VTB Capital

Macro

19 February 2016

Views

Belarus Sovereign Credit

A look into 2016

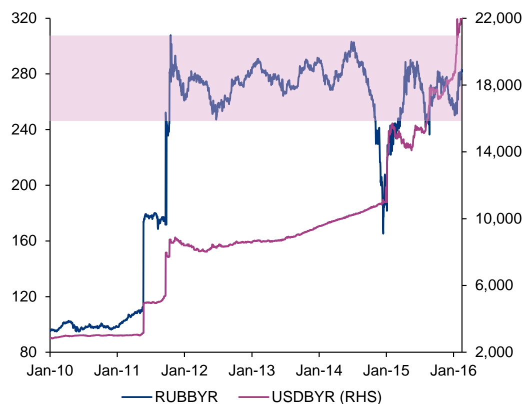
Belarus is in recession. In addition to the regular cyclical component (neither oil nor potash is doing well, nor is there growth in key trading partners), the negative GDP dynamics entail a significant structural factor, in our view. This is all the more important given that this recession is, formally, the first in 20 years. As a country with a traditionally very high investment ratio, and where the role of the state in directing and funding capital spending is paramount, Belarus is unable to afford this any longer.

The authorities have been having an ever more intensive debate about economic policy, and that is finding its way into public domain more vividly than in the past. The necessity to adjust policy is putting a lot of pressure on the way the government and the economy operate. In our view, the near future holds for Belarus if not privatisation (which no longer features as part of the conditionality in the official financing packages currently under discussion), then at least a highly elaborate enterprise reform. Under-appreciated in the past, the peculiarities of Belarus' enterprise governance have always introduced significant distortions into macro policies. Indeed, they have been *the* reason why, for example, the efforts to contain wage growth tended to fail, or why output/inventories/the trade balance have all been less sensitive to FX realignment than might have been assumed.

Both fiscal and monetary policy are set to be contractionary in 2016, while their longer term efficiency remains hostage to frequently conflicting constraints. On the fiscal side, still large surpluses are an artefact stemming from the 'below-the-line' treatment of debt repayments (a much better indicator of fiscal pressures is the first ever noticeable Pension Fund deficit). Contingent liabilities are likely to come to the fore, given how important domestic government guarantees were in the past. On the monetary side, the key challenge for the NBRB is dealing with high dollarisation and people's very FX/interest rate sensitive behaviour, as well as protecting thin FX reserves. All of this makes the transition to monetary (and then inflation) targeting much less straightforward.

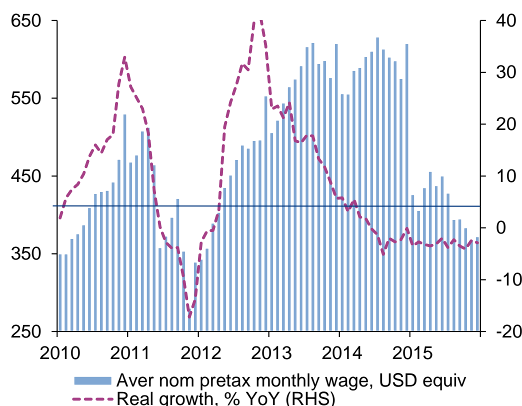
Yet in terms of willingness to pay, Belarus remains as disciplined as ever and in 2016 both the market perception and access to official / market financing are becoming more favourable. Western sanctions against the country's leadership have finally been lifted, and the chances of Belarus securing new EFSD (ACF) financing are strong, in our view. With regard to the IMF programme, the President's remarks at this week's meeting with the government suggest a more protracted negotiation period than expected before, we think. Together with the 'earmarking' mechanism for export duties on crude oil and products, as well as a greater 'diversion' of domestic FX savings away from banks and directly to the government's coffers, we think securing the requisite volumes of financing for Belarus this year is a less stringent task than in 2015.

Exchange rate dynamics



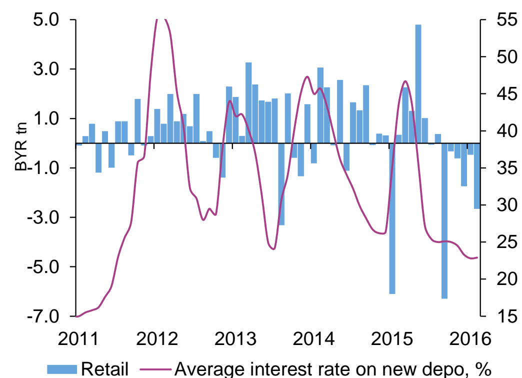
Source: Bloomberg, VTB Capital Research

Average nominal and real wages



Real growth in BYR deflated by CPI. Source: Belstat, VTB Capital Research

LC retail deposit monthly dynamics



Source: NBRB, VTB Capital Research

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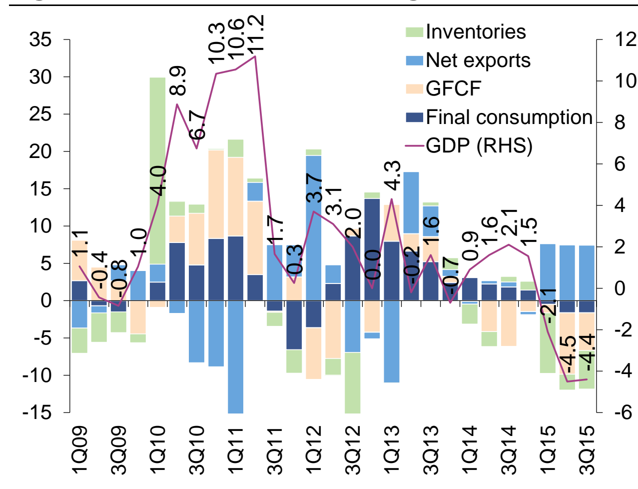
Structural issues

Belarus has changed from what it was just a little more than a year ago. At the end of 2014, comprehensive price controls were introduced under a decision by the Cabinet of Ministers (following the massive spillover from Russia), the NBRB was still spending reserves in order to protect the overvalued currency and to micro-manage the FX market, lending to state-owned companies was growing in double digits, the ACF programme had gone off track and there was little hope of bringing the IMF back to Minsk. Later in the year, however, most prices were liberalised, the exchange rate was allowed to float properly, the government stopped issuing new guarantees, strict credit rationing was introduced and relations with official lenders were put back on a normal footing (although interest rates are still under strict control).

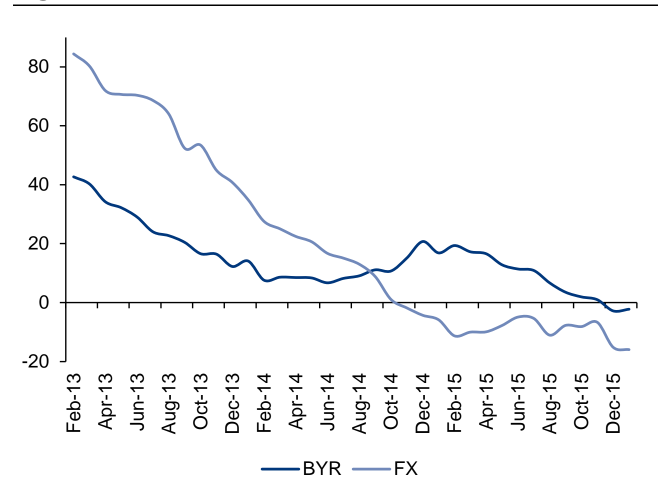
Is Belarus' economic model really undergoing significant structural changes? It is certainly not the first instance when the authorities, overall, have been willing to follow the policy advice of official lenders more closely. There have been occasions, though, when the country backtracked from the course of action suggested. However, it ended up paying a high price for doing so. And the common attitude we see nowadays among technocrat-level policy makers in Minsk is that more orthodox steps is the only way to go.

Figure 1: GDP contributions and growth, YoY %



Source: Belstat, VTB Capital Research

Figure 2: Gross loans to state-owned firms, YoY%



Source: NBRB, VTB Capital Research

Not only is the debate about economic policy intensifying, but it is also finding its way into the public domain more so than in the past. If, previously, the publicly-observable side of the debate was first and foremost concentrated within and around specialised non-government think-tanks, what is different now is that the call for reforms is also starting to be heard publicly from high-level officials[1]. Yet the signals we are seeing from Minsk do not, as of yet, convey the message of a fully coordinated and consistent set of policies to be implemented not only in 2016, but also beyond. Figuring out what they will look like, it seems, remains largely a work in progress.

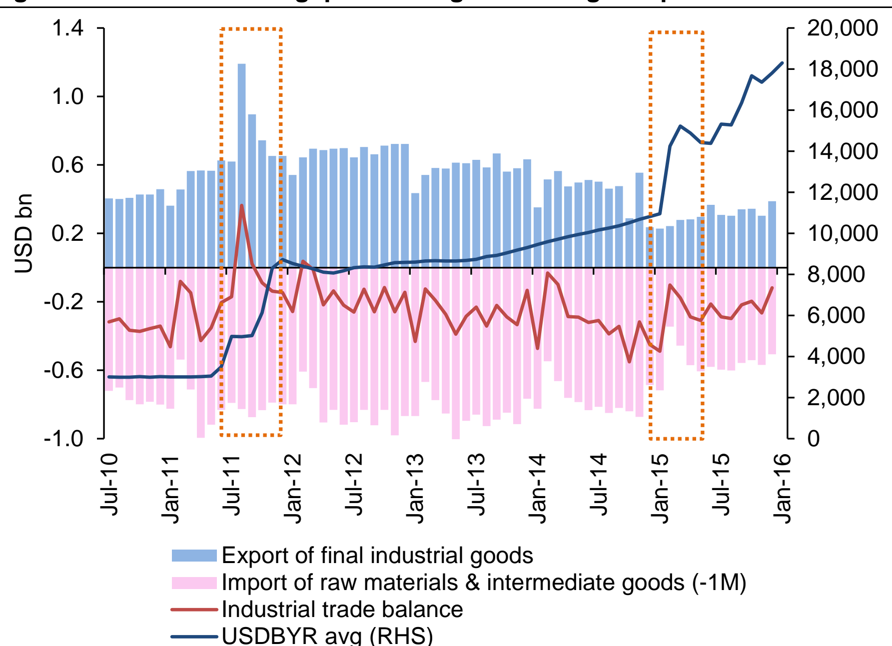
There are many dimensions to what could be called the 'structural reforms' for Belarus. To take just one, the authorities have agreed both with the IMF and the EFSD (formerly known as EurAsEc Anti-Crisis Fund) to limit the volume of LPG (loans under government programs; measured by turnover of new loan origination) at BYR 28tn in 2016 and BYR 20tn in 2017. True, Belarus' experience with LGPs has in the past been a very uneven one; but if this agreement is finally (and fully) implemented, that would represent a massive contraction from the BYR 44.2tn in 2015. Although not formally a part of the budget expenditures, LGPs were a key economic policy instrument at the government's disposal. Cuts in LGPs would therefore continue to have a negative impact on investments, as would ongoing budget consolidation and

[1] See, for example, *Financial Diet: Belarus Public Finance Reform*, co-authored and edited by Kirill Rudyi, President Lukashenko's economic aide, which has just been published in Minsk (only available in Russian).

very tight monetary policy. There is a certain lack of clarity as to whether the Development Bank will become the sole operator of the remaining LGPs this year; our view is that it is more likely than a continuation of the current practice. [2]

The commitment to limit the issuance of new domestic government guarantees which, alongside interest rate subsidies, customarily accompanied LGPs (so that the outstanding volume remains unchanged), reflects the same tight course of fiscal policy and can only be welcomed from the structural point of view, given the many distortions generated by LGPs. Currently, there is BYR 43tn of domestic guarantees outstanding (5% of GDP). The number is somewhat down from the peaks of mid-2015, following the conversion of USD 700mn equivalent of domestic guarantees issued previously against the debt of several wood & furniture works and a glass works into outright government debt. Whether or not there are more such 'bailouts' to come is difficult to say; not all of the LGPs in the past were doomed to become an NPL, and most 'guaranteed NPLs' originate from the agricultural sector, which has been massively funded in the past with the support of government guarantees. The Development Bank is to be spared from taking control of those; there is a new and separate agency being created to tackle agricultural sector exposure which is officially deemed 'consistently non-performing'.

Figure 3: Industrial trade gap excluding oil refining and potash



Dotted areas show periods of quickest depreciation. Source: Customs office, VTB Capital Research

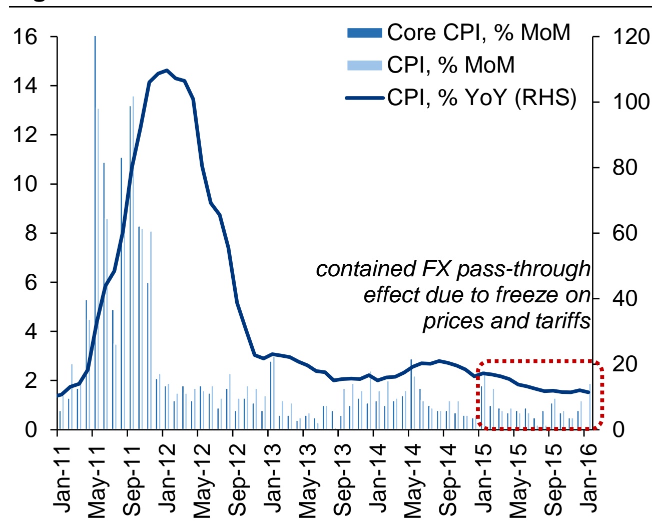
In terms of privatisation, it is difficult to expect any significant change – it seems unlikely to us that any major asset is going to be sold this year (or in future years). We understand that the staff-level agreements with either the Fund or the EFSD do not include any target on privatisation. This is the major difference with the previous programmes in 2009-10 and 2011-13 and, in a way, is a move towards greater realism in programme modalities.

If not privatisation, than at least a highly elaborate 'enterprise reform' awaits Belarus in the near future. Frequently under-appreciated in the past, the peculiarities of corporate governance have always been a significant distortion for macro policies. Indeed, they are *the* reason why efforts to contain wage growth tended to fail, or why output/inventories/the trade balance have all been less sensitive to FX realignment than might have been assumed. (As Figure 3 shows, the industrial part of the

[2] There are two different sets of government-approved investment projects in Belarus every year. One is the 'state investment programme', which is directly funded from the budget and is much smaller than a variety of other (usually sector-based and multi-year) programmes that are funded by banks through LGPs under government guarantees and interest rate subsidies. For 2016, the 'state investment programme' is approved at BYR 4.5tn; the Cabinet of Ministers' resolution on LGPs, which typically contains a detailed breakdown on bank-by-bank and project-by-project LGPs plans, has not yet been adopted for this year.

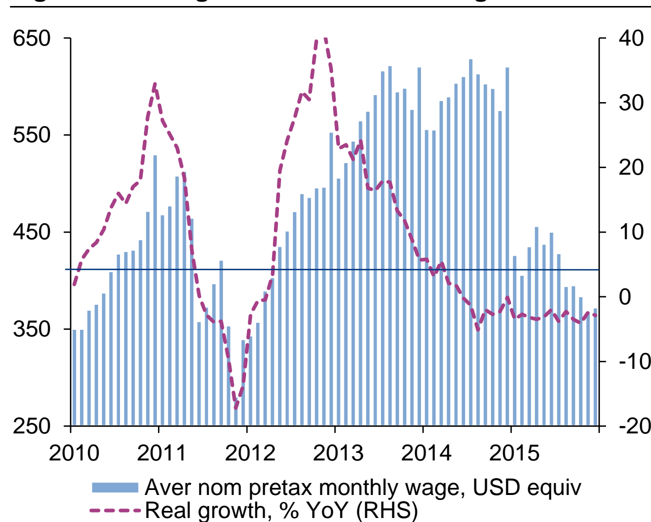
economy away from the oil refining trade and the potash business has in the past burned the same volume of FX, irrespective of where the exchange rate was).

Figure 4: Inflation



Source: Belstat, VTB Capital Research

Figure 5: Average nominal and real wages



Real growth in BYR deflated by CPI. Source: Belstat, VTB Capital Research

One significant difference from previous years is that, for the first time since Belarus' independence, the indicative targets that are set for the largest enterprises in the country (29 on the list currently), are formulated exclusively at the central government level (which some while ago abandoned the practice of setting volume-based KPIs). Local governments are prohibited from adding other KPIs, which tended to be output- or employment-based for any enterprise on the list. It remains to be seen if this 'partial reform' measure – intended to make the incentive structure of public-owned enterprises more akin to the privately-owned part of the economy – makes a visible difference to how they operate.[3]

Fiscal situation

To gauge what was happening last year, it is helpful to look at the budget revisions, of which there were two: in September and December. And it is worth remember that the biggest shocks occurred at the very end of 2014 and in early 2015, meaning that the initial version of the budget for 2015 (which was voted into law on 17 December 2014) could not have foreseen the magnitude of the stress that was awaiting the Belarus economy. In this sense, the revisions on the expenditure side reflect the policy stance rather than a change in the environment.

Most importantly, despite the devaluation and spike in inflation, social outlays from the republican budget only went up 3% from the initial plan. Similar dynamics were observed in the off-budgetary Fund for the Social Protection of the Population, effectively the pension fund of Belarus. During the election year (presidential elections were held in October), pensions were indexed only 5.5% in September, while the 'first tariff rate' (see footnote below) increased just 6.2% YoY, given that the full-year inflation printed on average 13.9%. To be clear, there are no automatic procedures or commitments to adjust pay in the public sector (and, by corollary, pensions – see Footnote 4 below). These decisions remain in the full discretion of the President.

[3] In the past, the 'matrix' organisational structure of the Belarus economy (large enterprises report to both their respective ministries (or 'concerns', in several cases) and are also accountable to the local authorities) was the central reason behind the breakdown of the 'partial reform' efforts of the central government. Whereas the latter was ready to experiment with the existing approach, essentially telling enterprises that they had to 'emulate' privately owned companies, the former worked as a drag on these initiatives, because they themselves used to receive their own KPI formulated in terms of a 'gross regional product' (GRP) number and could only achieve them by requiring the factories to add respective 'slices' of target GRPs to their KPIs. For the avoidance of doubt, local governments still have their target GRPs for 2016, just as they did before, but are now prohibited from adding their wish-lists to what the central government asked of the largest enterprises. How this setup will evolve is difficult to foresee, but it is clear that the resulting system could well be far from being coherent. Also obvious is the risk of a setback; as János Kornai put it decades ago, "The sundry methods of administrative coordination constantly reproduce themselves spontaneously and naturally, without special compulsion. There is no need for a central command; on the contrary, administrative coordination rises again even if some stern central resolution lays down that it must be curtailed."

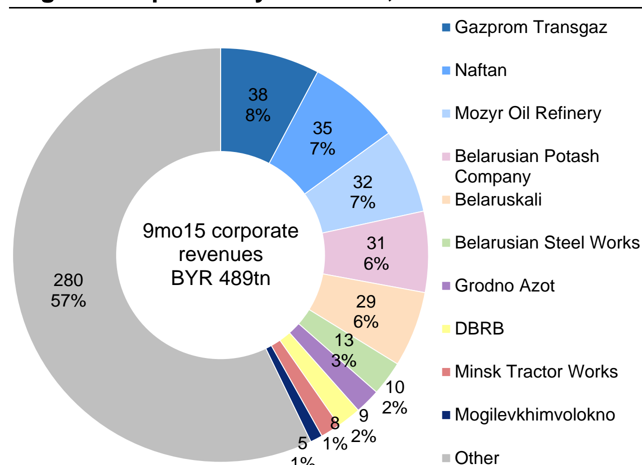
Figure 6: Budget 2015 revision process; selected items only

Budget 2015, BYR tn	Initial plan	September revision	December revision
Revenues	**156.7**	**+6.6**	**-0.7**
Tax revenues	128.1	-0.4	-3.3
Profit and personal income taxes	8.2	-0.3	+0.5
Value added tax	52.3	+0.4	-3.3
Non-tax revenues	19.3	+7.0	+3.4
Expenditures	**141.0**	**+11.9**	**-0.1**
General government	62.3	+9.9	-0.2
Assistance to corporates	4.4	+1.4	0.0
Budgetary loans	-1.8	+8.5	0.0
Social outlays	14.7	+0.5	0.0
Financing	**-15.7**	**+5.3**	**+1.3**
Domestic financing	-1.7	+2.1	+9.2
Treasury accounts	1.7	+7.5	+5.0

Republican (central) budget only without local budgets and the Pension Fund. Source: MinFin, VTB Capital Research

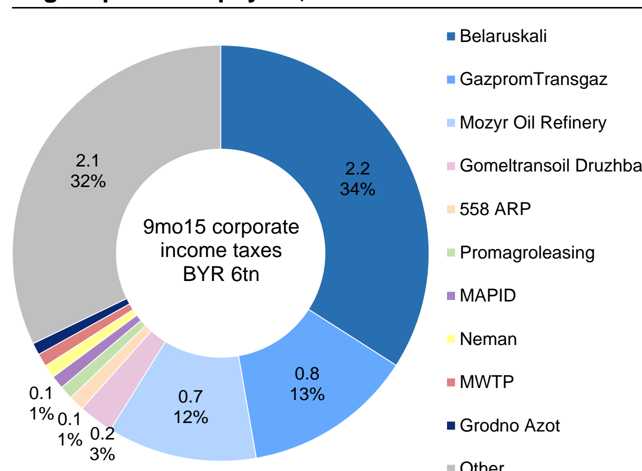
We note the poor performance of the revenue side: despite significant devaluation and inflation, tax revenues by the end of the year were projected to be smaller in nominal BYR than initially (and particularly as concerns VAT). For an economy that is open and undergoes such a massive exchange rate shift, the opposite might have been expected, which also testifies to imperfections at the micro level.

Figure 7: Degree of concentration in industry: largest companies by revenues, BYR tn



*Source: MinFin, VTB Capital Research. *Excluding banks.*

Figure 8: Degree of concentration in industry: largest profit tax payers, BYR tn



*Source: MinFin, VTB Capital Research.*Excluding banks.*

We also note the large compensatory impact of non-tax revenues, which is mostly one-off dividends from potash company Belaruskali (for 2016, the export duty on potash fertilizers is to go up to EUR 55/t, from EUR 45/t last year, moving this source of cash more into 'tax' revenues). In times of recession, the tax base, in addition to shrinking, also becomes more concentrated, but in Belarus' case the dependence of the revenue side on just several large taxpayers is particularly strong (Figure 8).

Most importantly, we note how quickly the government is eating into its accumulated assets – the deposits originating from fiscal surpluses of the past. The total usage of balances on treasury accounts and deposits for the central budget (over BYR 12tn) was directly comparable with a quarter of all VAT receipts[4]. This perhaps represents the sharpest contrast with the past, when the government (together with the Pension Fund, where most surpluses resided before) placed its BYR deposits in commercial banks, and then – effectively in a back-to-back transaction – directed them where to deploy this money. The fiscal surpluses of the past, therefore, were the source of funding for government programmes, and the only source after 2011, when the NBRB discontinued the longer dated provision of liquidity (*de facto* funding) to banks.

[4] Belarus does not publish detailed treasury reports (budget execution reports) with both debit and credit turnovers, so the number of BYR 12tn is only reflective of the expected debit turnover as planned in the budget law. It might or might not be representative of the degree to which deposits of the past have actually been used.

On the other hand, the issuance of new budgetary loans – the most straightforward way of supporting the economy – had to go up materially in September, when the bailout of Minsk Tractor Plant and a number of other enterprises was completed.

Within the limits of what was practicably achievable, the Ministry of Finance's efforts to contain the growth of expenditures in this situation are both difficult to implement and also highly commendable. The need to restrict domestic demand further despite all the social costs it generates seems to be well supported within MinFin and the Cabinet of Ministers as a whole (let alone the NBRB). The logic here extends beyond usual aggregate demand arguments: in a country, where half of existing loans are subsidised, the only way to switch to healthier market-based lending is to bring rates lower much faster than usual. And for that, the Ministry of Finance needs to be as anti-inflationary as possible.

Figure 9: Key official targets

Key indicators	Measurement	Plan 2015	Factual 2015	Plan 2016
GDP	% YoY	+0.5	-3.9	+0.3
Real incomes	% YoY	+1.3	-5.6	+0.5
Inflation, Dec/Dec	% YoY	+12.0	+12.0	+12.0
Export growth	% YoY	-3.8	+1.2	+3.5
Trade balance	% of GDP	-2.5	+0.3	-0.3

*Source: Government, Belstat, VTB Capital Research. *Factual – the last available YTD figures*

For this year's budget, the government continued to adhere to a conservative approach. Initially the 2016 budget draft used the same assumptions as in Russia (oil at 50, USDRUB at 63.3), with the government projecting economic growth to remain in marginally positive territory. The slump in commodities at the beginning of the year raised the question of a budget revision, making the outlook for 2016 even tighter, with some of the measures discussed at the government level, including even more capex reductions, very conservative wage/pension indexation (the total payroll is to increase a maximum of 0.3% YoY) and probably some changes in the social assistance mechanism[5].

Figure 10: Budget execution

BYR tn	2010	2011	2012	2013	2014	2015	2016P
Revenues	**30**	**54**	**95**	**106**	**128**	**167**	**181**
Profit taxes	3	3	5	5	7	8	9
VAT	12	19	32	39	48	50	58
Excises	4	6	11	18	21	19	21
Int. trade taxes	-	15	25	23	18	39	42
Other	11	12	21	20	34	50	51
Expenditures	**34**	**52**	**96**	**108**	**123**	**152**	**163**
General government functions	14	25	44	53	57	70	73
National economy	9	9	19	17	19	25	27
Social outlays	7	10	19	23	26	32	36
Balance	**-4**	**2**	**-1**	**-2**	**5**	**15**	**17**

Source: Minfin, VTB Capital Research

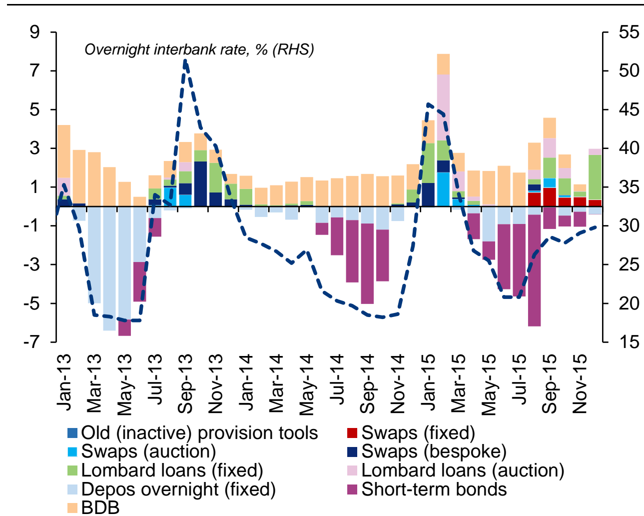
[5] Belarus has a complex system of social assistance and labour market regulation. In a nutshell, there are four key indicators, which determine personal income and play a crucial role in state budget planning. 1) The minimum wage determines the lowest possible level of an employee's earnings in Belarus and is set by the government on an annual basis. During the year, the minimum wage might be indexed if, since the previous indexation, the cumulative CPI growth exceeds a 5% threshold. However, the indexation applies not directly to the minimum wage value, but to the minimum per capita subsistence budget (MSB). In particular, MSB is indexed on cumulative CPI index growth (since the last indexation), and this incremental increase is added to the minimum wage. In 2015, wages were indexed 5.1%, with the minimum wage rising to BYR 2.18mn from BYR 2.10mn. 2) MSB is a key indicator of living standards of Belarus, which is calculated as the minimum cost of the goods and services basket, necessary to maintain human health. MSB is determined by the Ministry of Labour on a quarterly basis. The list of food products is formed by the Ministry of Labour and the Ministry of Health, the value of non-food products is determined as a fixed 77% share of the food basket. MSB is used to calculate minimum wage/pension rates, scholarships and various social benefits (child allowances or assistance to low-income individuals). Specifically, the minimum pension rate is set at 25% of the maximum value of MSB for the last two quarters. In 2015, MSB was increased to BYR 1.57mn from BYR 1.40mn, the minimum pension rate was increased three times (+0.5% in February, +0.8% in May, +1.6% in August). 3) Another measure of living standards in Belarus is the minimum consumer budget for a four-person family (MCB). The key difference from MSB is that this indicator includes goods and services, which are necessary not only for physical health, but also for basic socio-cultural needs. The value of MCB is calculated by the Ministry of Labour on quarterly basis. MCB is a base value for determining the eligibility of getting subsidised mortgages. In 2015, MCB was increased to BYR 2.50mn from BYR 2.10mn. 4) The first tariff rate (FTR) is a base value for the remuneration system in Belarus. To calculate the wage rate, one needs to multiply FTR by the coefficient from the unified tariff system (exists for every profession and qualification). Importantly, pension indexation is linked to the average nominal wage growth, so an increase in FTR leads to an increase in pension payments. In 2015, FTR was changed twice (to BYR 277,000 in February (+BYR 2,000), to BYR 292,000 in March), pensions were indexed 5.5% in September. The level of FTR indexation is determined by the government; the decision is not rule-based and depends on the performance of the economy.

Monetary policy

After the December 2014 shock (and a period of experiments with taxes on FX purchases, shutting down the OTC market for corporates and the manual management of FX exchange trading), Belarus switched to a nearly-free float and a monetary targeting regime.

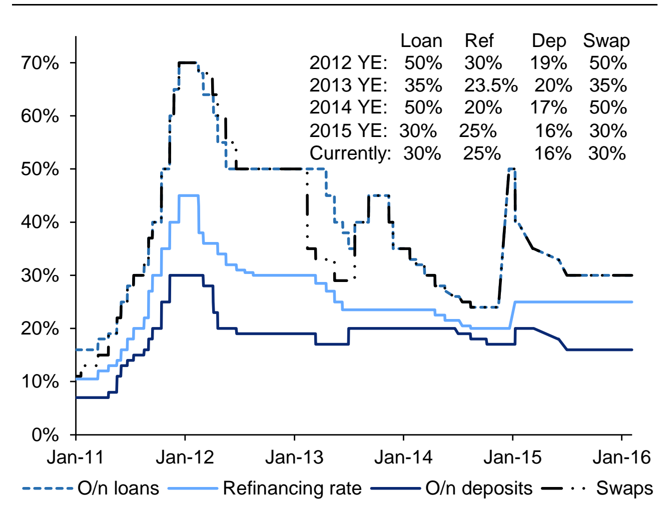
A free float is almost always a direct function of the (factual or perceived) lack or loss of reserves available for active interventionism. In Belarus' cases, this was aggravated by the orthodox approach that Russia was taking in its FX policy (and completely porous borders/unrestricted movement of goods between the countries). Shocks therefore continue to propagate between Russia and Belarus as quickly as ever, with August 2015 showing another one – following the slide in oil to sub-45 levels – which caused a further exodus of BYR deposits (that was only slightly smaller than the one at the beginning of the year).

Figure 11: Banking liquidity



Source: NBRB, VTB Capital Research

Figure 12: Policy rates



Source: NBRB, VTB Capital Research

Domestic liquidity in Belarus is more often than not a direct mirror of what is happening with FX, and 2015 was no exception. Up until mid-summer, a structural liquidity surplus prevailed (generated by a reversal of BYR deposit outflows from early spring on the back of higher rates, some small-sized purchases of reserves by the NBRB in 2Q15, and then a negative adjusted[6] consolidated budget from February 2015), with the NBRB absorbing the access through its short-term bonds at around 16%. After August, when the balance turned around on the back of another deposit outflow, the NBRB had to start providing rather than absorbing BYR, and the upper boundary of the rates corridor became binding at 30%.

Monetary policy guidelines for this year call for 12% CPI (Dec/Dec) as the main target, and 18%±2% growth in broad money (M3 aggregate) as the intermediate target (average Dec/average Dec). The BYR monetary base remains the operational target. The NBRB's estimates and technical advice from the Fund have both been that the correlation between broad money and inflation is the strongest of all the potential indicators that can be chosen as an intermediate target (see here). It is unclear whether the relationship is strong in times of a declining BYR monetary base and when demand is so depressed and the loss of wealth so material. In the past, apparently, there were periods of monetary profligacy, but how informative they are in terms of correlations now is questionable. One interesting thing to bear in mind is a collapse in the FX pass-through intensity (from 0.7x in 2014 to 0.3x at the moment). In

[6] Export duties on oil and oil products are collected in dollars and go straight to the government's USD account at the NBRB, thus having no impact on BYR liquidity. They are also spent directly from that account. They are customarily reflected in the budget accounts 'above the line' with regard to receipts (commingled with other revenues which are all in BYR) and 'below the line' with regard to their actual usage – as debt repayments always are. If one takes the export customs duties out, the budget has been in deficit since February 2014, explaining its liquidity-positive impact.

October, the NBRB's monetary policy department estimated year-end inflation at 15-18%. The actual print turned out to be just 12% (with no reason to expect data massaging, in our view.)

Since the M3 indicator treats domestic and FX deposits equally (i.e. includes both), the exchange rate is a significant driver behind the dynamics of the intermediate target. Last year is vivid testimony as to how the target might move, irrespective of what is under the direct control of the monetary authorities: whereas the BYR component of the monetary aggregate (M2) declined (even in nominal terms) during 2015, the revaluation component from the FX-denominated part of the M3 (and FX deposits themselves, measured in constant FX rate) help to explain all of the positive 39% YoY change in the indicator.

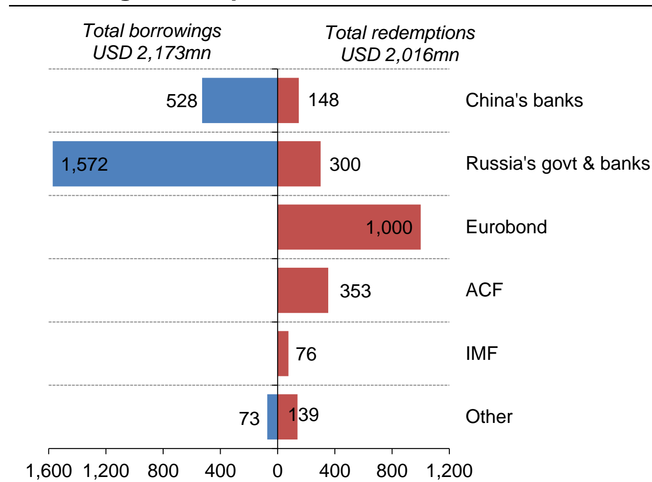
What this effectively means, if the NBRB is serious about reaching the 18% target for this year (and given the likely distribution of FX rate shocks during the year), is that the policy is to remain tight and rates elevated. In particular, at its board meeting this week, the NBRB clarified that the broad money supply for 2016 would have to remain unchanged when measured in constant currency. More likely, this target could become a lesser priority when and if oil rebounds and there is appreciating pressure on BYR. The guidelines require that the NBRB simultaneously achieves a small increase in the FX reserves, but it seems a plausible assumption that were a better performance on this target to require a sacrifice to the M3 (which would be difficult to sterilise), then the priorities could well change accordingly.

Debt management and FX reserves

Belarus continues to cope with large FX debt repayments. According to the NBRB, total FX debt repayments amounted to USD 6bn in 2015, including all principle and interest payments on external and domestic FX liabilities and unwinding the NBRB's FX swaps with banks. Net FX redemptions totalled USD 0.8bn in 2015, as USD 3.8bn was refinanced and another USD 1.4bn came from oil export duties. The missing part was financed from FX reserves, which declined USD 880mn over the year.

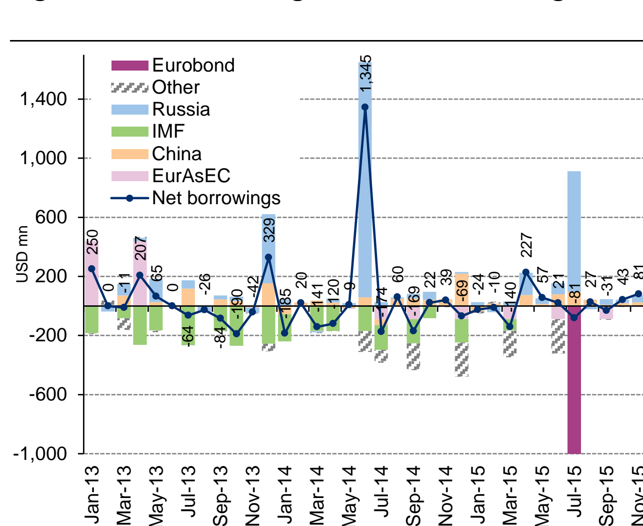
In 2015, external government debt redemptions amounted to USD 2bn, but the headline figure of the external government debt declined only USD 134mn, as the government refinanced the maturing liabilities via fresh borrowings from Russia and China. Effectively, Russia's new loan helped Belarus to pay on the USD 1bn Eurobond in August, while China's new funding helped to process payments to other creditors and to the AFC. As follows from Figure 14, Russia and China have remained the key sources of funding for Belarus in recent years. The authorities approach the task of amassing the pile of FX necessary to service FX debt, as has been the case in the past, in the following three ways.

Figure 13: External sovereign borrowings/redemptions in 2015



Only debt to non-residents without domestic FX debt. Source: MinFin, VTB Capital Research

Figure 14: Net external government borrowings



Source: MinFin, VTB Capital Research

Export duties

The export customs duties on crude oil (of Belarusian origin, some 1mnt a year) and oil products (which are predominantly produced from Russia-supplied crude) are now kept by the Belarus budget. There is a limit of up to USD 125mn a month (or USD1.5bn a year) after which the excess, if any, becomes subject to a transfer to Moscow. At the moment, the latter clause remains a distant possibility, of course, as do the prospects of a return to the 'tax manoeuvre' in Russia in its initial form (that called for a relatively steep decline in export duties; Russia is relevant here since Belarus committed to identical export duty rates with the Russian ones). In other words, although the initial expectations for a large windfall gain for Belarus from a new export duty distribution scheme did not materialise, further downside risks to the volumes Belarus retains there do not seem significant, with the Russian budget debate effectively shielding Belarus from large losses there.

There is a related, although formally separate, line of disagreement between the two countries that has to do with Belarus' commitment to supply some 1mnt of oil products back to the Russian market, which Minsk claims is now unprofitable compared with shipments to Europe. In 4Q15, the volumes supplied to Russia were already down more than two thirds, and in January 2016 they were discontinued completely. Belarus interprets the relevant provisions in the inter-governmental agreement as relieving it from the obligation to supply Russia. The Russian side, however, does not appear to agree.

As our working hypothesis, we assume that these disagreements do not put at risk Belarus' ability to retain USD 1.5bn every year. Under the base case scenario (oil at 50, USDRUB at 63.3), the Ministry of Finance projects oil export duties at USD 1.2bn, but if oil stays at USD 30/bbl, revenues would be around USD 570mn. Oil export duties are earmarked items in the budget and can be used only for external debt servicing.

Domestic FX bonds

Domestic FX bonds have become a significant source of hard currency for both the government and the NBRB.

For the NBRB, this is effectively a substitute instrument for the long-term swaps that banks have entered into with it in the past (frequently called 'deposit exchange schemes' in local parlance). Neither the IMF not the ACF welcomed swaps in the past, as they were customarily included into the FX reserves number by the NBRB, much against the spirit of the Fund's typical approach to defining reserves. Using bonds instead of swaps allows one to separate the BYR financing leg from the FX leg – the timing, size and cost of the former becomes easier to manage. Another technical advantage is that you can use the NBRB's FX bonds to raise BYR liquidity in its auction or standing facilities. The NBRB's FX bonds are fairly short-term, but we think the rollover prospects are good, unless the banks face another leg of panic withdrawals from FX deposits.

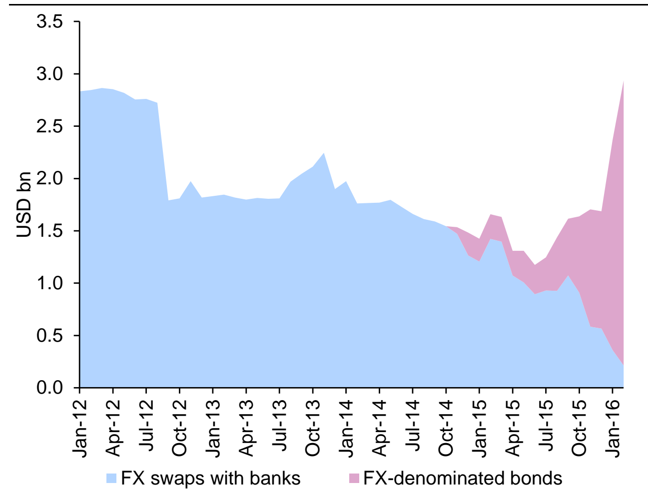
We include the NBRB's FX bonds as an instrument to support government FX liquidity, because as the government's only banker the NBRB has a lot of liabilities in FX to the sovereign, the usability of which depends on the NBRB itself being liquid.[7]

For the government, FX bonds sold to FX-rich companies have the advantage of overcoming the credit/liquidity/regulatory risks that might be associated if a bank serves as an intermediary and takes a deposit of a comparable size and tenor; additionally, the government is a more competitive bidder for FX than a bank, since there are only a few good-quality borrowers with FX revenues willing to take FX loans, and so banks' ability to make good margins on the FX part of their balance sheets is severely restricted – containing their demand for corporate FX deposits. In December 2015, banks paid on average 4.6% on new FX corporate deposits with an 'up to 1yr

[7] When the regulatory limits on open currency positions (OVP) for banks were tightened in autumn 2015 (with the all-currencies limit reduced to 10% of regulatory capital, from 20% previously), the resolve with which the new regulation was enforced shows just one additional channel which the regulator can again use if banks are not willing to roll.

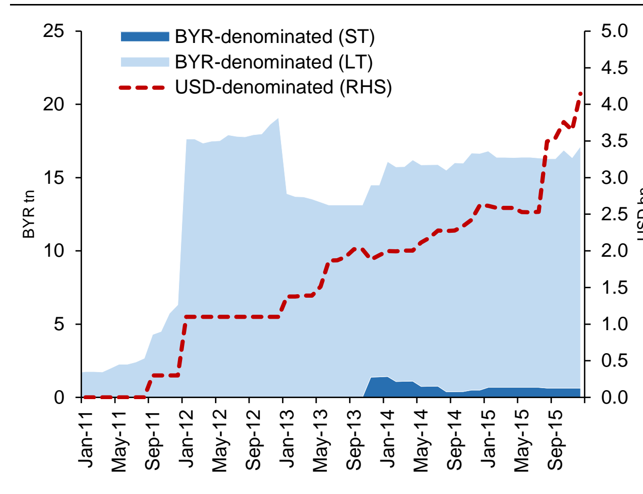
tenor' and 5.9% on 'over 1yr tenor'. MinFin's current on-the-run offer (Aug 2017, USD 100mn, 5.5% rate, quarterly paid) is very much in line with that.

Figure 15: NBRB outstanding FX debt



Source: NBRB, VTB Capital Research

Figure 16: Local sovereign debt issuance



Source: Cbonds, VTB Capital Research

As a warning, the data on outstanding FX bonds reflects many different things, ranging from one-off government-orchestrated placements such as Belaruskali's jumbo purchase of local FX debt (funded by what was effectively an inter-government loan from Azerbaijan) back in 2011 to a non-cash restructuring of guarantees issued to banks under certain LGP loans in summer 2015. In short, stock data is not really helping to gauge the flow.

Individuals are also becoming a visible source of FX for the government. The project started in summer 2015, and the debut retail bond carried a coupon of 7% (tax-exempt). Then the domestic bid received an unexpected booster from the NBRB, as one of the unintended consequences of the NBRB's fight with the instability of banks' BYR retail funding base.

The locally-famous presidential Decree #7, signed after the re-election, introduced non-callable personal deposits and ruled that only they would be exempt from personal income tax (with regard to the interest income received) from 1 April, providing that they are at least one-year tenor for BYR and two years for FX deposits. Either callable or shorter-than-threshold non-callable deposits are to be subject to the tax (13% of interest received).

At the same time, continuing with its fight against high rates in pretty much the same logic as before, the NBRB updated its 'recommended' cap on retail deposits: they are now 30% for non-callable and 25% for callable (BYR deposits) and 5% and 4%, respectively, for FX deposits, irrespective of tenors. The deposit dynamics since late 2015, when gradual outflows from BYR and FX deposits started again, shows that the depositors do not find these limitations very exciting.

The bond that is on sale now is at a 5.5% coupon rate (also tax-exempt for individuals). The idea now is to get rid of the distinction between 'retail' bonds and 'corporate/bank' bonds; the new on-the-run issue is equally offered to all.

External funding

External funding is one of the key priorities for this year. The government is negotiating on two fronts at the moment, seeking a new three-year USD 3bn programme with the IMF and a two-year USD 2bn programme with the EFSD8. We understand that that the IMF programme is to consist of three equal USD 1bn tranches, while the schedule of the EFSD programme implies the first USD 1.1bn

[8] The previous IMF stand-by programme (2009-10) totalled USD 3.5bn and was taken in full. The previous EurAsEc programme (2011-13) amounted to USD 3.0bn, but only USD 2.6bn was taken, since Belarus did not fulfil all the agreed terms regarding structural reforms.

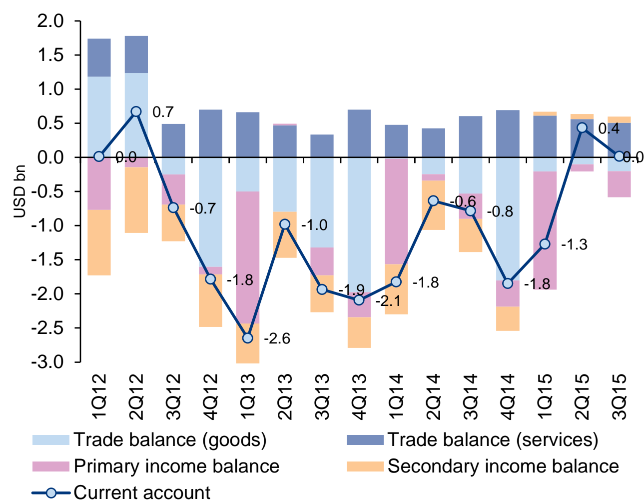
tranche in 2016 and three tranches next year (USD 500mn, USD 300mn, USD 200mn).

It seems that Belarus has found a compromise with the IMF and the EFSD regarding the volumes of LGPs, with only the pace at which utilities' tariffs increase still a stumbling block in negotiations with the Fund. One of the IMF requirements is a reduction in the cross-subsidisation in housing services as well as bringing utility and transport tariffs rapidly to full cost recovery (currently, it is about 30%). The authorities have already made a concession, abandoning the VAT exemption on utility bills – this effectively increases energy tariffs 20%, but does not contradict presidential Decree #550, according to which housing tariffs are increased by USD 5 annually starting from 2014. However, more effort is needed, and the schedule of further tariff hikes is the most difficult topic of the negotiation process.

All in all, in terms of the financial needs for this year, the Ministry of Finance is to redeem USD 1.0bn of external liabilities and USD 1.2bn on local FX-denominated bonds (note that these are counted as domestic debt). Total interest payments on debt in FX are an additional USD 1.0bn. For the NBRB, the main task is to refinance USD 2.5bn of FX-denominated bonds maturing this year (also part of domestic debt, the criterion in official statistics being the residency of the creditor and not the currency of the loan).

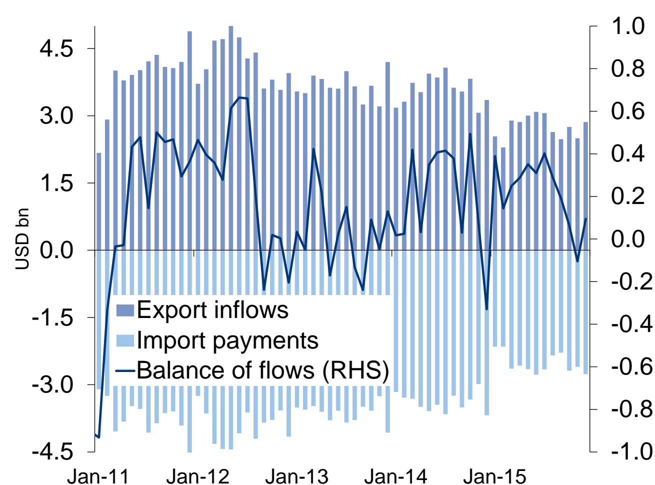
Almost any recession brings an improvement in the current account, and Belarus does not seem to be an exception here (Figure 19). Recent monthly data shows a certain worsening in export inflows, which we think can most likely be attributed to the unresolved issue of where to sell gasoline and diesel when prices in Russia are relatively low (see above). Away from the oil trade, both consumer imports and intermediate industrial imports (used to produce final exportable goods) suffer in the Belarus case, and it seems the rebound will not be quick: the massive negative wealth effect on the consumer side (from depressed real incomes and nearly non-existent consumer lending) and a massive decline in investment demand, in both Russia and Ukraine (the key trading partners), is not going to turn around swiftly.

Figure 17: Current account



Source: NBRB, VTB Capital Research

Figure 18: Payments for G&S, income and transfers



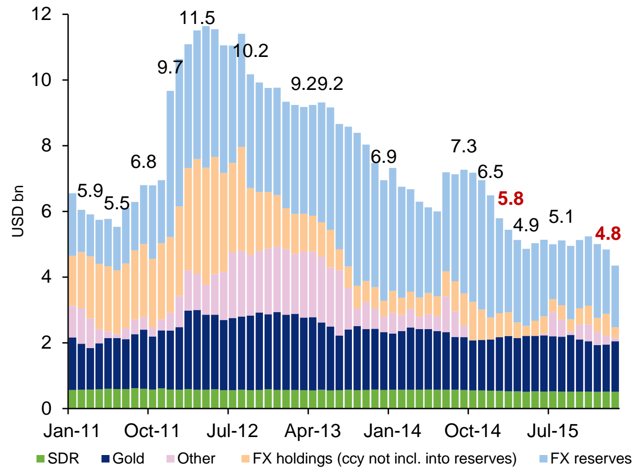
Source: NBRB, VTB Capital Research

Also, part of the negative current account balance, when it resurfaces, already comes with financing attached: either in a statistical sense, such as with the reinvestments of profits earned but not paid out to foreign shareholders, or in real terms, when for example a nuclear power plant-related import is funded with a USD 10bn intergovernmental loan from Russia (nearly USD 1.6bn is already drawn down).

Because of the structural reasons outlined above, we feel historical relationships between FX and the trade balance might now be breaking down in Belarus. We therefore do not think econometric current account estimates are particularly reliable at the moment. Anyway, what seems certain is that debt repayments are a larger

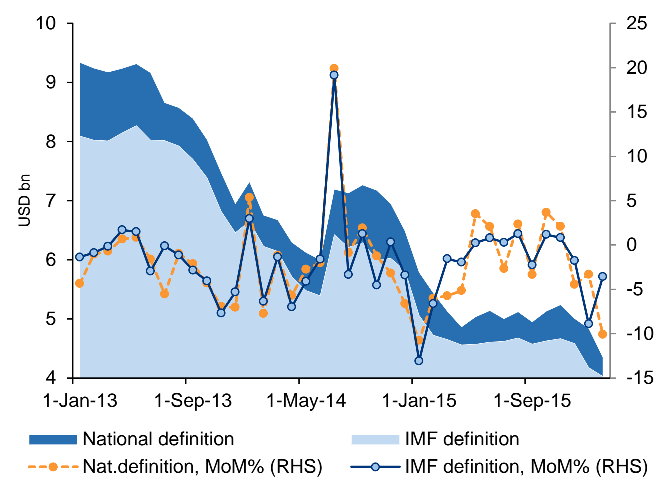
component of financing requirements than a current account gap in 2016. Given all of the above, we think securing requisite volumes of financing for Belarus this year is a less stringent task than it was in 2015.

Figure 19: FX reserves breakdown



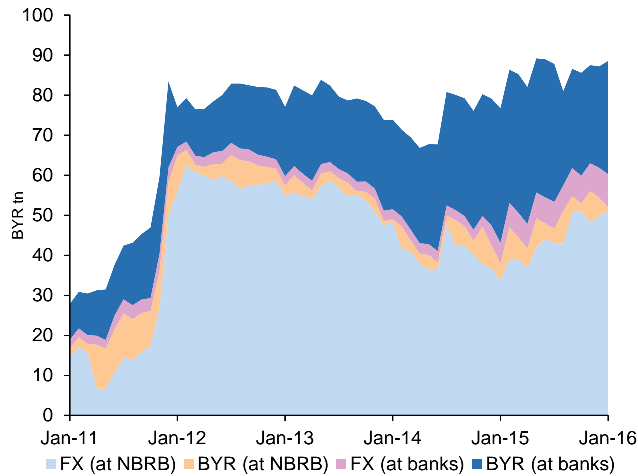
Source: NBRB, VTB Capital Research

Figure 20: FX reserves dynamics



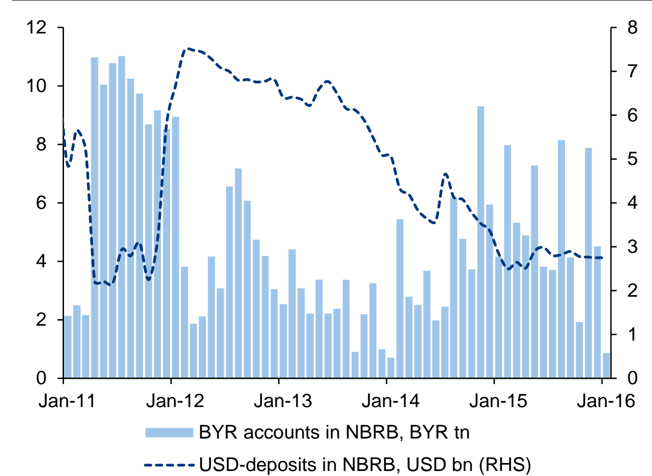
Source: NBRB, VTB Capital Research

Figure 21: Government accounts



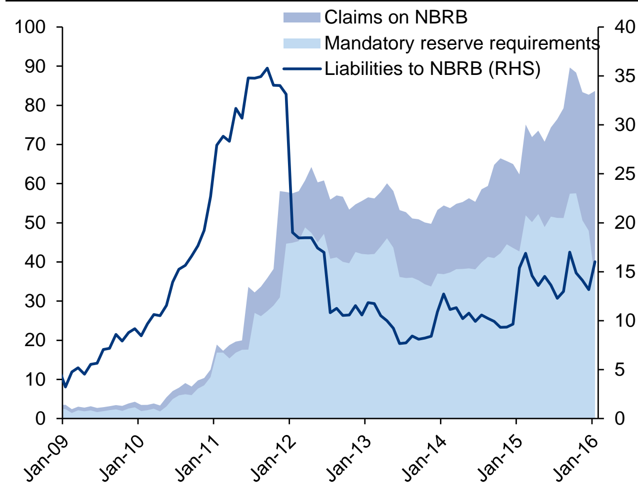
Source: NBRB, VTB Capital Research

Figure 22: Government accounts in the NBRB



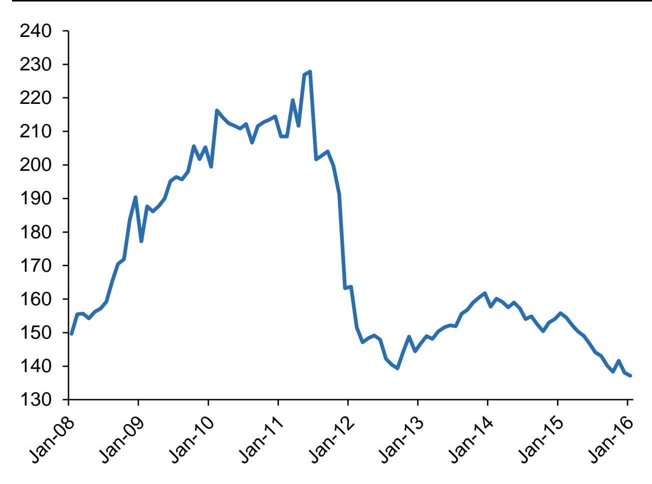
Source: NBRB, VTB Capital Research

Figure 23: Banks claims on the NBRB



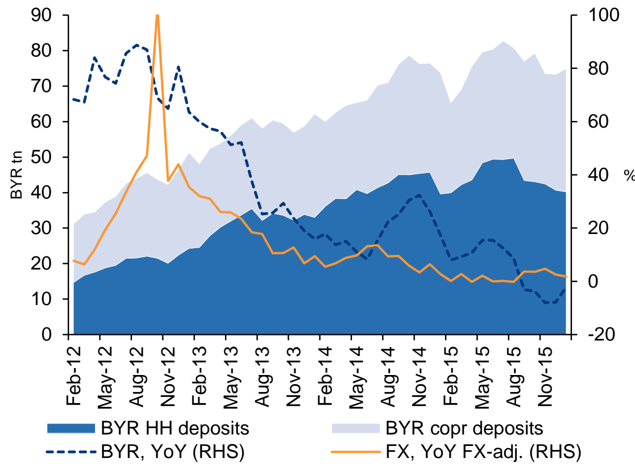
Source: NBRB, VTB Capital Research

Figure 24: Loan-to-deposit ratio



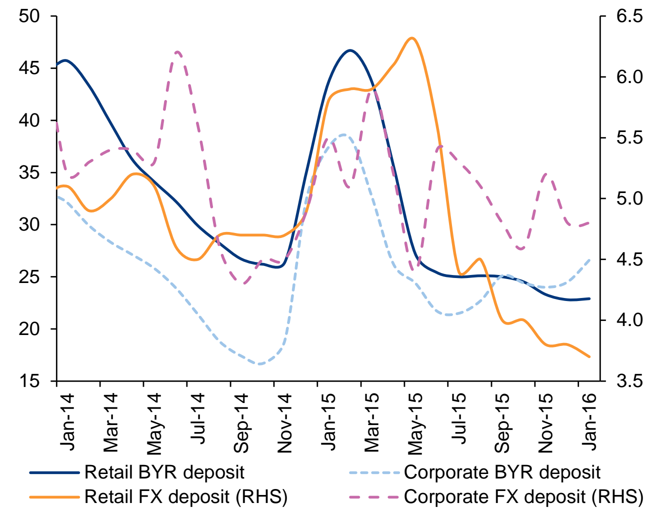
Source: NBRB, VTB Capital Research

Figure 25: Funding base



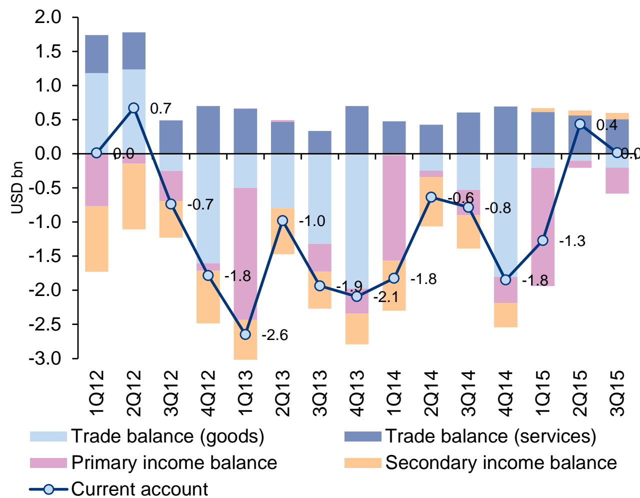
Source: NBRB, VTB Capital Research

Figure 26: Deposit rates (new contracts)



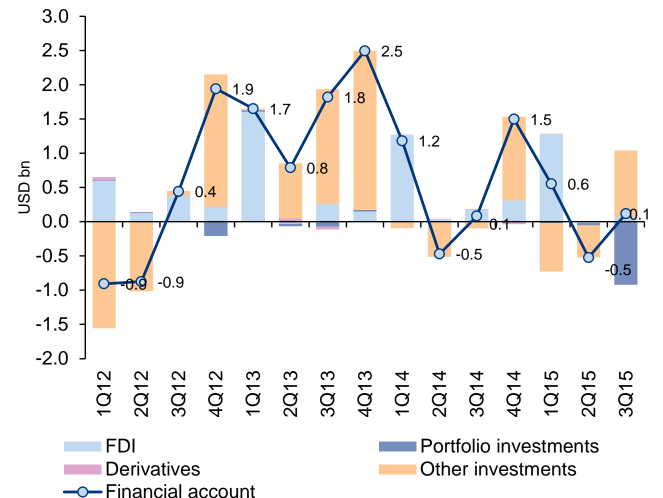
Source: NBRB, VTB Capital Research

Figure 27: Current account



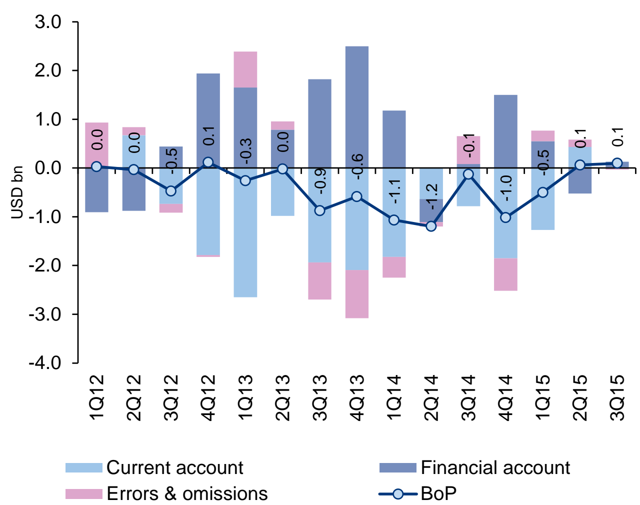
Source: NBRB, VTB Capital Research

Figure 28: Financial account



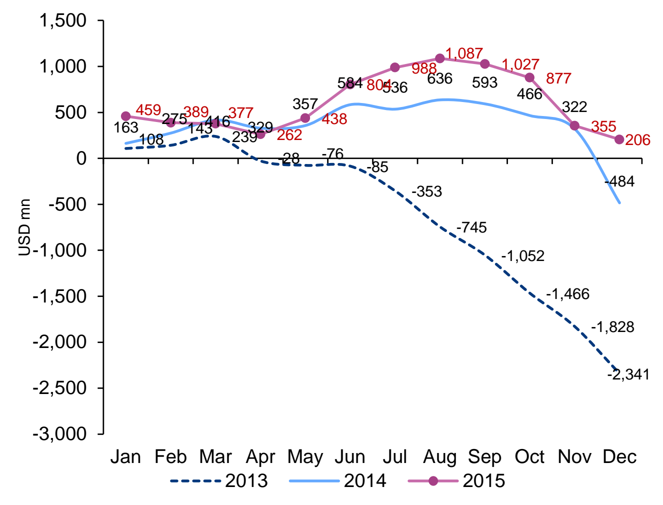
Source: NBRB, VTB Capital Research

Figure 29: Balance of payments



Source: NBRB, VTB Capital Research

Figure 30: Trade balance (goods & services)



Source: NBRB, VTB Capital Research

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Hold	60	47%
Sell	29	22%
Restricted	1	1%
Not Rated	0	0%
Under Review	3	2%
	129	

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Hold	3	17%
Sell	5	28%
Restricted	1	6%
Not Rated	0	0%
Under Review	1	6%
	18	

Source: VTB Capital Research as at 31 January 2016

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