

**Analytical note:**  
**Monitoring of the situation in**  
**the field of economic security**  
**of Belarus**  
**(April 2016)**

## The risk of financial instability

After transition to the floating exchange rate regime and stabilization of the situation with servicing the external debt, a principal threat to the financial stability of the country is represented by the banking risks. In particular, a serious problem is the rapid growth of bad debts, which amount as of the beginning of the year has increased by 70% and exceeded the level of 11.5% of bank assets. The cause of this trend is the increase in servicing the foreign currency loans due to weakening of the Belarusian ruble and the ongoing recession in the national economy. In this case, according to the banking statistics, the most vulnerable status may be assigned to the system-creating banks, which are actively involved in lending to the large-scale state-owned enterprises (in particular, Belarusbank, Bealagroprombank, Belinvestbank and BPS-Sberbank). The probability of improving or even stabilizing the situation with the bad debts is still rather low due to weak foreign trade situation, as well as tight monetary and fiscal policies of the authorities. To prevent the further growth of problems in the banking sector, the authorities will probably have to reimplement the successful experience of 2015, when part of the debts of the large-scale enterprises in the amount estimated as USD 2.3 bln. was re-arranged to the Government through the issuance and sale to the banks of the foreign currency bonds. In fact, without implementing these measures, the bad debts at the current moment would have exceeded 23% in the structure of the banking assets. The deterioration of the situation will also require participation of the State in recapitalization of the largest banks, aimed at ensuring their capital adequacy.

A side effect of such a policy of saving the situation by means of public funds is the growing fiscal risks. Displacement of social spending and investment spending to support the real sector further stimulates the economic downturn and increases the procyclical nature of the fiscal policy. The authorities cannot switch to the regime of accumulating the budget deficit due to inflation risks, the low level of the gold and foreign exchange reserves (hereinafter referred to as the reserves) and limited resources in the domestic market. The creditors will not support a major easing of the policy as well, especially since the new program with the IMF has not yet been approved and the conditions of its implementation will be further developed.

The authorities are well aware of the seriousness of problems in the banking sector. To minimize it, in 2015 the so-called club of creditors, which consisted of experts of the National Bank, commercial banks and businesses, made decisions on refinancing and restructuring of debts of the largest borrowers. During the April monitoring of the financial system stability the IMF and the World Bank experts also recommended that the authorities set up a special Council to ensure the financial stability, aimed at managing credit risks in the real sector.

However, it is fundamentally impossible to solve the problem of bad debts only by means of measures in the banking sector. A necessary condition for normalization of the financial situation is to stop directed lending to the chronically insolvent and inefficient public sector enterprises. It is state-owned enterprises, which for a long time have been the main beneficiaries of the state lending and supporting policies, but have been the least ready for operation under the condition of hard budget constraints and expensive credits. In the most difficult situation turned out to be the agricultural sector, which for decades has been the largest recipient of public investment and operational assistance. Thus, according to the official statistics, almost half of the problem of ruble debt accounted for

by this sector and its total liabilities are 2.5 times more than the value added in 2015. There are several options for the authorities to act in such a situation: either reforming the public sector, with the inevitable reduction in activities, sanitation, privatization and even bankruptcy, or continued funding of the enterprises at the expense of the state budget or by means of the emission mechanism. The costs and benefits of each approach are different: in the first case the reform of the policy will be accompanied by a sharp rise in unemployment and the biggest failure of GDP in the short term, but would create conditions for long-term economic growth. The second approach is only delaying the solution to the problem of inefficient allocation of resources in the economy and is accompanied by an acceleration of inflation (in case of issue), or an increase of budget problems, but at the same time it helps avoid unemployment and social stratification.

Judging by the public statements made by the country's leadership, no political decision on profound reforms in the public sector is taken at the moment. Only in September, the government should prepare a concept of reforming and restructuring the state organizations. However, there is no sign of a possible easing of fiscal and monetary policy. A good proof of the latter is a new state program "Housing construction" for the period 2016-2020, according to which the preferential funding of housing already in 2017 is planned to be reduced almost 4 times. It may be assumed that the authorities once again choose the tactics of interlocutory decisions, when recovery and bankruptcy proceedings affect only part of the small and medium-sized organizations. The Government will try to provide support to the GDP-forming companies in hope to improve the situation on foreign markets and a sufficient reduction in lending rate in the country.

### **The risk of economic recession**

Growing financial problems along with subsidence of the key export markets increases the likelihood of a long-term recession in the economy. The fall in GDP for the first quarter was 3.6%, while the only sector that has demonstrated a slight increase (+2%) was agriculture. The traditional anti-leaders (mechanical engineering, metallurgy and construction) were also joined by production of potash fertilizers, which drop made almost 30% in January-February 2016 in natural value and more than 38% in foreign currency. The unfavorable situation develops on the food market as well (especially the milk market), as a result of which, even though the physical growth of its export takes place, its value declined by 2.7%. In such circumstances, the international organizations seriously worsened the forecast of economic recession in Belarus in the coming years. Thus, the decline in GDP is forecasted by the IMF at 2.7%, by the World Bank in 2016 at 3%, and in 2017 by 1%. Return to the minimal positive trend, according to World Bank experts, is only possible in 2018.

Responding to the criticism of Alexander Lukashenko and trying to improve the economic performance, the National Bank continued strengthening the administrative pressure on deposit and credit markets. Thus, since May 1 the refinancing rate was reduced again (this time to the level of 22%) and the rate on the liquidity market operations (liquidity provision to 27% withdrawal - up to 15%). At the level of the new recommendations, the banks were reported the significantly reduced allowable rates for the ruble and foreign currency deposits of individuals and legal entities (for example, for the population to the level of 21.6% -27% per annum, depending on the conditions of accommodation). On the one hand, the regulator has the fundamental reasons for such

tough actions. The growth in inflation in the first quarter, which amounted to 5.7%, is largely due to the factor of a single growth in the prices for services, and the National Bank is serious about complying with its annual forecast of a 12% inflation rate. The favorable situation in the foreign exchange market, characterized by strengthening of the ruble and excess of currency supply, seriously increased the relative yield of ruble deposits. In this situation, the regulator says about the need to reduce the risk premium to the normal level, and reduce the cost of loans to 24-27% per annum. However, according to the dynamics of deposits, the inflation expectations of the economic agents are still quite high and may grow in case of possible weakening of the ruble due to external reasons. Their neglect by the National Bank creates the risks of unbalancing the money market, where demand for loans will rise sharply against the background of reduction of the resource base.

Along with the deteriorating economic situation the number of possible programs, plans, concepts, in which the government determines the planned measures of economic policy, is increased. So, in addition to the package of measures to address the socio-economic development, which is actually the Government Program of Action comprised of 91 points, there was adopted a plan of action to implement Directive No.3 “On priority directions of strengthening the economic security of the State”. The plan includes a list of 114 events, most of which are not marked by specifics (such as “increasing the economic attractiveness of the export activity of resident organizations through the use of world experience”) or a large scale (e.g., “creation communities in social networks and channels on Youtube for the exporting enterprises”). Also in April there was approved the development program for the next five years, in addition to which the 20 state programs were developed in detail. Despite its scale, the latter has already received criticism from Mikhail Myasnikovich, because of its lack of specific numerical targets and an emphasis on “beautiful thesis”.

### **Conclusion**

The increased credit risks in the banking sector due to deterioration of the financial situation of the borrowers and the high relative share of the foreign currency loans represent the biggest threat to the financial stability of the country. The government still has the opportunities for leveling these challenges, but only at the cost of increasing the problems with budget execution. The cornerstone to address the problem of bad debts in the banking system is the increase in efficiency of the public sector enterprises. However, there is still no political consent on this issue; and instead of making strategic decisions the Government has concentrated on developing a set of policy documents, not distinguished by fundamental and specific character.

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