rate in 2016 amounted to 5.8% - this figure based on the widely accepted ILO methodology was published by Belstat for the first time. In overall, these indicators signal that the tension on the labor market persists.

Employment and new working places

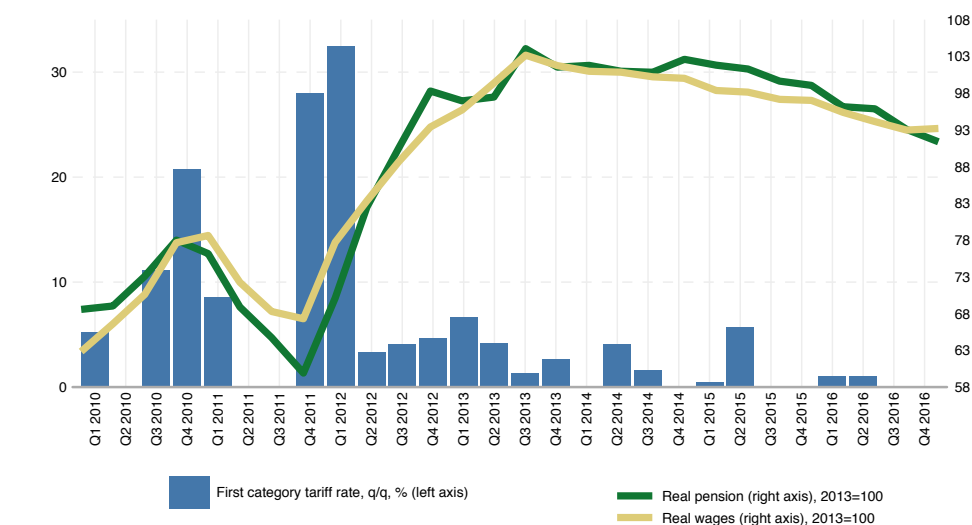


Note: Indices are seasonally adjusted

Has the bottom in real wages been reached?

Modest growth of the real wages was achieved for the first time after 3 years of persistent decline. It could indicate reaching a bottom. Decrease in employment and unit labour costs could influence this trend. At the same time, prolonged structural contraction leaves serious doubts that the period of wages decline is over. Besides, announcement of the government to support certain level of employment in 2017 could be a strong factor of getting back on track of decline in real wages.

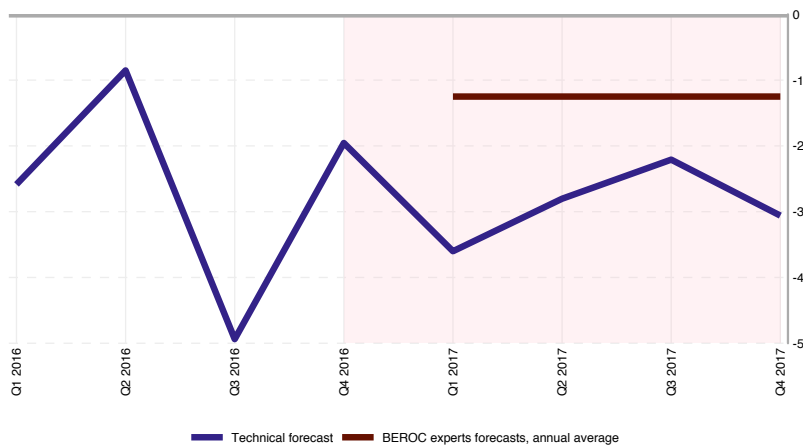
First category tariff rate and households income



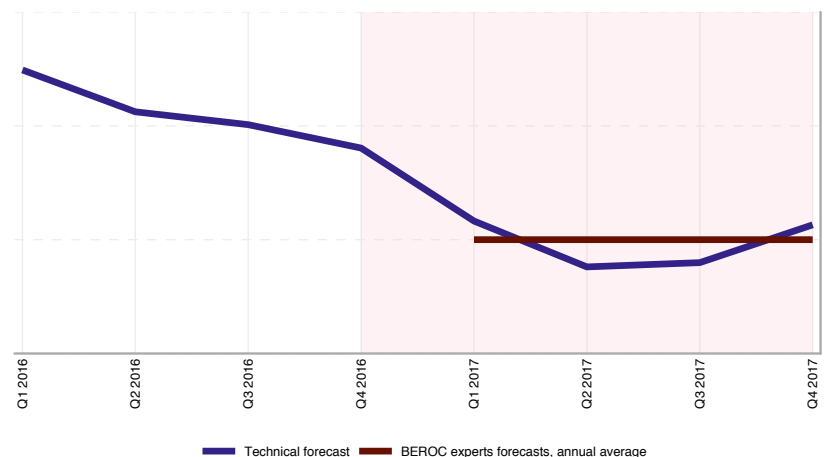
Note: Indices are seasonally adjusted

Technical forecast

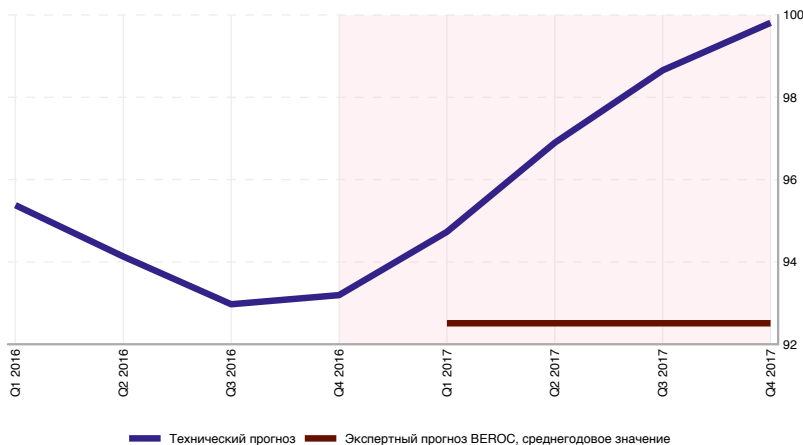
Output growth, quarter on quarter, % (annualized)



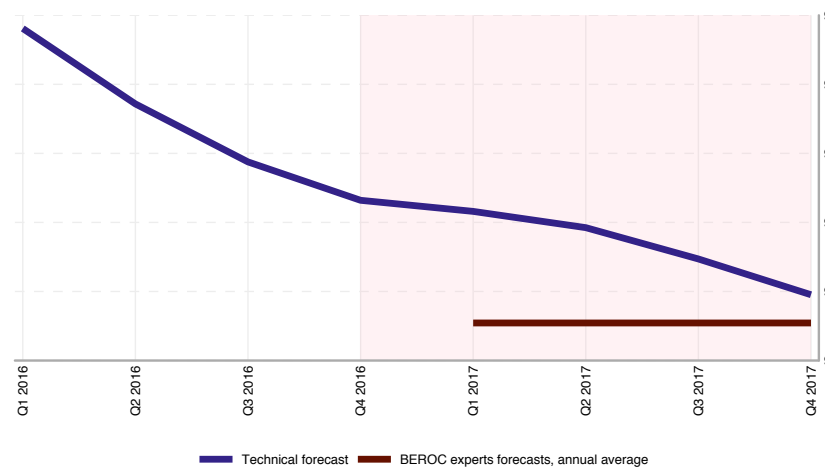
Inflation rate, annual average, %



Real wages, 2013 = 100



Employment, 2013 = 100



Technical forecast is an automated procedure that selects the best specification of ARIMA model for certain dataset based on Akaike information criterion (AIC) and employs this model for forecasting for 4 upcoming quarters. ARIMA-based forecast just takes into account past trends of selected indicator and doesn't consider other factors, neither in the past nor in the future. "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 with a particular indicator in a short-run period provided that inertial scenario is applied. That is, in case fundamental parameters of economic environment don't change, exogenous factors don't impact the environment and fiscal and monetary policies don't change either".

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International Monetary Fund (www.imf.org)

R Core Team (2016). R: A language and environment for statistical computing. R Foundation for Statistical Computing, Vienna, Austria. URL <https://www.R-project.org/>.

Please forward your comments or suggestions to beroc@beroc.by

Prospekt Gazety Pravda 11B, Minsk, Belarus

Phone +375 17 272 20 91

beroc@beroc.by

www.beroc.by