Belarusian Economic Research
and Outreach Center

BEROC

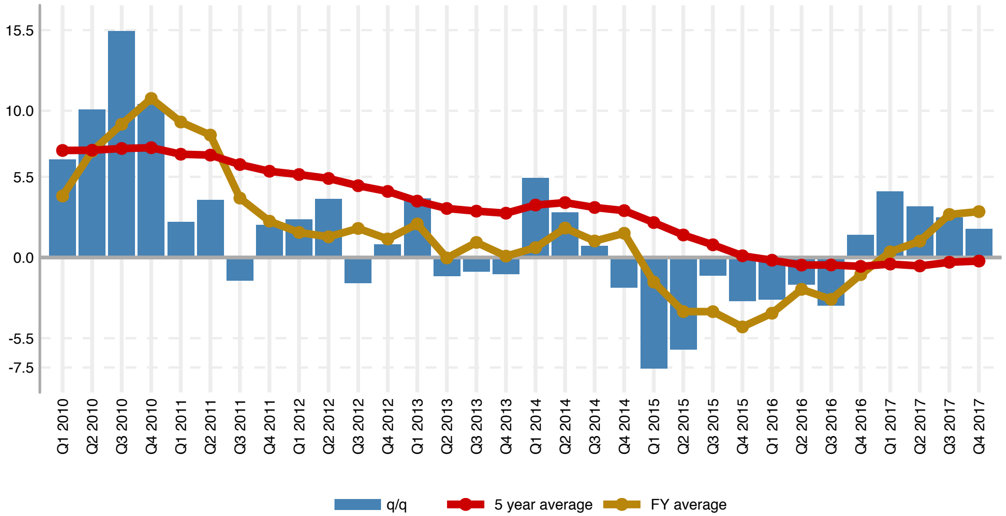
Economic Outlook

Fourth Quarter 2017

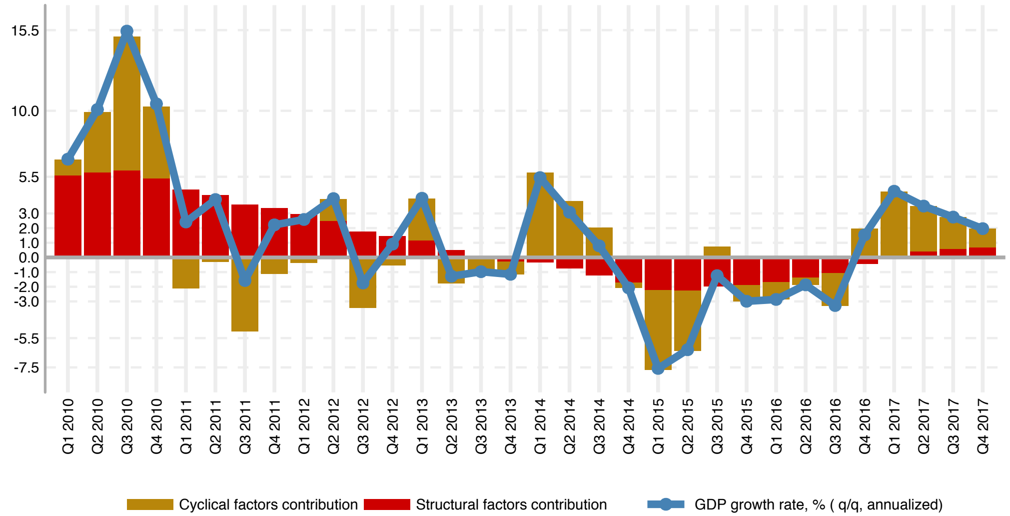
Expectations of Growth Acceleration Contrasted with its Fading

- Reemergence of domestic demand growth
- Inflation expectations have hit the rock bottom
- The external environment has improved, while the trade balance has deteriorated
- Consumer lending boom
- Firms have become more optimistic in the labor market
- Application of administrative tools has ensured an explosive growth of wages with an increase in income inequality

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

The inertial growth deceleration has continued. However, the favorable shocks observed in late 2017 have enabled a short-term surge in economic activity.

In the second half of 2017, the output growth tended to slow down. It points at the fact that the period of rapid recovery growth—following the recession of Q4 2014 – Q3 2016—is coming to an end. In the aftermath of such disturbances, on condition that there are no new shocks emerging, the economy should find a path of stable growth, with a rate of growth close to the medium-term equilibrium, which is estimated at 2-2.5% per year.

The available (preliminary) data on Q4 2017 output indicate that the growth continued fading away. However, the analysis of monthly output and other indicators of economic activity suggests that some prerequisites for a new round of growth acceleration started to emerge in late 2017. Therefore, the fourth quarter generally combined the inertial growth deceleration with emerging new factors for its acceleration.
The first of the factors worth highlighting is the world oil price growth (about 17% per quarter). The second is the real wage growth acceleration as a result of administrative stimulus, which led to consumer demand strengthening. The third one is the significant improvement of the economic sentiments of economic agents in the later months of the year—largely due to the first two factors. Expecting more orders, firms started hiring more employees, as well as lending and investing more actively. Hoping for higher incomes in the future, households were borrowing extensively, expanding their current consumption. Banks began to lend more actively, while bringing interest rates down, using their accumulated excess liquidity for these purposes.

These favorable shocks observed in the fourth quarter heated up the domestic demand, producing just a slight effect on the external demand. Due to the high import intensity of the domestic demand and the fact that its boosting mainly occurred at the end of the quarter, the new shocks had little impact on the output performance in Q4. However, they will change the evolution of economic indicators in the subsequent 1-4 quarters. But these changes may vary. If, in addition to domestic demand, the new shocks spur the external demand—for instance, if the demand for Belarusian exports in Russia strengthens in the context of faster economic growth in Russia on the back of higher oil prices—then the output growth will accelerate, with its rate exceeding the equilibrium for a few quarters. If it is only the domestic demand that is heated up, it will lead to the output growth acceleration for only 1-2 quarters. And this acceleration will result in higher pressure on prices and the exchange rate.
It is important to note that the new favorable shocks can only affect the short-term output dynamics. The most likely scenario for the medium-term perspective (4-8 quarters) is still that the economy would tend to move to its equilibrium trajectory (with the rate of growth of about 2-2.5%).

Informational background

Reversal to directed income policies

Despite the abundance of statements about the need to ensure average wages of BYN 1,000 by end-2017, for most of the year the economic authorities did not resort to active measures of artificial wage stimulation. Therefore, during three quarters of 2017, the growth rate of real wages and that of labor productivity were very close, while the level of real unit labor cost remained practically unchanged and was close to its equilibrium level.

In Q4, the situation changed: the authorities began to actively use both economic and policy tools to ensure wage growth. As a result, the annualized (seasonally adjusted) real wage growth rate amounted to about 30% in Q4. This giant leap generated a surge in consumer optimism and demand. But, its reverse side is the negative impact on price stability, the pattern of the exchange rate, the budget, and firms' competitiveness and profitability. If the jump in wages is a one-time "outlier" for Q4 and subsequently the authorities discontinue the practice of artificial wage stimulation, these negative effects will be insignificant and will wear off within Q1-Q2 2018. If wages are maintained at an artificially high level in 2018, the negative effect will strengthen, turning into a full-scale risk to price and external stability.

Presidential Edict on digital economy is adopted aiming to boost economic growth

In December 2017, the President signed the Edict "On the Development of the Digital Economy". According to the authorities, its main goal is to reorient Belarus' IT sector to the product model. This is expected to significantly improve the value added and the level of technical capacity. The decree introduces a wide range of benefits, special rights and preferential treatment for residents of the High-Tech Park. In addition, the Edict creates a legal framework for cryptocurrency and token emission and circulation, as well as ICOs in Belarus (through High-Tech Park residents).

The effects of the Edict are not yet obvious. The expectations of positive long-term effects are based on the fact that any progress in improving the level of technical capacity and integration of Belarusian firms into global value chains is beneficial for the country. However, the "price" paid in the form of benefits and preferences can be excessive in comparison with the generated effects. In addition, the focus on sectoral preferences could negatively affect the transparency and competitiveness of the business environment. In the short term, the decree can generate a favorable effect in the form of capital inflows into the country's IT sector. But it also bears a risk: a focus on cryptocurrencies and tokens could turn the Belarusian market into a platform for dubious transactions, and the corresponding capital flows may be excessively volatile.

Output and demand

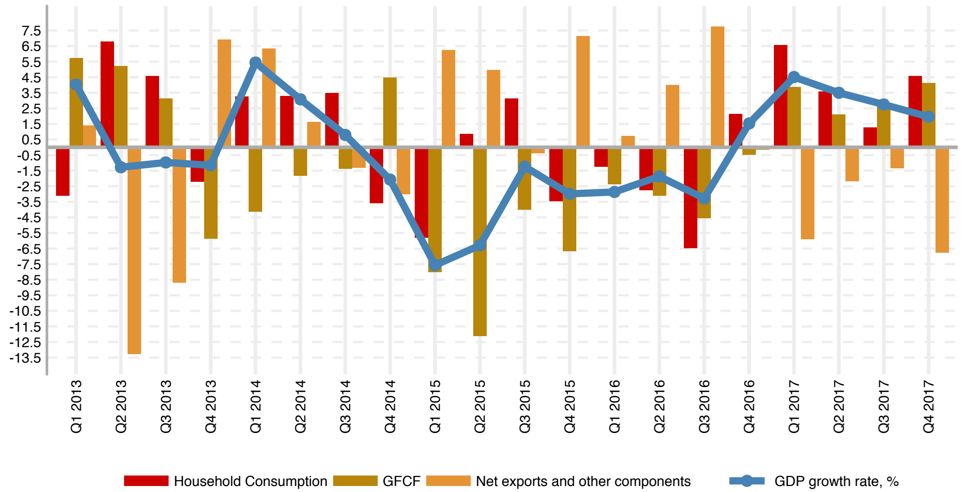
Reemergence of domestic demand growth

In Q4, there was a change in the household consumption trend: its weakening was replaced by a new wave of strengthening. That was caused by the sharp growth of wages, the stronger consumer optimism, and the accompanying explosive growth of consumer lending. As a result, consumer spending once again became the key demand-side driver of output growth. A somewhat lower contribution was made by the investment demand recovery. The new round of domestic demand growth has traditionally led to a comparable—from the point of view of contribution to the GDP growth—deterioration of net exports. It clearly demonstrates the specific feature of Belarus' economy: growth of domestic demand is no guarantee of comparable output growth in the economy.

Return on investment is stabilizing

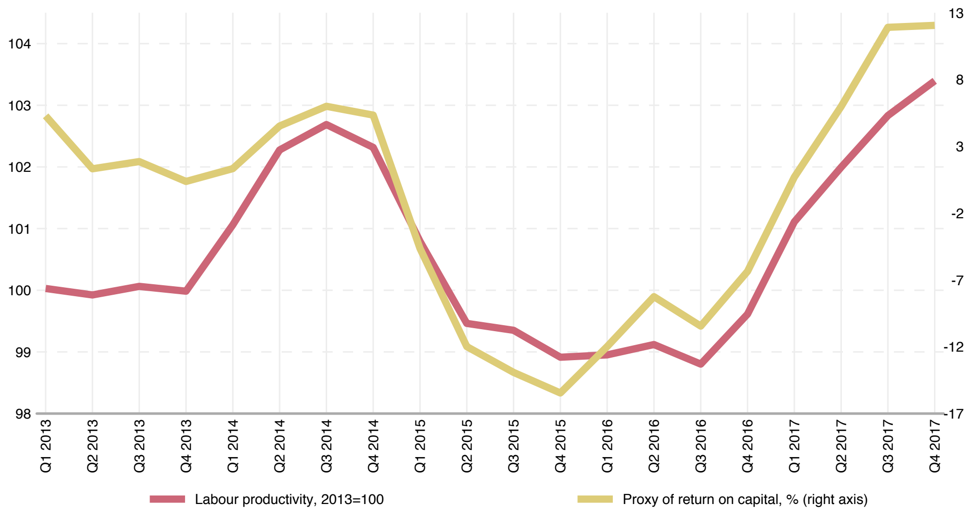
The investment demand growing for the fifth quarter in a row gives the ground to state that the long-term investment depression is over. Such depressions are often followed by extended periods of high (recovery) growth. A similar development was observed in Q3 and Q4, when the rate of investment growth was accelerating. In Q4, however, the return on investment stabilized against the background of higher volume of investments. This signals that the economy has found the optimal investment to GDP ratio. In this case, the accelerating growth of investments should be soon replaced with its deceleration, followed by a stabilization phase.

Contribution to output growth, percentage points



Note: The rate of 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

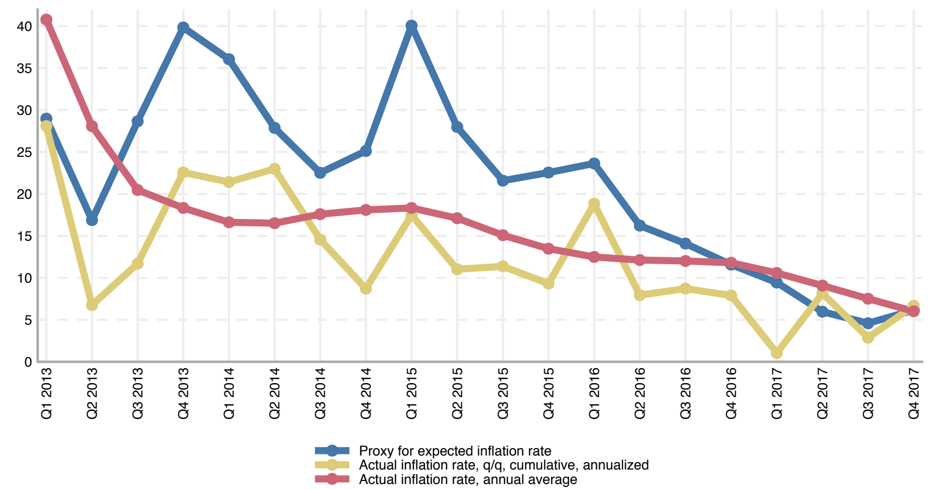
Inflation expectations have hit the rock bottom

In Q4 2017, there was an increase in inflation and inflation expectations. That growth most likely signals the end of a long period of disinflation and the emergence of an upward price pressure. The relevant impulses are, first of all, generated by the growing domestic demand. Secondly, the enterprises, whose prices are administratively regulated, are more actively lobbying for price increases, justifying that with their higher labor costs following implementation of directives on wage growth, as well as higher prices on imported raw materials. Thirdly, the process of household foreign exchange deposit conversion into BYN ones has started to fade away, while it used to work as a factor constraining inflation. In this context, unlike in the comfortable monetary environment of 2017, the National Bank would need to make stronger efforts to achieve its inflation target of no more that 6%.

Consumer lending boom

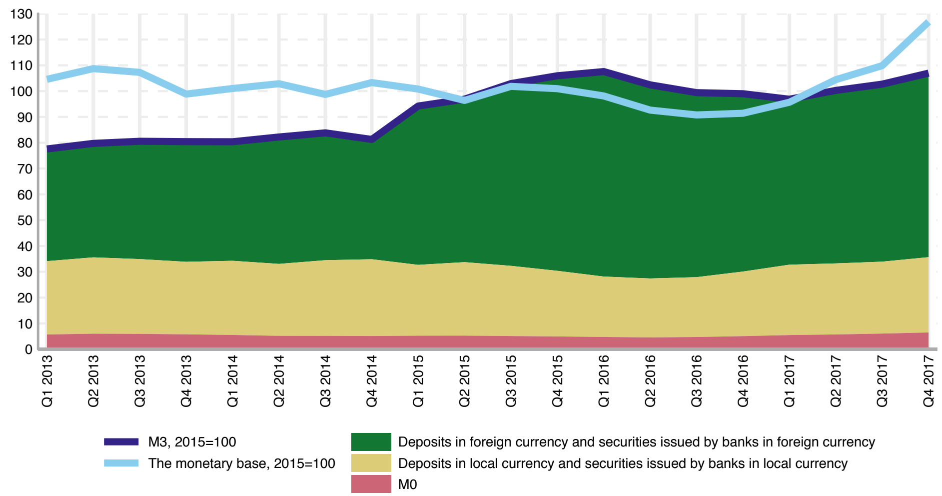
In Q4, as well as in Q3, banks' claims under loan agreements grew by about 13% (in annualized terms). That proves that, following the extended period of stagnation, the credit market has shifted to the phase of "heating up". The key source of this growth is the segment of households, where the situation could be described as a credit boom—the annualized rate of growth is about 37% in this segment. The upsurge in banks' lending has triggered the money supply growth, while the composition of money supply remains quite stable.

Inflation and inflation expectations %



Note: Inflation expectations are proxied by the difference between interest rates for new term deposits and call deposits of households. All the indicators are annualized in percent.

Monetary aggregates



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

Fiscal sector

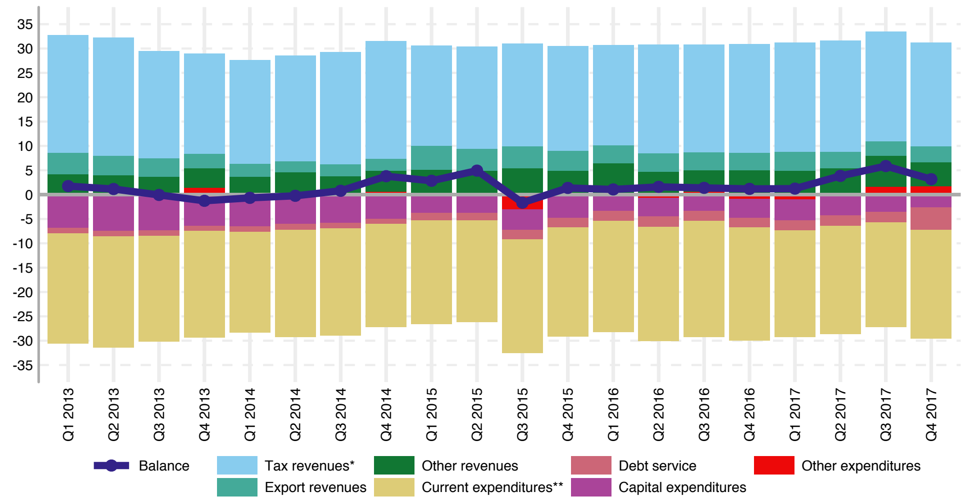
Financing higher public sector wages is a challenge for the budget

In Q4 2017, the budget was still executed with a surplus, which was, however, markedly lower compared to the two preceding quarters. The key reason for that was the increase in expenditures, most of which was related to payment of wages and salaries and payroll charges. The budget surplus declined significantly in Q4 despite the fact that the peak wage and salary payments were made only in one of its months (December). It shows that maintaining the expenditures on wages and salaries at a level close to the one registered in December might make the task of balancing the budget a serious challenge.

Public debt burden is declining

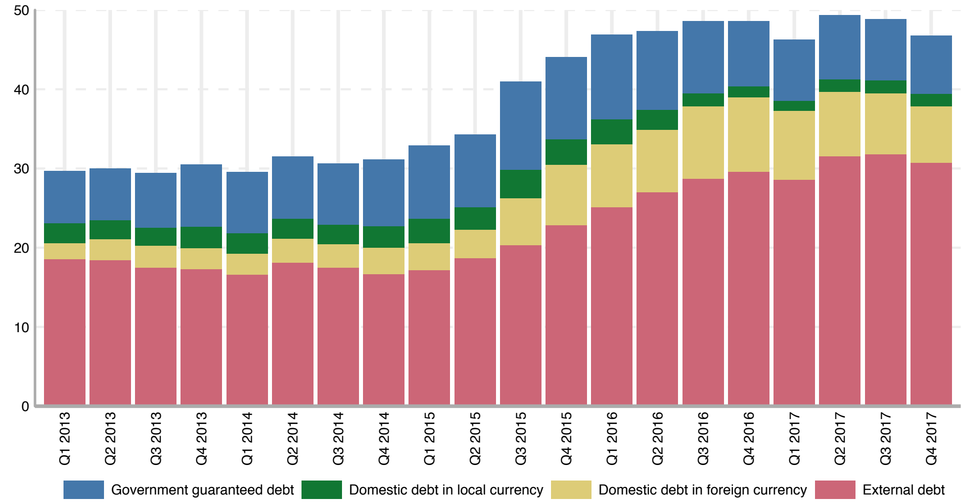
The public debt showed some growth (of about USD 122 million) in Q4 in absolute terms. In that period, the government mobilized USD 600 million—the key donors being the EFSD, the Government of the Russian Federation, and Chinese banks—and repaid about USD 200 million of its external liabilities, as well as about USD 300 million of domestic foreign currency-denominated government bonds. The continued trend of substituting domestic foreign currency-denominated liabilities with external ones could be associated with higher transparency in public debt management. In addition, a positive effect emerged in Q4 and is likely to remain for the short-term perspective: the key indicator of debt burden (public debt in % of GDP) declined in the context of GDP growth in dollar terms.

Consolidated budget performance, % GDP



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

Public debt, %GDP



Note: As at quarter end.

External sector

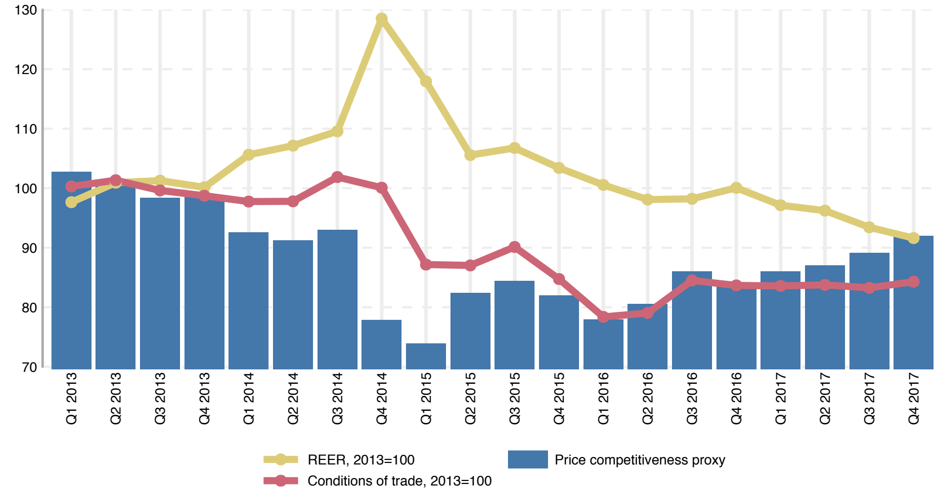
Improved external environment

The terms of trade (the ratio of export and import prices) improved for Belarusian firms slightly in Q4 2017. Combined with the remaining trend of smooth depreciation of the real effective exchange rate, it contributed further to improving the price competitiveness of domestic producers. This background seems to help mitigate the negative impact of the Q4 sharp wage growth on firms' competitiveness.

Oil prices have increased instilling optimism about growth in Russia

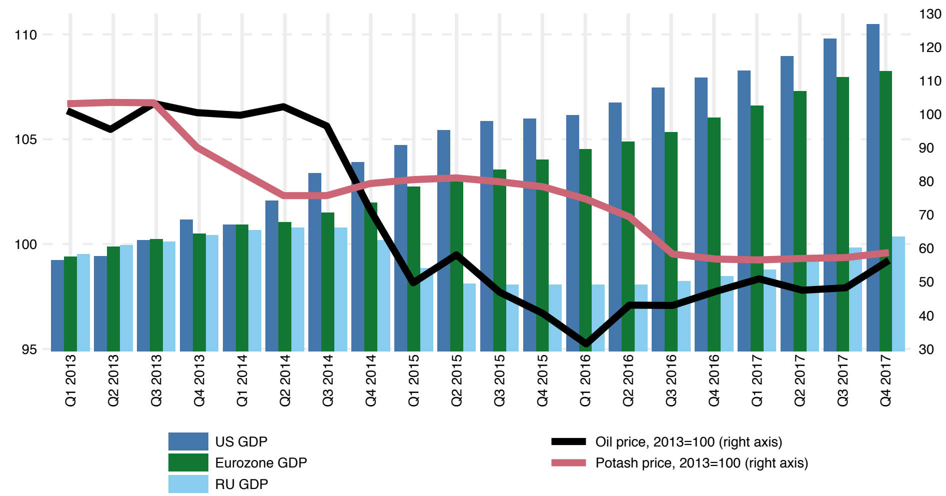
One of the key trends in the global economy in Q4 was the massive growth of oil prices by about 17% compared to Q3, which generated significant changes in Russia's growth agenda. The trends observed in Q3 and Q4 pointed at growth deceleration and, with a few caveats made, even some technical recession in Russia. At the beginning of the quarter, it strengthened the risk of a new round of recession. However, Russian economic agents have radically changed their sentiments and behavior in the context of the growing oil prices. Therefore, while the economic growth continued to be quite low in Q4 under its own momentum, its future prospects have markedly improved. Against the background of the remaining strong growth of the global economy and growing prices for other commodities, it has improved the external context for the Belarusian economy.

External price competitiveness indices, 2013 = 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, 2013=100



Note: All the GDP series (left-hand side) are seasonally adjusted, measures with an index of 2013=100. The commodity price indices are calculated based on indicators from the World Bank Global Economic Monitor database.

External operations

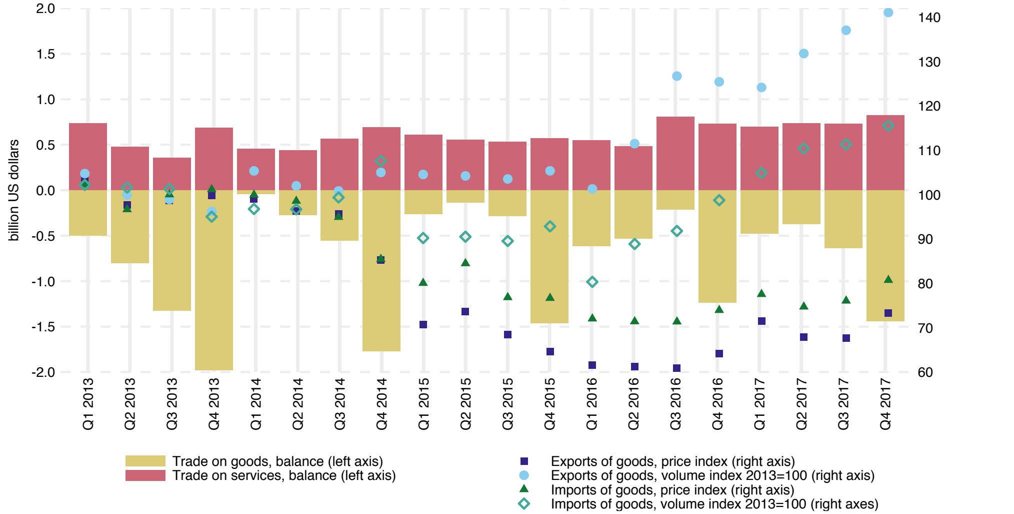
Export growth has slowed down, import growth has accelerated, trade balance has deteriorated

Supported by the more favorable external environment, the physical volume of exports continued growing, reaching another all-time high. But its (annualized) rate of growth has somewhat slowed down, declining from 17% in Q3 to 12% in Q4. However, the growth of the physical volume of goods imports accelerated compared to Q3, shifting from 3% to 16% on the back of the domestic demand upsurge. That resulted in worsening of the balance of trade in goods (including, the seasonally adjusted indicator), which, combined with the stable surplus of the trade in services, also implies a deterioration of the overall trade balance. That created a new old status quo in foreign trade. The import growth could be off-set with comparable export growth. However, it is getting increasingly difficult to generate it, as the demand for many commodity items is saturated, while the access to new markets is hindered by the weak non-price competitiveness.

Belarus' external borrowing cost is close to its historic lows

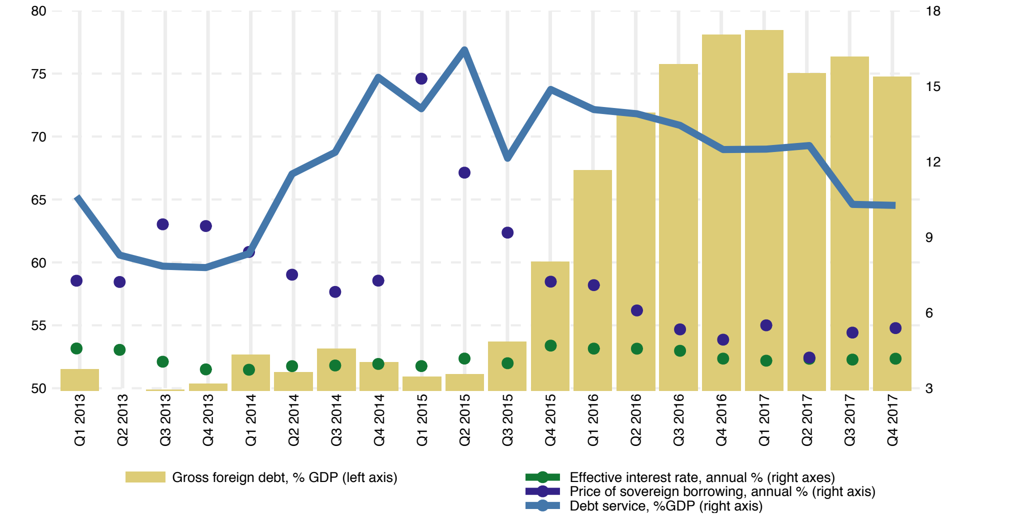
The external borrowing environment remained favorable for Belarus in Q4: the interest rates were close to their historic lows, while the debt burden was declining. This egged the economic authorities to brisk up their work on issuing a new sovereign Eurobond in Q1 2018.

Prices and volume of international trade, 2013=100



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

The volume and price of foreign borrowings



Note: The debt size is as at the quarter start. 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

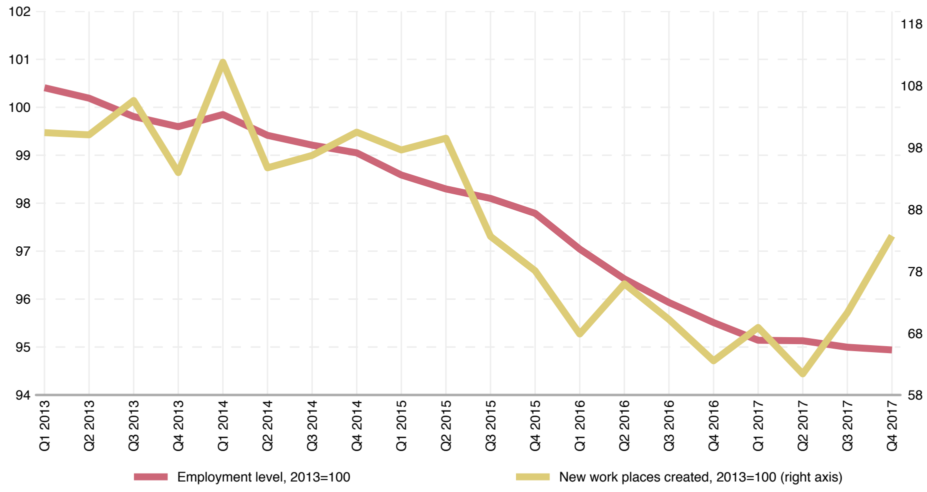
Firms have become more optimistic in the labor market

In Q4, the trend of the growing number of new jobs strengthened. It shows that firms are optimistic and tend to think that the stage of adaptation to the new macro environment through employment adjustment is over. It is likely to lead to stabilization of the employment rate in the coming periods. However, it does not mean that the issue of unemployment is off the agenda. The actual unemployment rate has declined insignificantly compared to the previous year, moving from 5.8% in 2016 to 5.6% in 2017. Moreover, it is markedly higher in certain regions: for instance, according to the census results, the unemployment rate in Molodechno rayon is 9.1%.

Administrative pressure has resulted in wage growth and higher income inequality

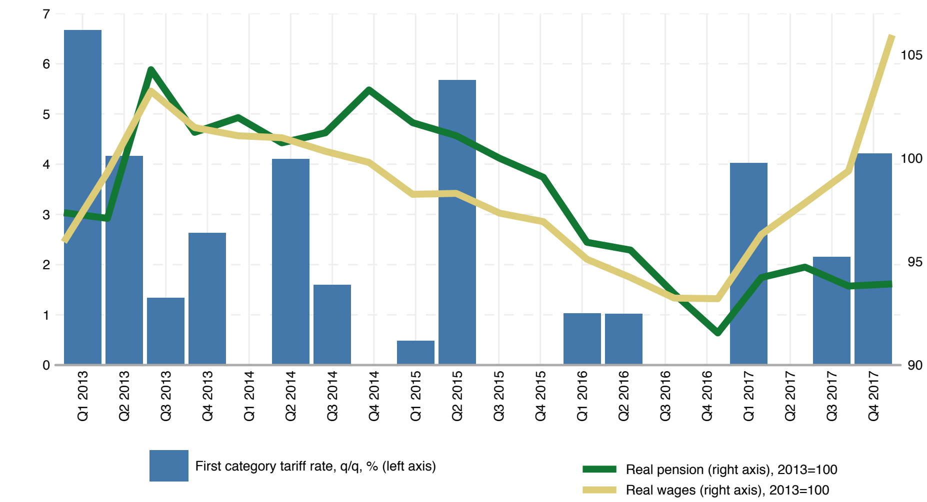
The stimulation of wage growth through application of administrative tools helped achieve the proclaimed goals: the average nominal wages nearly reached BYN 1,000 in December, which was accompanied by a sharp increase in real wages. However, the distribution of benefits of the explosive wage growth was far from even. In the context of the deemed tight budget constraints, “rich” industries, which offered already relatively high wages, managed to demonstrate the highest wage growth. That resulted in stronger income differentiation, although the poverty rate did not change, remaining at 5.9%, which is identical to the Q3 level.

Employment and new working places



Note: The indices are seasonally adjusted.

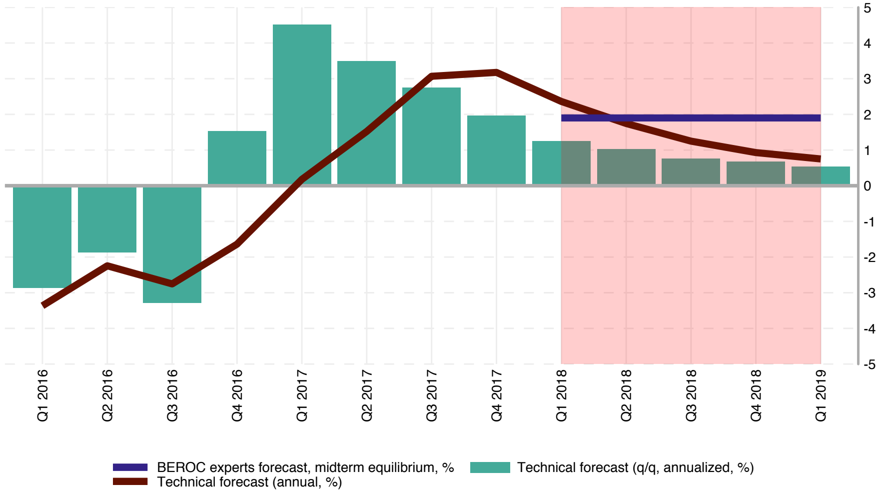
First category tariff rate and households income



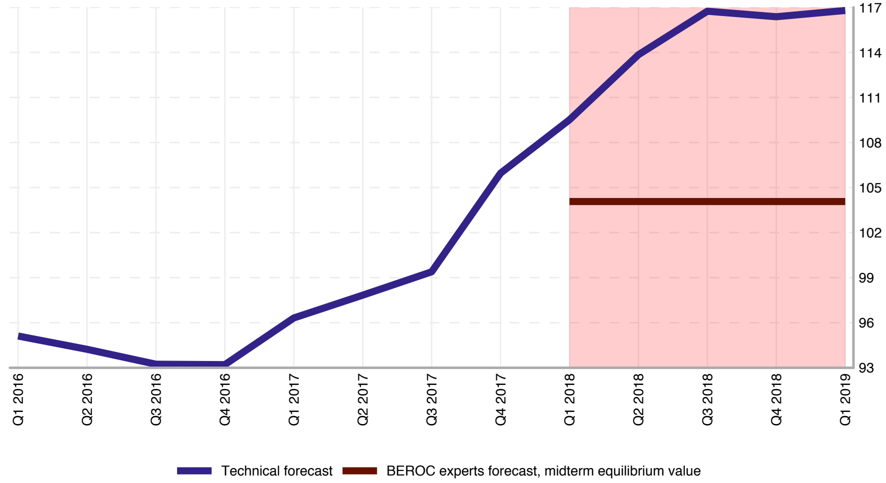
Note: The indices are seasonally adjusted.

Technical forecast

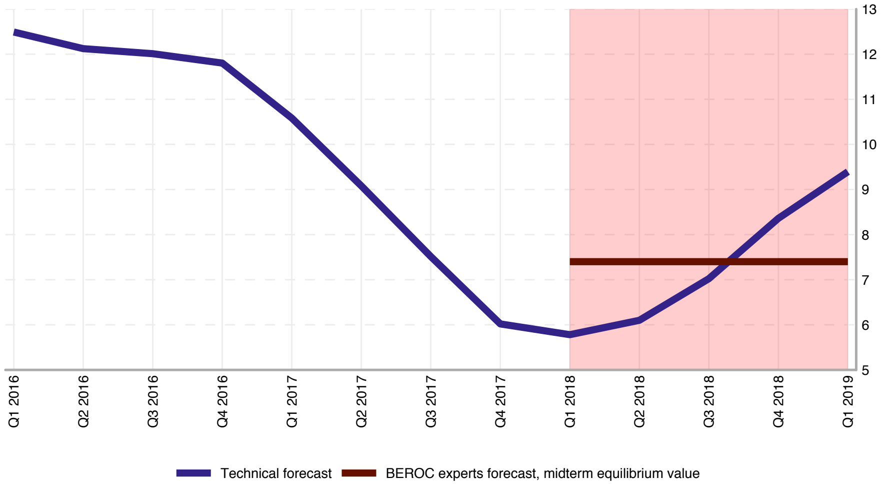
Output growth, quarter on quarter, % (annualized)



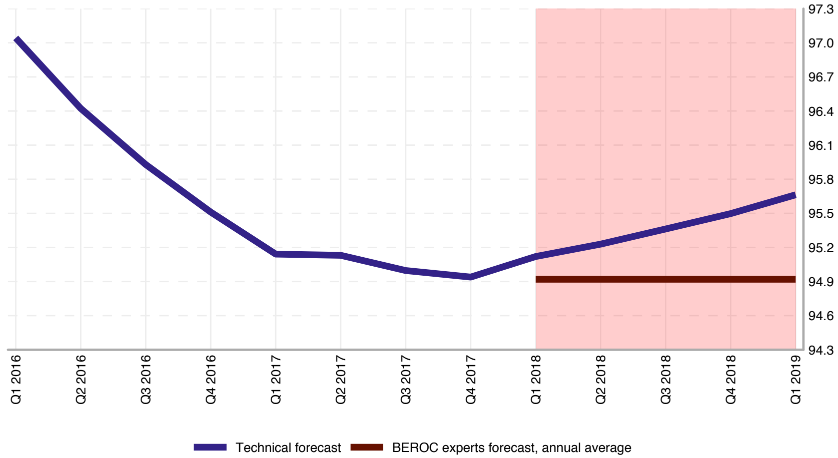
Inflation rate, annual average, %



Real wages, 2013 =100



Employment, 2013 = 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 as well?" BEROC's judgmental forecast shows the medium-term equilibrium of a relevant indicator, to which the latter would gravitate in the coming 4-6 quarters.

This publication is published under the editorial responsibility of **Dzmitry Kruk** and **Dzmitry Kolkin.**

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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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