BEROC Economic Research Center

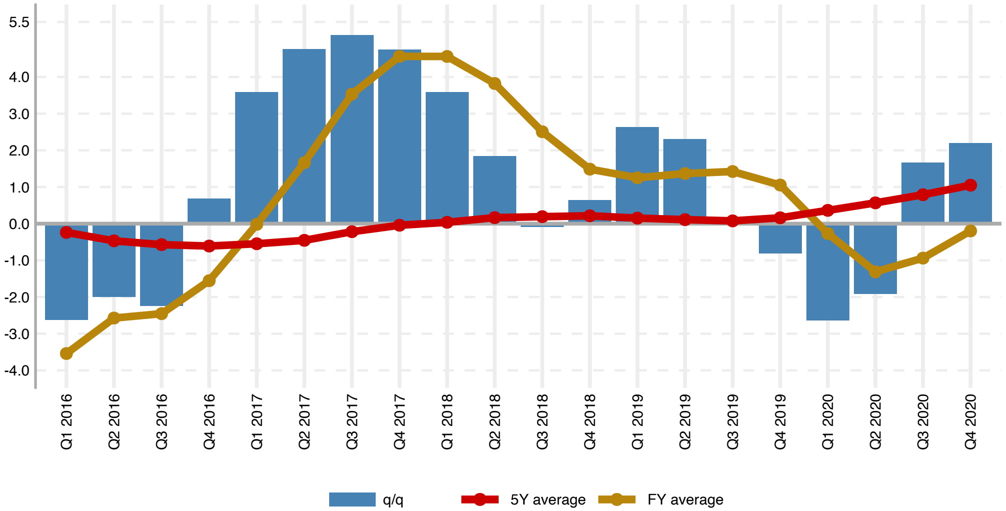
Economic Outlook

Third and Fourth Quarters 2020

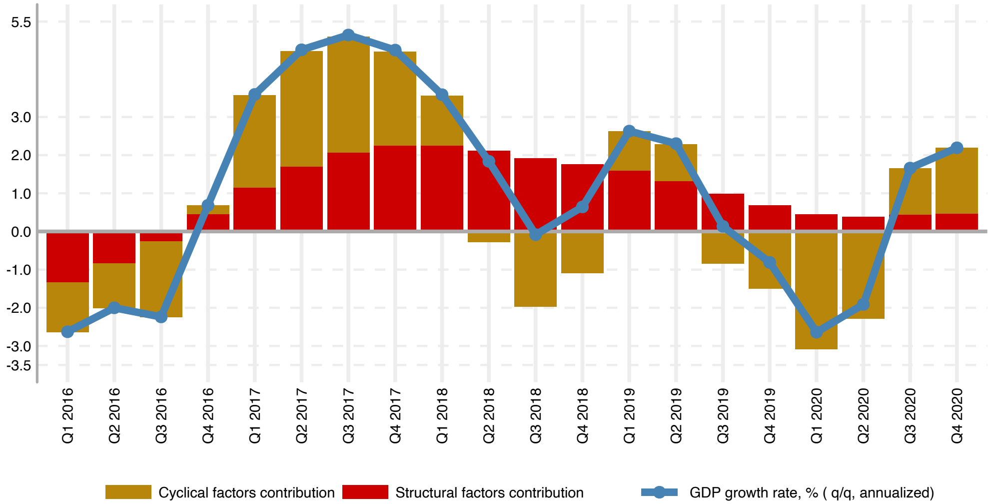
Growth recovery amid off-the-scale uncertainty

- Consumption continues to be the key driver of the GDP
- A surge in inflation and inflation expectations
- The external position has significantly strengthened
- Mounting threats to financial stability
- The fiscal space is narrowing
- Real wages are rising no matter what

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. All data for 4th quarter are estimate.

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).

Current trends

The economy is seesawing and shifting into uncertainty

In Q3-Q4, the economy demonstrated some slight recovery growth of output. The peculiar rebound in the GDP became the key trend of the second half of the year in almost all countries and was associated with hopes for a quick end to the pandemic. Although this model is applicable to Belarus in general terms, it has got significant specificities.

The V-shaped visualization of the COVID-19 recession is unlikely to prove appropriate for the country. The growth generated in Q3-Q4 did not help make up for the loss of output, which occurred in the first half of 2020. Moreover, the sustainability of the recovery trend is highly questionable. Many qualitative indicators (for example, profitability of firms, debt burden, labor productivity, new jobs, etc.) remain within displeasing ranges. This shows that there are strong prerequisites remaining in the economy for a delayed and protracted recession. In other words, it is highly likely that the price for the “sacrifices”—the weakening financial position of firms and the realization of threats to the financial stability—made to ensure fair GDP performance in Q3-Q4 is to be paid in subsequent periods. For instance, to improve their financial shape, firms may limit output, trying to sell off their inventories, as well as trim labor costs. Such evolution of their behavior would contribute to deferred losses in output.

Additional prerequisites for renewed recession have formed amid the continued political crisis. Negative expectations of households and firms result in contracting demand. For example, many consider the near future unfavorable for investment and big-budget purchases. Moreover, the political crisis is also negatively affecting the savings behavior of economic agents, weakening the already fragile financial stability.

If the current economic environment was frozen, the most likely scenario for 2021 would be sluggish deepening of the recession – about 0.5%, following a decline of 0.9% in 2020. However, this inertia scenario is far from being the most likely one today. Numerous threats have become urgent for the economy, each of which, taken separately—and even more so in some combination—is able to lead to sharp qualitative changes in the economic environment. These include financial destabilization, exacerbation of the political crisis, the pandemic, renewed tensions with Russia, new shocks in the global economy, sanctions, waves of migration, etc.

Against this background, the range of potential scenarios for Belarus is extremely wide for 2021. From skimpy growth (up to 1.5%) accompanied by some elements of financial and price stability preserved—if all the threats are neutralized and there is a significant improvement in the external environment—to sharp and massive deepening of recession (up to 10%) accompanied by financial and price destabilization—if the above threats materialize.

Institutional environment

Erosion of economic confidence and institutional environment

The political crisis faced by the country is fraught not only with short-term losses in output, but with erosion of the institutional environment leading to long-term losses in output and welfare.

One trend that is already emerging is eroding economic confidence. It is most clearly manifested in declining confidence in the national currency as a store of value, as well as in Belarusian banks as financial intermediaries. It has already affected the indicators of monetary statistics. Ultimately, the eroding confidence is fraught with new emerging structural constraints on financial intermediation and monetary policy. The capacity of banks to engage in financial intermediation (the size of their loan portfolios) will be limited that will compress the potential output. The capacity of the monetary policy to influence the dynamics of inflation and short-term output will be narrowed further.

The weakening confidence is also evident in relationships between firms. Surveys of businesses show that their counterparts increasingly insist on additional conditions and reservations (prepayments, sureties or guarantees of third parties, etc.) when closing deals. The primary impulse of this lack of confidence has every chance of escalating into increasingly widespread practices. A firm that has faced increased distrust is likely to try to limit it by projecting the distrust onto its other counterparts to hedge its own risks in dealing with them. The environment of the kind represses the potential economic activity.

Another distinct channel of erosion of the institutional environment is the deteriorating perception by firms of protection of their rights, which is also clearly evident in business surveys. The quality of legal and law enforcement systems is often seen as a key criterion for the quality of public institutions and the business climate in general. Therefore, low confidence in the legal system may directly lead to weaker economic activity. Existing businesses would shift their focus to short-term strategies, since long-term projects begin to be viewed as too risky. A number of firms are considering the option of relocating their businesses, or have even started the process. For example, a few regions in Poland saw record high growth in registration of businesses from Belarus in 2020, and in some of them, our country ranked the first in terms of this indicator. The lack of guaranteed security of their rights restrains the inflow to the national economy of new businesses, which tend to contribute most to the productivity growth.

These long-term mechanisms (as opposed to short-term ones) and related challenges are characterized by high levels of inertia and it would be impossible to stop them quickly when their trigger is removed. For example, it usually takes a long time to restore confidence, e.g. in the national currency, the financial system, between firms. It would be possible to implement failed transactions and investment projects only partially at a later stage. A business that has migrated and/or been established abroad as an alternative to Belarus is unlikely to be ready to return to the country quickly. Thus, long-term losses are much easier to prevent than to mitigate post factum.

Background information

Nuclear power plant launched

The NPP is the greatest infrastructure project of recent years. The authorities expect it to contribute to diversifying the country's energy balance, reducing gas imports, as well as lowering the cost of energy consumed. However, the achievement of these effects and the general economic feasibility of the project have been questionable so far. The reservations are fueled by the risks associated with potential excess electricity, as well as the process of integrating the NPP into the country's power grid.

New packages of Western sanctions adopted

Western countries are responding to the political crisis in Belarus with stronger sanctions. Moreover, the economic component of the sanction packages is gradually increasing. This aggravates the unfavorable background and risks for the Belarusian economy.

Energy deals with Russia worsen the market conditions

Belarus has reached an agreement with Russia on the terms and prices of gas and oil supplies.

Based on publicly available information, the conclusion could be that, compared to 2020, the price of gas has slightly increased, and the conditions of oil supplies suggest an increase in the price relative to the world one in line with the logic of the Russian tax maneuver. This would slightly weaken the competitiveness of Belarusian producers, as well as result in further shortfalls of revenues from oil duties in Belarus' budget and probably give a new impetus to the growth of fuel prices in the domestic market.

The 2021 budget is adopted with a deficit

The consolidated budget revenues are expected to decrease to 27-28% of GDP in 2021 (against 30-31% in "boom" years). This is a result of further shortfalls of revenues from foreign trade and lower domestic tax revenues due to market developments, against the background of a cyclical recession. At the same time, the considerations of a positive fiscal impulse dictate the need to boost spending, while those of financial stability call for reducing it and avoiding a deficit. As part of this dilemma for 2021, the authorities are trying to find a fragile compromise, which they defined as a deficit of the consolidated budget of 3% of GDP.

Hikes of regulated prices and some tax rates, revitalization of directed lending

In an attempt to somehow address the sprawling conflicts between the goals and objectives of economic policies, the authorities are increasingly resorting to unconventional solutions.

The Government has adopted a program of action

The program declares the Government's intention to ensure accelerated economic growth. However, in a number of instances, the stated methods are insufficient to achieve it or are limited by the authorities' de facto ability/willingness to live up to their declarations. After all, the flaws and imbalances of the national economy would be exposed in this case. Therefore, this program is likely to suffer the fate of the previous one, with the most important and ambitious of the stated goals and objectives remaining no more than a declaration.

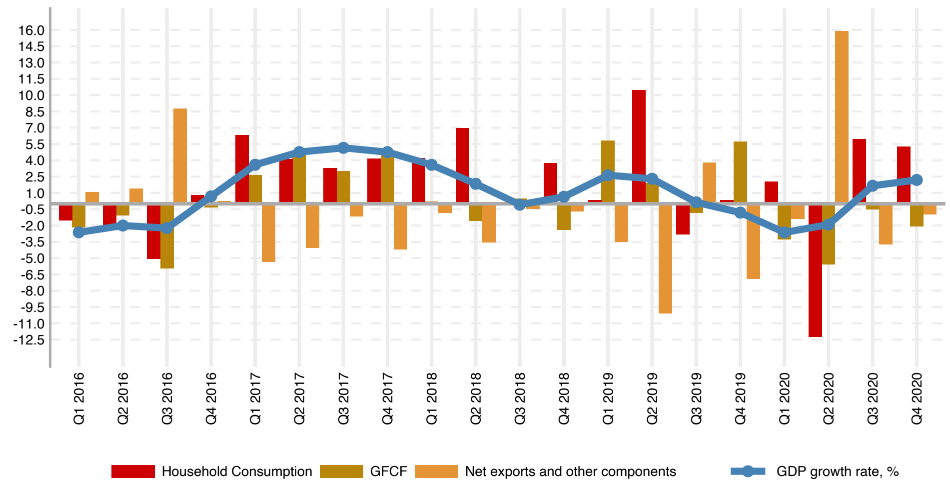
Output and demand

Household consumption continues to be the key driver of the GDP

Following its sharp drop in Q2, household consumption re-established its role of a positive contributor to the GDP and became the key factor in its positive demand-side evolution in the second half of the year. This occurred as real wages and cash incomes in general "broke away" from the evolution of output, showing steady growth. For example, in 2020, the average annual rate of change in output was negative—within the range of -0.2 to -1.3%—and the growth of real wages was within the range of 7-8%. Hence, it can be argued that incomes of the population were in a sense taken outside the general economic context and protected from its impact, being placed in an isolated reality. And that, in turn, has largely ensured the GDP growth recovery (through the consumption channel).

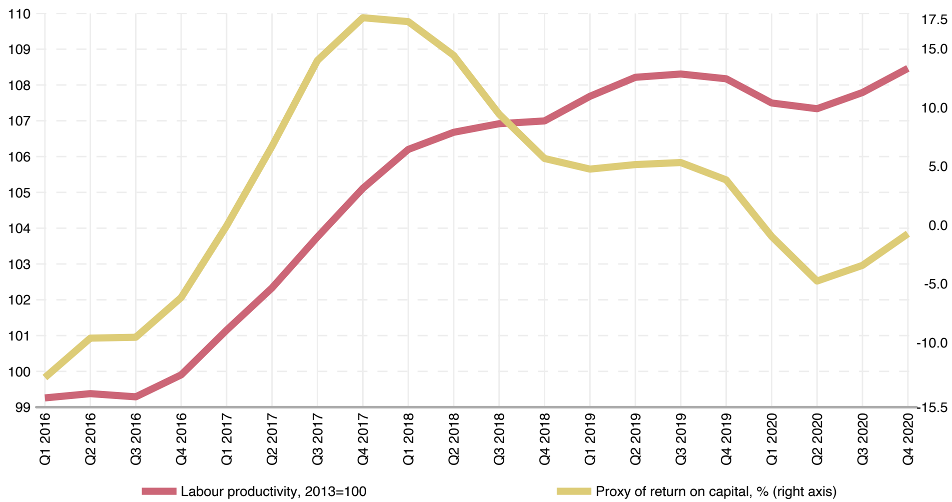
From the point of view of macro stability, this mechanism is fraught with excess domestic demand and the risk of external disequilibrium (deterioration in net exports). These threats are looming on the horizon, but the domestic demand is chilled by lower investments that has so far limited their relevance. However, the economy has to pay for this mechanism of supporting demand and output with revitalized financial threats emerging already today. For example, firms raising wages despite the economic conditions exacerbate their financial position and become a source of financial risks for the whole economy.

Contribution to output growth, percentage points



Note: The rate of the GDP growth and the relevant contribution of demand components are annualized quarter on quarter (with a seasonal adjustment); GFCF is gross fixed capital formation.

Quality growth indicators



Note: The proxy for the return on capital is calculated as a ratio of the annual average output growth to the share of GFCF in GDP.

Monetary sector

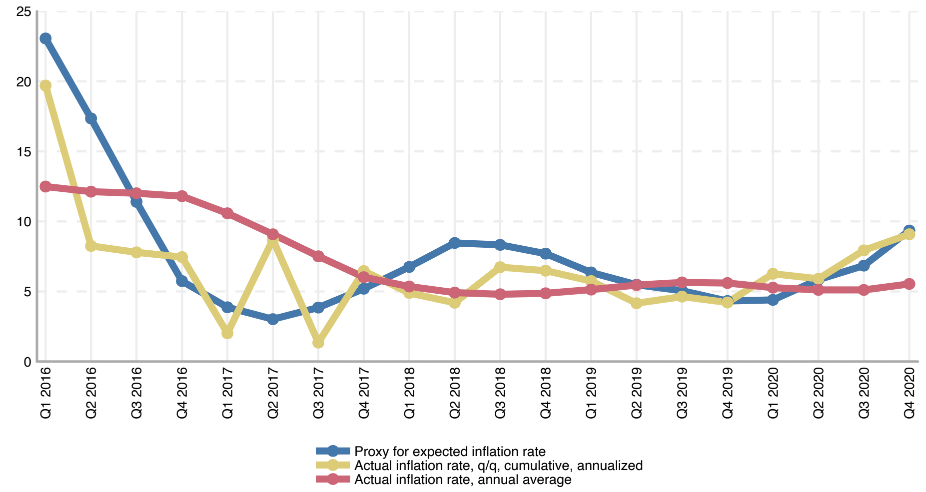
A surge in inflation and inflation expectations

There was a significant surge in inflation and inflation expectations in the second half of the year. Initial impulses of the accelerating price growth could be related to intensified injections of cash to the corporate sector using conventional and unconventional instruments in Q3 that helped maintain the excessively high rate of wage growth. The trigger for the rising inflation expectations was the political crisis. The combination of these trends “rocked” the lending and deposit, and the foreign exchange markets, giving a boost to exchange rate depreciation. As a result, the monetary environment changed in early September with rising inflation expectations and inflation mutually reinforcing each other.

Strengthening conflicts in monetary policies

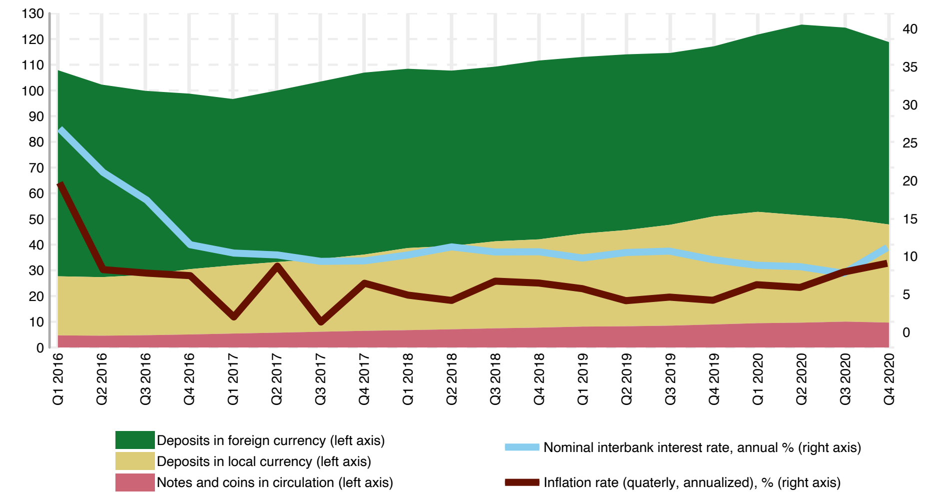
In the changed monetary environment, the National Bank faced significantly greater conflicts. To stabilize the financial markets and prices, it was essential to tighten its policies. To support the economic activity and financial stability, with a focus on the financial position of the state-owned sector, it was, on the contrary, critical to relax its policies. The National Bank tried to address the conflicts by resorting to practices that enable virtually manual regulation of bank liquidity and financial markets. However, this approach would only freeze the existing conflicts, at the cost of distortions in the functioning of financial markets and their segmentation. Therefore, it could only be a temporary solution at best.

Inflation and inflation expectations %



Note: The inflation expectations are calculated on the basis of the methodology developed by Kruk (2016). All the indicators are annualized in percent. The quarterly inflation is seasonally adjusted.

Interbank interest rate and monetary aggregates



Note: M3 components correspond to the scale M3 2015=100. All the indicators are seasonally adjusted in real terms.

Financial stability

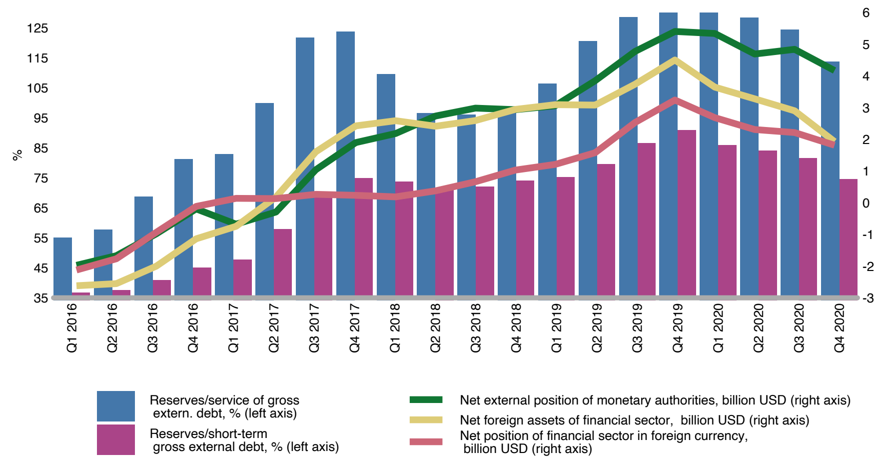
The foreign currency liquidity position deteriorated and became one of the financial vulnerabilities

In Q3, amid the political crisis, there was a sharp surge in demand for foreign exchange and withdrawals of foreign currency deposits increased. To counter that, the authorities stepped up their own external borrowings, as well as encouraged such actions taken by banks. By stabilizing the situation in this way, they hoped to weaken the incentives for increased demand for cash and outflows of foreign currency deposits. In Q4, these trends abated, but remained relevant. In addition, due to the outflows of foreign exchange from the financial sector in 2020—about USD 1 billion or 9% of all foreign currency deposits and about USD 2 billion of net purchases of foreign exchange by households—the foreign exchange liquidity remains constrained and turns into one of the financial vulnerabilities.

New loans to service old debts

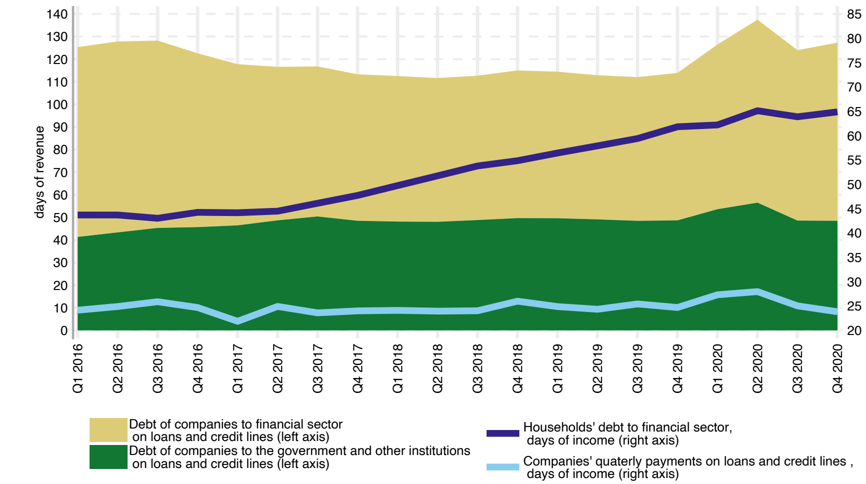
Against the background of disruptions and shocks in the monetary environment, the credit market was developing in jerks. Moreover, a significant part of lending was associated with unconventional instruments. They were in high demand because the amount of market-based lending in the current environment does not help maintain the liquidity of firms (state-owned sector). This is largely due to the high debt pressure in the state-owned sector and its demand for new injections of liquidity to repay and service old debts.

Foreign exchange liquidity indicators



Note: The indicators of reserve assets are as of the beginning of the quarter. The gross external debt service includes interest and principal payments for the previous 12 months. The net external position of the monetary authorities is calculated as the difference between the reserve assets and the costs associated with them over the coming 12 months.

Size and quality of private debt



Note: Companies' liabilities to the government etc. under loans are calculated as the difference between the total amount of companies' liabilities under loans and their liabilities under loans provided by the financial sector.

Fiscal sector

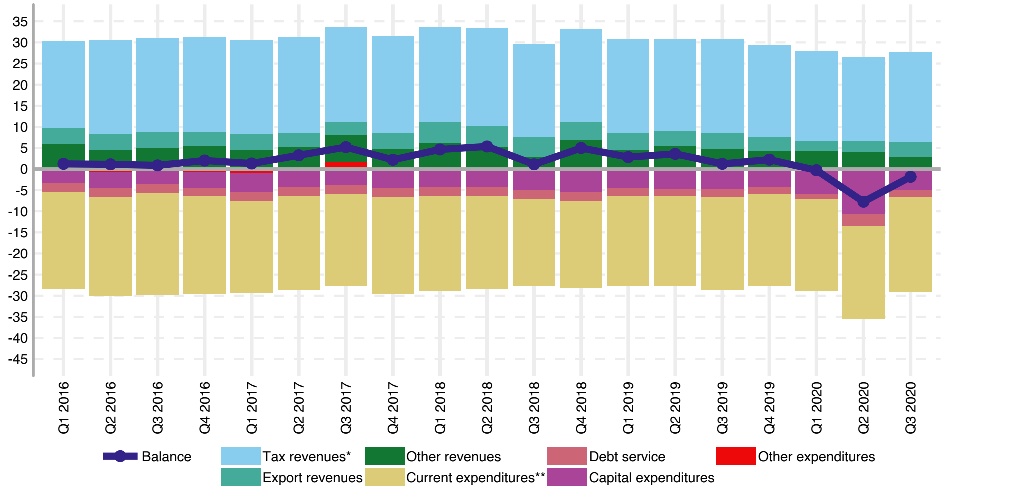
Getting used to fiscal constraints

Following the “COVID” Q2, revenues of the consolidated budget improved in the second half of the year. It was primarily due to a recovery in domestic tax revenues amid positive impulses in the economic activity. However, the revenues remained significantly below their level of 2018-2019. That was mainly a result of the long-term trend of lower revenues from foreign trade amid the Russian tax maneuver. As a result, the revenues were close to 28% of GDP, while the level the authorities “were used to” was 31-32% of GDP. But the budget spending was hardly affected by the revenue shortfall. Owing to the buffers accumulated in previous years, the authorities had some space for maneuver and preferred to maintain—and in some cases even to slightly raise—their spending in real terms to support the economy. However, as the accumulated buffers are spent, the deficit will become less acceptable and the fiscal space will narrow.

New debts to stabilize the foreign exchange market

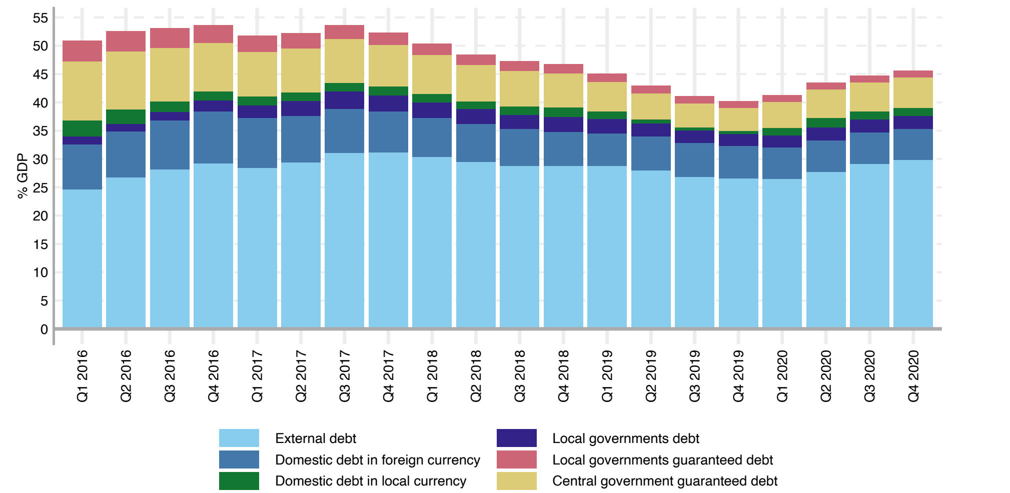
Against the background of the turbulent monetary environment and foreign exchange market, the authorities bet on new loans to stabilize the situation. Through their political efforts, they managed to mobilize loans from the EFSD and Russia—2 tranches of USD 500 million each. The new loans, along with the contracting dollar equivalent of the GDP, have reinforced and added persistence to the trend of the growing public debt burden.

Consolidated budget performance, % GDP



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

Public debt, %GDP



Note: Quarter average.

External sector

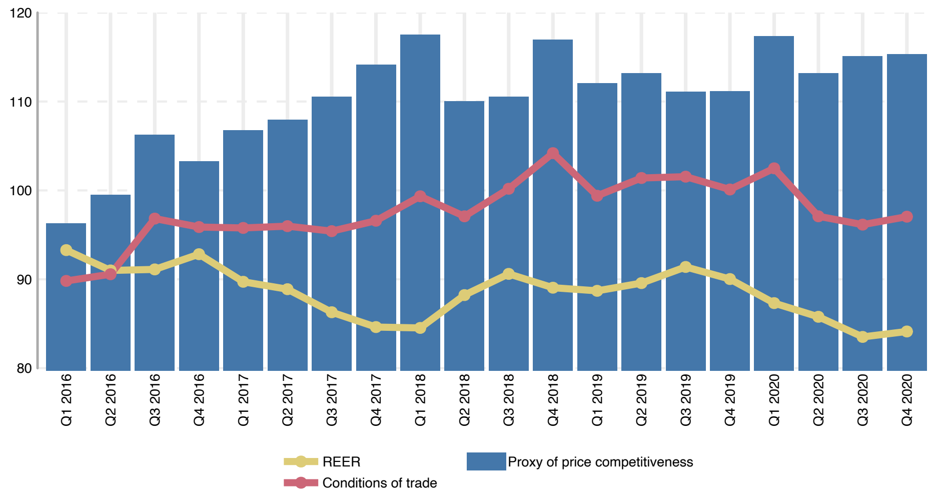
Frozen price competitiveness

In the second half of the year, the environment for the price competitiveness of Belarusian producers improved slightly compared to the “COVID” Q2. And it remained virtually unchanged in Q3 and Q4. In Q3, the depreciation of the real effective exchange rate made a more significant contribution to improving the price competitiveness. In Q4, on the contrary, there was some increase in prices, but it was offset by a comparable positive shift in the terms of trade (the ratio of export and import prices). The global conditions are likely to predetermine the synchronized export and import price movements in the coming periods. But domestic factors—the rising price of Russian oil and gas supplies—are likely to worsen the terms of trade. This could be a prerequisite for price competitiveness support at the expense of the exchange rate.

Recovery growth in the global economy

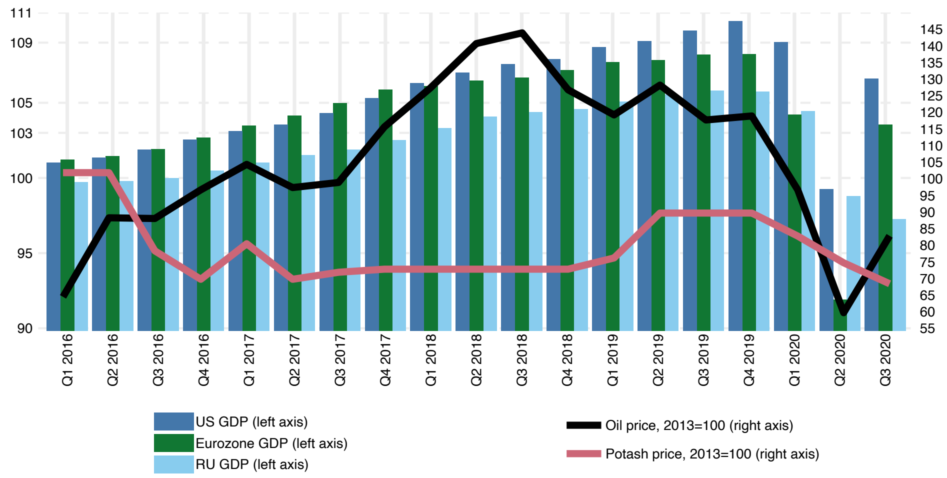
In Q3-Q4, almost all countries of the world experienced some growth recovery and the predominant expectation was that the COVID recession would be V-shaped. Therefore, forecasts of growth accelerating in 2021 prevail in the world. At the same time, a number of international institutions point to the likelihood of new shocks—up to a new wave of recession—as well as possible pockets of weaker growth (for example, in Russia).

External price competitiveness indices, 2015=100



Note: The price competitiveness index is calculated as the product of the terms of trade index and the reverse REER index, multiplied by 100.

Global economic indicators, 2015=100



Note: All the GDP series are seasonally adjusted. The commodity price indices are calculated based on the World Bank data.

External operations

The external position has significantly strengthened

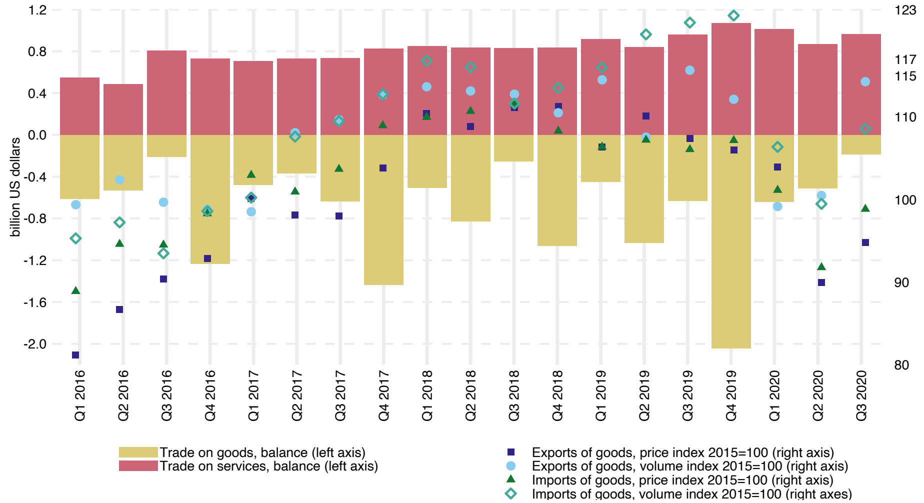
The post-COVID second half of the year was a period of substantial strengthening of the country's external position. With the terms of trade remaining fairly stable, this was a result of significantly better performance of physical volumes of exports compared to imports.

The export recovery has been almost comprehensive. The volumes of exports of many commodity items—food products, fertilizers, tractors, cars—significantly exceeded their pre-COVID levels. As to other major export items—trucks, ferrous metals, woodworking products—although the recovery was not full, they showed some positive performance. Against this background, exports of services did not follow the trend, showing a number of negative developments in the second half of the year. Imports of the prevailing majority of commodity groups recovered at a slower pace. The main explanation for that is the continued depressed state of the economy and, first of all, domestic demand for investment goods.

Fluctuations in the external financial environment

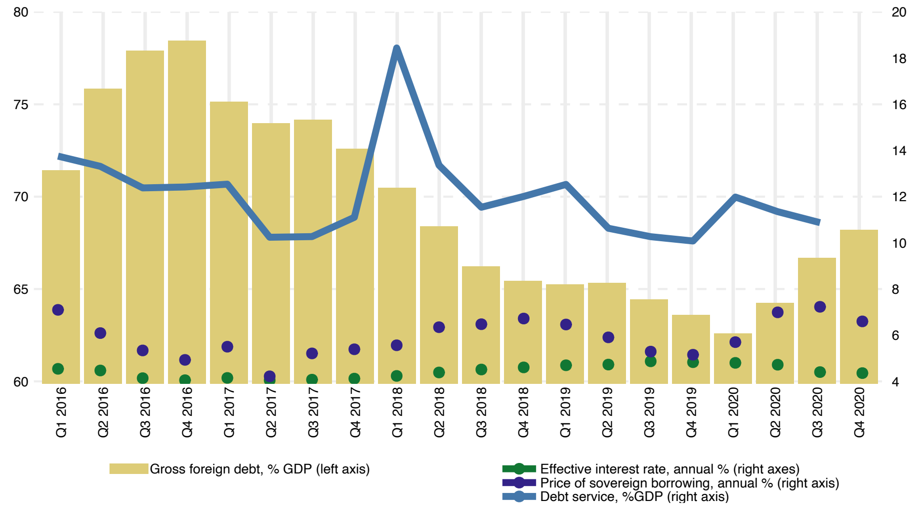
Belarus' foreign markets have also been affected by significant tensions in the domestic financial market amid the political crisis. The price quotations for Belarus Eurobonds dropped significantly below their par value in Q3. But the subsequent freeze of the domestic situation might have eased investors' anxiety and helped stop and reverse the negative trend.

Prices and volume of international trade, 2015=100



Note: PI – price index; PVI – physical volume index. The indices are seasonally adjusted. The balance of trade is not.

Volume and price of foreign borrowings



Note: Debt service data in % of GDP include both interest payments and principal repayments. The effective interest rate is calculated as a ratio of public debt interest payments over the last 4 quarters to the average public debt size over that period. The cost of sovereign borrowings is an estimate calculated as the average yield to maturity for all sovereign Eurobonds outstanding at the time of calculation.

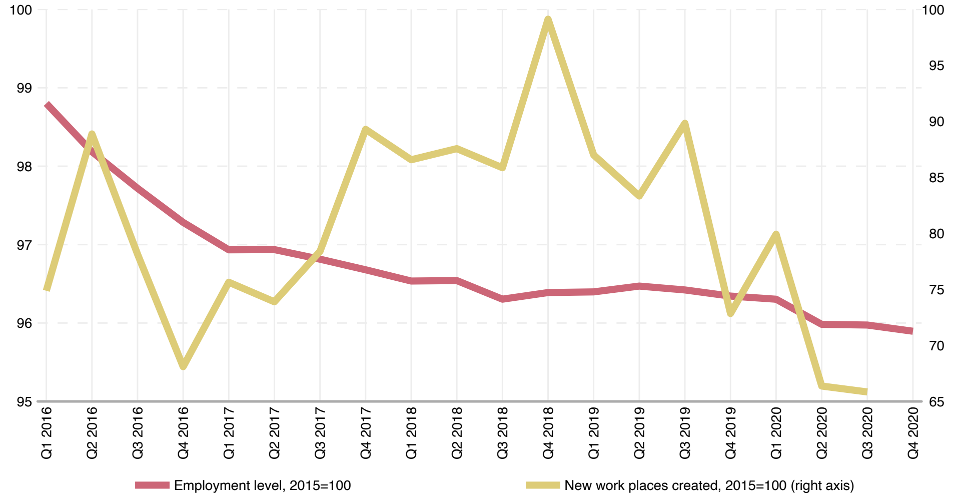
Social sphere

Wages are rising no matter what

In the second half of the year, there were prerequisites emerging for at least some meaningful slowdown in the growth of wages. Since mid-2018, their growth has noticeably outpaced the productivity growth. At the macro level, this leads to unbalanced growth of consumer demand and affects the evolution of prices. At the micro level, firms face inflated unit labor costs that limit their competitiveness. This challenge got aggravated during the peak of the coronacrisis in Q2. Therefore, even ex post containment of the growth of labor costs could be an important tool to restore the financial health of the corporate sector. However, the wage growth in the second half of the year slowed down only slightly, remaining close to 7% in annual terms. This forced firms to continue to manage their labor costs mainly through the size of employment, which contributed to its decline, with slight fluctuations in the unemployment rate (within the band of 4.0-4.2 %).

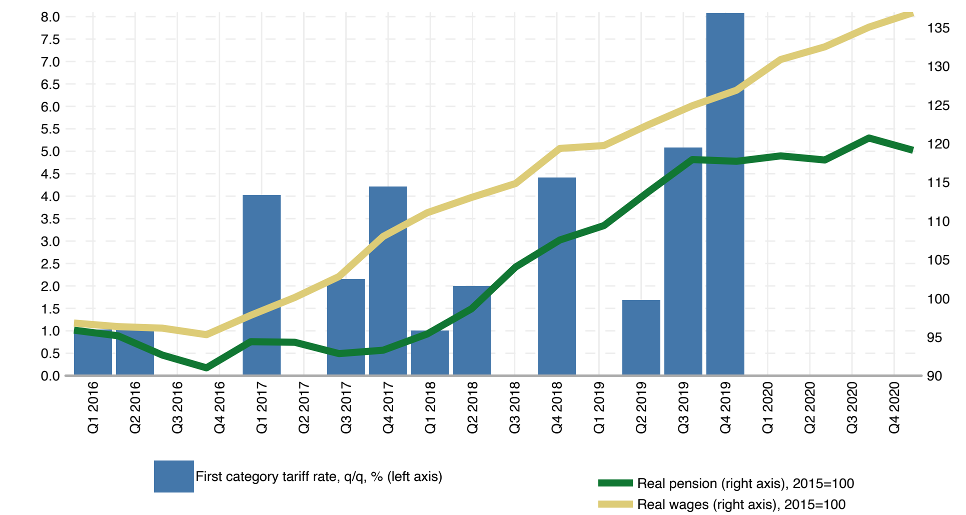
Pension benefits and other social transfers were raised in two steps, in July and in December. It helped regain the poverty rate of 3.4%, after its slight increase in Q2. But in subsequent periods, it will be harder for the authorities to smooth out income disparities. Against the background of the narrowing fiscal space—about 7% of the SPF revenues come in the form of subventions from the Government budget—it is difficult to support even some small nominal growth of social transfers. Moreover, in the current conditions, it is quickly "eaten up" by inflation—this is what happened in Q4.

Employment and new jobs, 2015=100



Note: The indices are seasonally adjusted.

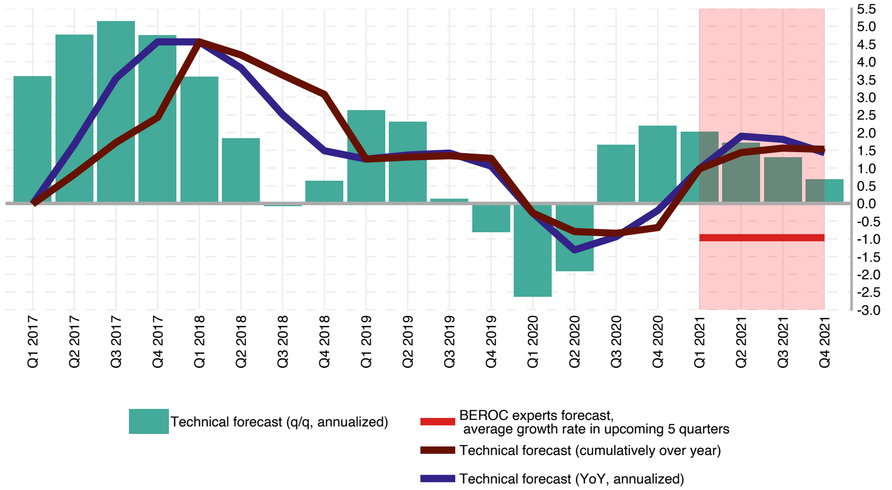
First category tariff rate and household income



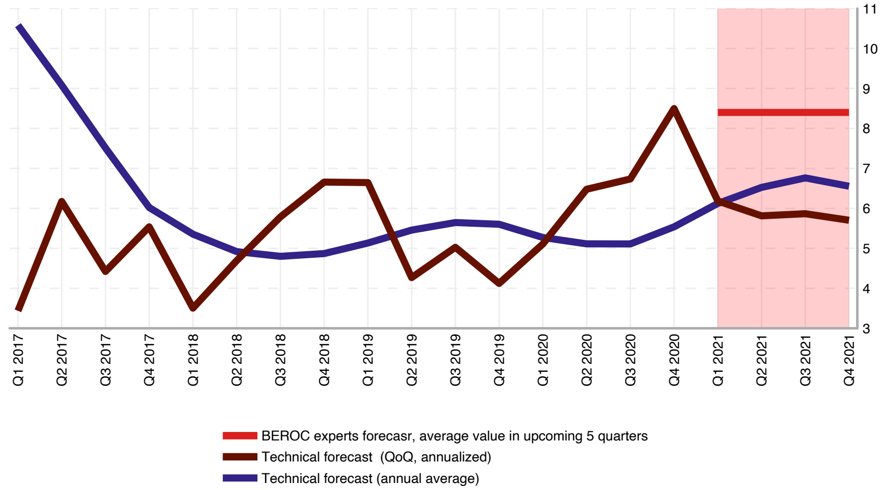
Note: The indices are seasonally adjusted.

Technical forecast

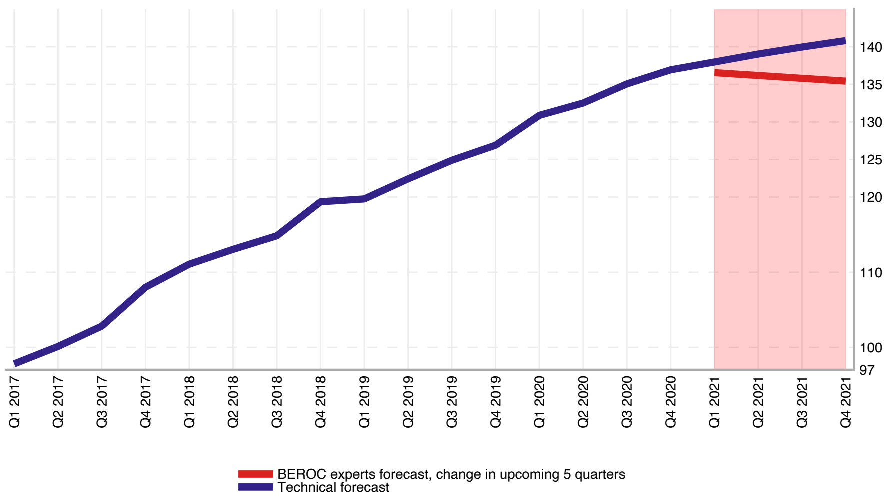
Output growth, quarter on quarter, % (annualized)



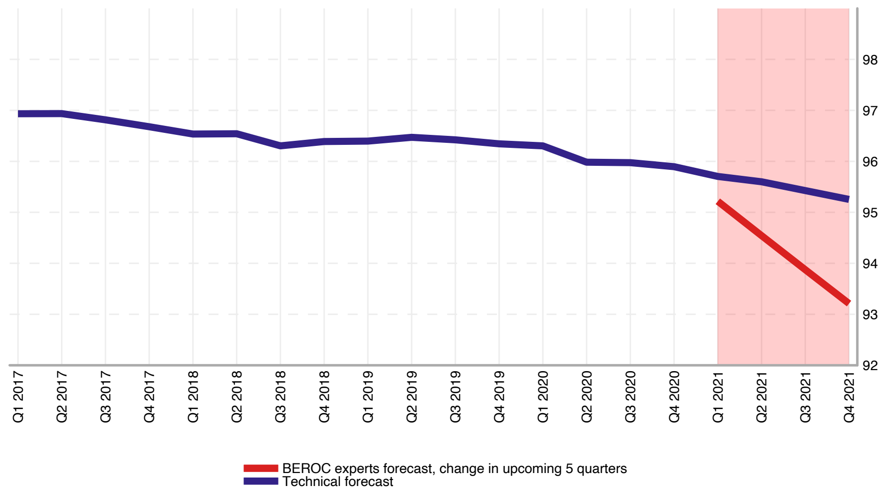
Inflation rate, annual average, %



Real wages, 2015 =100



Employment, 2015 = 100



The technical forecast is an automated procedure that selects the best specification of ARIMA model for a certain dataset based on the Akaike information criterion and employs this model for forecasting for 5 upcoming quarters. An ARIMA-based forecast just takes into account past trends of the selected indicator and doesn't consider other economic variables, either in the past or in the future. The term "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 to a particular indicator in the short-run, provided that the baseline scenario is applied, i.e. in case the fundamental parameters of the economic environment don't change, no exogenous shocks impact the economy, and fiscal and monetary policies remain unchanged compared to the current period?" BEROC's judgmental forecast shows the medium-term equilibrium of a relevant indicator, to which the latter would gravitate in the coming 5 quarters.

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National Statistical Committee of the Republic of Belarus (www.belstat.gov.by)

Ministry of Finance of the Republic of Belarus (www.minfin.gov.by)

National Bank of the Republic of Belarus (www.nbrb.by)

International Monetary Fund (www.imf.org)

R Core Team (2017). R: A language and environment for statistical computing. R Foundation for Statistical Computing, Vienna, Austria. URL https://www.R-project.org/.

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