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# Belarusian economy: structural crisis

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*Growing Current Account Deficit in Belarus since 2007 accompanied by expansionary monetary and fiscal policies in 2010 has led the country to exchange rate collapse and prices boost in 2011. Now it may take years for the Belarusian rouble to get back on controlled track and inflation in Belarus to decrease back below 10%.*

**Introduction**

Demand for foreign currencies, mostly US dollars and Euro, in Belarus has been continuously exceeding the supply of the currencies at the internal foreign exchange market for the amount of $ 7.2 bn in 2010 (excess demand was equal to 30% of total currency supply) and $ 1.6 bn in January-May 2011 (17% to total currency supply). Under „crawling peg" regime of Belarusian rouble (BYR) to the basket of Euro, US dollar, and Russian rouble, in March 2011 National Bank of Belarus (NBB) has stopped interventions on the currency market that satisfied excess demand for foreign currencies. Since then excess currency demand along with devaluation expectations from business and households resulted in fast devaluation of Belarusian rouble and existence of multiple exchange rates existence in Belarus.

**Explosion of the balance-of-payment crisis**

Noticeable problems in the economy have begun to disclose immediately after the presidential elections held on December 19, 2010. Following generous administrative growth in salaries, pensions, minimum wage and other social benefits shortly before the elections[1], the demand for foreign currencies rose significantly in 2011[2]. Inflated household demand along with growing prices for imported energy resources[3] contributed to fast increasing import volume. In the 1st quarter 2011 Belarusian foreign trade deficit amounted to $ 3 bn, 2.5 times more than in the 1st quarter 2010. In the 1st quarter 2011 current account deficit (CAD) equaled to $ 3.6 bn or 27.6% GDP while net foreign direct investment (FDI) amounted to only $ 0.7 mln (40% less than in the 1st quarter 2010). Under „crawling peg" regime of Belarusian rouble (BYR) to the basket of Euro, US dollar, and Russian rouble, official international reserves decreased by 37% to $ 3.7 bn from November 1, 2010 to April 1, 2011 being equal just for 1.1 months of imports.

In March 2011 the government sent a request to Russia and the Eurasian Economic Community for loans of $ 3 bn in total. In anticipation of the foreign credits NBB decided on rather unusual

[1] e.g. in November 1, 2010 salaries in the public sector (50% of total employment) were increased by ⅓. In 2010 nominal wage was increased by 46% while inflation (CPI) amounted to 9,9%.

[2] Among others there was a significant growth in household demand for EUR and USD due to increase in used car import into Belarus from EU countries (custom duty for used car has been raised from July 1, 2011 in average of around 4 times to be equal with the custom duty in Russia). We estimate the excess demand for foreign currencies related to massive used car import for about $ 1.4 bn during January-June 2011.

[3] First of all, gas price imported solely from Russia in qI-qII 2011 was 32% higher comparing to qI-qII 2010 contributing to about $ 0.6 bn of import volume increase in Belarus in the first half of 2011.

steps in monetary policy, which resemble the situation after the collapse of the USSR in the early 90's. At first, on March 14, NBB introduced a 30-day deadline for the currency demand in the inter-bank market[4]. Shock in the banking sector, triggered off by the regulation of NBB, eventually forced the central bank to cancel its decision a week later. Instead, NBB suspended intervention at the interbank market. With fixed exchange rate it meant a restriction for banking sector to meet the excess currency demand. Importers[5] raised prices by 20-30% already in March, thereby taking into account their devaluation expectations.

Having regard to the surplus demand for currency, on March 29, NBB widened the fluctuation range of exchange rate from the official rate at the non-bank market from ±2% to ±10%. Next, on March 31, NBB introduced a moratorium on the adoption of any decision at the currency market for a month, i.e. until receiving the expected loan from Russia. There appeared big queues to the exchange offices and for the first time since the late 90's an unofficial exchange rate came along in Belarus. On April 19, when NBB allowed for alternative session at the foreign exchange (FX) market with unfixed currency rate, US dollar transactions were concluded at the level of over 66% higher than the official rate. Already on the next day NBB issued a recommendation for commercial banks to quote foreign currencies within the alternative session by the price not higher than 50% of the official rate. The interbank market stopped again – the currency supply disappeared. After a week NBB abolished the alternative session.

In the 1st half of May NBB was still trying to stabilize the foreign exchange market administratively. NBB lost all credibility due to the lack of determination. One day NBB would issue a recommendation and then cancel it the next day. It demonstrated the inability of the authorities to implement consistent and comprehensive policies. Eventually, on May 24, NBB devalued BYR against the currency basket by 54,4%[6] but limited possible currency basket fluctuations for 2011 within the band ±8% of its central value as on May 24. Nevertheless, multiple exchange rates regimes persisted although the black market premium fell to approximately 20-30%. On May 31 the government and NBB announced that they would ask for a new stand-by loan from the IMF in amount of $ 3.5-8.0 bn. On June 4, the Eurasian Economic Community finally approved a 3-year stabilization loan for Belarus in amount of $ 3 bn. At present, the official exchange rate to the currency basket is 75% higher than it was on January 1, 2011 but until now (mid July 2011) the FX market is characterized by the lack of foreign currencies supply.

Panic at the FX market and the strong devaluation contributed to higher prices of imported goods and the inflationary pressure. Prices skyrocketed by 43.8% in June 2011 comparing to June 2010. There has not been such rapid inflation for the last ten years. The government promised to increase wages to the percentage rise in the cost of living. Taking that into account along with the official devaluation, which took place in the second half of May, the inflation should rise further by another tens of percents. Therefore, the balance-of-payment crisis is transforming gradually into the economic crisis.

**Reasons of the crisis**

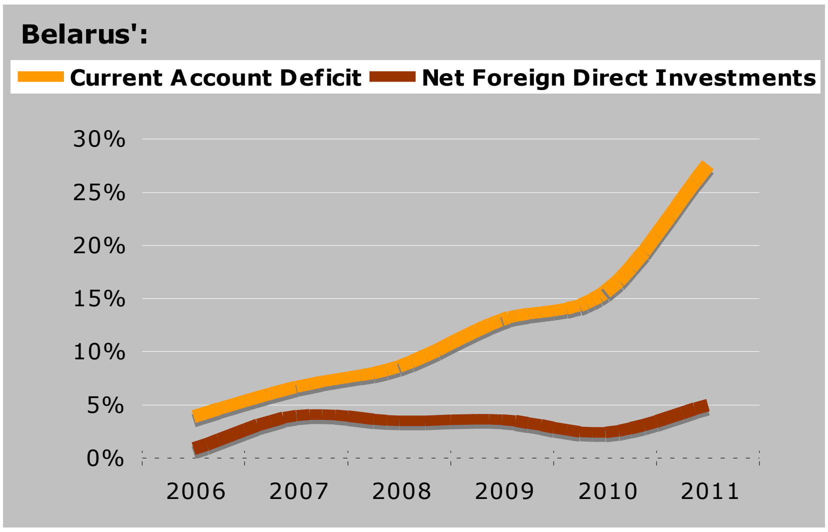
Belarusian economy highly depends on foreign factors. For the long time since 1995 there have been cheap energy resources (crude oil and gas) available from Russia that sustained Belarusian economic “miracle”. Belarus could have developed fast without almost any structural reforms. Consistently since 2007 the prices for Russian crude oil and gas have been raised due to the deterioration of Belarus-Russia political relations. In 2007-2010 Belarusian oil industry was gradually dispossessed of the extraordinary profits due to the obligation to discharge to Russia the duty for exported oil

[4] That meant that the nearest currency transaction could have been carried out only a month after demand application was submitted.
[5] Among others the construction market, electronics, food industry and travel agencies
[6] Exchnage rate of BYR to US Dollar lost 56% in one day on May 24, 2011, to EUR Belarus national currency lost 53%, and BYR/RUB exchange rate was lower by 54% on May 24 comparing to previuos day.

products processed from Russian crude oil. In 2006 import of energy resources (mainly crude oil and gas) was covered with interest – $ 208 mln (0.6% GDP), by export of energy resources (mainly oil products). Whereas in 2010 that balance was responsible for a deficit of amount $ 4.9 bn (9.0% GDP). This means that the change in terms of contracts for energy resources trade with rest of the world has cost Belarus around 9% of GDP since 2007.

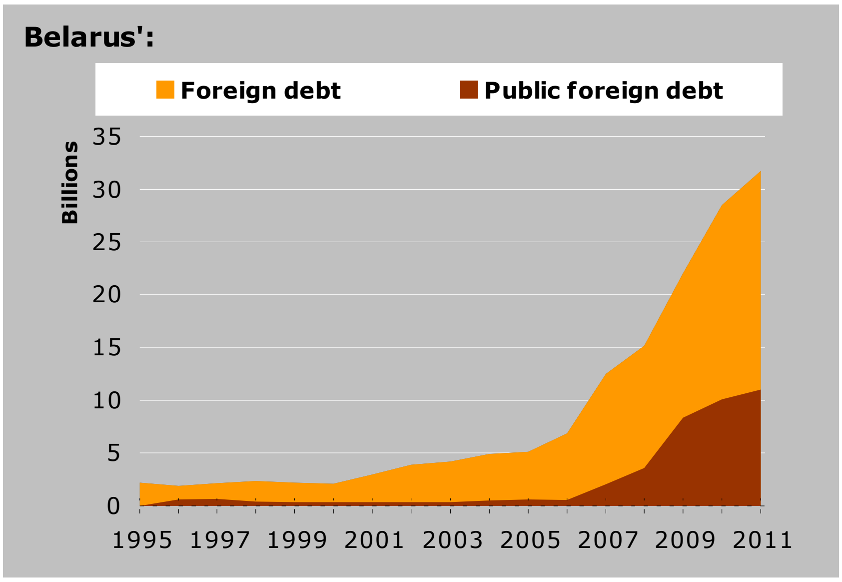
Moreover, Belarus was affected by the global crisis in 2008-2009. The price and volume of the main domestic product exported to the West – potash mineral fertilizers, decreased considerably. The current account deficit had continued to grow – from 3.9% GDP in 2006 to an emergency level of 15.5% GDP in 2010 (see figure 1). Foreign exchange reserves and net FDI in Belarus have been insufficient to finance the trade deficit. In 2007-2010 net FDI inflow financed only ⅓ of CAD. In order to finance the growing trade deficit and maintain basic economic stability (first of all stable exchange rate and low inflation) the authorities decided to incur a foreign debt. Thus, the foreign debt of Belarus in the past 4 years has more than quadrupled – from $ 6.8 bn on January 1, 2007 to $ 28.5 bn (52.2% GDP) on January 1, 2011 (see figure 2). While foreign public debt had risen even faster due to small-base effect – by 17 times, from $ 0.6 bn to $ 10.1 bn (18.4% GDP). However, foreign debt did not exceed a dangerous level when a country can no longer meet its financial obligations.

**Figure 1. CAD and net FDI (in % of GDP) in Belarus in 2006-2011***




Source: *National Bank of Belarus.* * As 2011 there are given data for the 1st quarter 2011.

**Figure 2. Total foreign debt and public foreign debt of Belarusian economy in 1995-2011* (bn USD)**




*Source: National Bank of Belarus.* * As 2011 there are given data for the 1st quarter 2011.

The current economic problems apart from structural are also triggered off by irresponsible and unpredictable economic policy of Belarusian authorities caused by political cycle. In the aftermath of the pre-electoral policy the external imbalances went out of control. In 2010 nominal wages growth (46.1%) was 4 times higher than the labor productivity growth. Throughout 2010 NBB led an expansionary monetary policy. The monetary base in 2010 rose by 69.4% while the main refinancing rate fell from 13.5% to 10.5%. At the same time the Belarusian rouble in relation to the currency basket was kept within +/-8% yearly corridor due to interventions of the NBB. Groundless wage rise along with fixed exchange rate generated the consumption bubble, which has transformed into growing CAD and price boost.

The inconsistent monetary policy in the 1st half 2011 only exacerbates the devaluation and inflation expectations. The monetary base rose for further 20% in first 5 months of 2011 and the real interest rate was negative. Main refinancing interest rate in June – 18%, was significantly lower than inflation – 43.8%. Even the sharp devaluation of Belarusian rouble by 75% as of July 1, 2011 in comparison to January 1, 2011 could not restore the equilibrium at the FX market.

**Concerns and government policy issues**

Surging current account deficit and currency crisis in Belarus not only do provoke further financial and economic turbulence but also raise a few serious issues that may affect Belarusian economy both in short and long period of time and require immediate government responses. Those issues are first of all external short-term debt, economy structure, stimulated GDP growth, and ability of government and National Bank of Belarus to respond fast and adequate.

One of the most distressed indicators seems to be the growing amount of external short-term debt (total $ 14.2 bn) as ratio to GDP (24.9%) and share in total foreign debt (44.6%) as of April 1, 2011. The major part of the short-term debt comes from trade liabilities of commercial sector (55%) represented mostly by state-owned enterprises. Trade liabilities have been growing fast recently adding more than $ 2 bn of short-term debt over the last year. Another reason to worry is that Belarus international reserves cover just 26.4% of short-term debt, which are literally enough for just a quarter of debt clean-up. There is a clear need for fast accumulation of international reserves by National Bank of Belarus in order to avoid financial collapse of the country. At the moment the market premium of Belarusian Eurobonds issued in the second half 2010 is already very high (11,5-12%) – close to the level of Greek bonds. Without a solid plan of reforming the economy, investors will not limit their risk premium.

Belarus is a unique European country in terms of economy structure, and its uniqueness may contribute to financial disorder and economic crisis expansion. As much as 70% of GDP is produced by state-owned or state-controlled enterprises. That poses extra burden for budget in terms of salary increase and salary-related social payments for employees[7] as well as direct and indirect subsidies for chosen enterprises in order to keep them on the market. On the other hand, state-controlled sector provides almost 2/3 of total central budget tax revenue (or about 44% of total consolidated budget of Belarus) that indicates high level of financial flows centralization in the country.

Evidently, fast GDP growth in Belarus stimulated by administrative, monetary, and fiscal instruments, leads to further structural imbalances in economy. For instance, recent analyses[8] show that massive investments into residential construction (accounted for over ⅓ of total capital investments during last 3 years in Belarus) along with preferential housing loans (when bank interest is much below inflation rate) resulted in misallocation of financial resources, growing cost of invest-

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[7] For instance, the administartive rise in salary in November 2010 cost as much as 0,9% of GDP of transfers from central budget to state-controlled sectors.

[8] See U.Valetka, 2010 (in Russian): Валетко, В. В. Институциональный механизм реструктуризации экономики как объект экономической политики / В. В. Валетко // Труды БГТУ. № 7, Экономика и управление. – 2010. – Вып. XVIII.

ments for other sectors as well as increasing of inflation pressure. Without real structural reforms then, first of all private sector development and financial flows decentralization, fast GDP growth does not help solving current financial troubles in Belarus, instead it ruins the fundament of the country's financial stability.

The current currency crisis can be seen as a somewhat replication as well as continuation of macro financial instability in Belarus in late 90s. In 1999, having multiple currency exchange rates along with average consumer prices inflation as much as 294%, National Bank of Belarus initiated the monetary stabilization program, which took nearly 15 months to implement before single exchange rate had been fixed. Yet inflation has fallen below 20% only in 2004 – five years later, and below 10% in 2005. Assuming similar internal and external political environment in Belarus, one can estimate that it will take National Bank at least one year since summer 2011 to soothe devaluation and inflation expectations of business and households. Setting positive real interest rates, using free market mechanism to set the exchange rate of Belarusian rouble, as well as rigid control of the monetary base could be helpful for Belarus if implemented immediately as a background for further economic reforms.

Concluding, there is a clear need for economic reforms in Belarus, aiming at economy structure change and supported by restrictive monetary policy instruments and increasing international reserves. Without reforms, current account deficit will keep growing fueled by fast GDP growth and balanced by international loans to end up in next currency crisis sooner or later. Economic reforms have to be undertaken fast and sound as every month of delay now may cost a few months of recovery later.