Macroeconomic problems of Belarus: This time is different*

Commentary 07/2015
September 24, 2015

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In the last 7–8 years, some stereotypes have been formed when discussing the economic policy in Belarus. Belarusian academic and expert communities, international financial institutions traditionally emphasized the vitality of adopting flexible exchange rate, and abandoning/weakening artificial expansion of domestic demand. The authorities traditionally responded that gradual and accurate change should be prioritized, in order not to generate a shock, for instance, for financial system and labor market. However, the situation seems to have been changed considerably.

Macroeconomic challenges for Belarus: Breaking the stereotypes

Before 2015, the policy mix in Belarus was roughly unchanged during roughly a decade and included boosting household and investment expenses along with the pegged exchange rate. Until growth potential was rather high, this policy mix secured attractive growth rates of incomes. However, since the potential growth began to reduce (approximately since 2007), the policy mix faced glitches. In order to secure the desired rates of income growth, the authorities had to continue expansionary policies in respect to domestic demand. The outcomes included progressing inflationary pressure, current account deficit, and imbalance between saving and investments. The imbalances were financed via external borrowing, which resulted in rapid accumulation of gross external debt.

These macroeconomic weaknesses progressed and become sustainable: there is a clear downward trend in GDP growth rates during the last 7–8 years, while business cycle turbulence increased and became more frequent, and financial instability turned out to be almost 'normal' state of affairs. However, economic authorities still adhered to a 'standard' policy mix, despite its inefficiency had becoming more and more evident.

In 2014, accumulated huge distortions along with a large external shock finally forced the authorities to revise their policies. Since 2015, they gave up pegged exchange rate regime, and substantially reduced the intensity of expenses support, both household (through directive control of wages) and investment (through directed lending).

If the old policy mix (pegged exchange rate plus domestic demand expansion) is considered as a source of imbalances accumulation, giving it up would mean, at the first sight, securing macroeconomic equilibrium. Indeed, flexible exchange rate and relatively tight monetary and fiscal policies seem to secure satisfactory level of current account deficit in forthcoming years (most probably, within 3% of GDP), and further disinflation. Such expectations bring a kind of euphoria, which sometimes is visible even in the expert community.

However, the euphoria is premature. The list of macroeconomic challenges for Belarus has changed, but it is still large. The underlining reasons for such challenges might be the best criterion for detecting and grouping them.

Impact of the worsened environment for long-term growth

Macroeconomic tradition assumes a 'watershed' between long-term and short-term agenda. However, in the last 6 years, the idea of interactions between long-term and short-terms problems has becoming popular. Academic studies designate possible impact of recession on growth potential. The evidence of weakening growth potential in the bulk of countries in post-crisis period (IMF, 2015) may support such an idea. Ball (2014) provides evidence that such a link exists for OECD countries, and Summers (2014) suggested a hypothesis of 'inverse Say's law' – a shortage of demand affects aggregate supply, i.e. leading to lower growth potential.

A reverse causality (at least, for a couple of forthcoming years) might be an issue for Belarus. A sharp decrease in growth potential during the last years, the lack of productivity growth alongside with excessively accumulated capital and its inefficient allocation (Kruk and Bornukova, 2014) determine a low level of natural interest rate for the economy. The latter means a low propensity to invest. On the one hand, these is good news. One may expect that the balance between savings and investments is going to restore. On the other hand, low natural interest rate may cause two severe challenges. First, it narrows the boundaries of interest rate policy, making it less effective (if having only unprofitable investments available, a firm will not associate its investment decisions with changes in current interest rate). Second, it may cause a

* The commentary is based on the preliminary results of the ongoing study of the natural interest rate dynamics and inflation expectations in Belarus (by BEROC). Results that are more complete will be published in BEROC policy paper series.

pressure on a business cycle: permanently weak investment demand might mean prolonged recession and further long-standing stagnation. A similar challenge for developed countries (but in their case, low natural interest rate might stem from the demand side) has become one of the most disputable topics a got a nickname 'secular stagnation' (Summers, 2014).

Heritage of policy mistakes of the past

Unfortunately, not all the problems associated with the old policy mix disappeared due to its change. Inertia, that is peculiar to the behavior of economic agents and economic adjustments, determines an impact of the past on present and future. Thus, a number of challenges that were born by previous policy mistakes are still vital today.

High and unstable inflation expectations

High level and instability of inflation expectations cause correspondingly high and volatile nominal interest rates at the money market of the country. Given a trend for disinflation (due to recession alongside with conservative monetary policy), it causes volatile but sustainably high real interest rates. Both these characteristics of money interest rates are again challenging for short-term GDP path and effectiveness of monetary policy.

High real and financial dollarization

Low level of international reserves

These two 'shadows of the past' contribute significantly to lower effectiveness of the monetary policy. First, they cause low effectiveness of monetary policy tools in respect to real variables. Secondly, costs of intervening into the economy through monetary policy increases. Thirdly, the response of nominal variables (in contrast to real variables) to monetary impulses is high. Fourthly, negative externalities are facilitated (Kruk, 2015).

Relatively high level of public debt

According to generally recognized criterions, this problem is not acute. For instance, the levels of both gross external and public debt are maintained at acceptable level, and servicing the debt does not assume a critical burden for the budget. Nevertheless, current level of public debt and its servicing has already narrowed the space for maneuver in fiscal policy. This issue seems to become vital given a lack of effectiveness of monetary policy. Hence, if there is an urgent need of fiscal stimulus in order to substitute unavailable monetary ones, the option might be unavailable as well.

Potentially high systemic risk in the banking sector

There are no reliable assessments of systemic risk in Belarus (both in cross-sectional[1] and time[2] dimensions), being based on correspondent methods developed during last couple of year (in a large extent, this because of lack of public access to detailed data on banking business). Nevertheless, there are grounds to advance a hypothesis that systemic risk is rather high in the national banking system. The key argument here is a high level of assets and liabilities concentration in the largest state-owned banks, and the important role of these banks at the interbank market.

High level of systemic risk (in cross-sectional dimension) does not automatically influence business cycle. However, given a prolonged recession environment and, correspondingly, steadily growing non-performing loans, the problems of individual banks may rapidly transform into disorganization of the entire banking system. Such kind of hypothetical cycle may generate new negative impulses, causing deeper recession and prolonging it.

Directions for policy agenda

Each of the threats listed above causes by itself a negative impact on macroeconomic dynamics. However, being combined together, these threats become especially dangerous. For instance, low natural interest rate alongside with sustainably high interest rates at the money market actualize for Belarus a threat of long exit from recession and further 'secular stagnation'. Low effectiveness of monetary policy and constraints in fiscal policy cause low resistance against new shocks. Hence, in case of such shocks, there is a threat of a new round of macroeconomic instability. Finally, prolonged recession/stagnation and/or external shocks may cause banking turmoil, which, in turn, may cause a negative pressure on economic activity. Thus, a vicious circle can appear.

Neutralizing these threats requires struggle not against them directly, but rather against their reasons. Hence, a number of priorities may be emphasized for enhancing macroeconomic stability in medium-term perspective:

1. Strengthening economic potential, which is to secure increase in natural interest rate and correspondingly facilitate to effectiveness of monetary policy. From this perspective, **Belarus has found itself in rather rare situation, when structural reforms are beneficial not only in the long-term perspective, but in the short-term as well.**
2. Securing controllability of inflation expectations by the National Bank.
3. Reduction of real and financial dollarization.
4. Stabilization of the level of public debt.
5. Reduction of systemic risk in banking sector.

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[1] This dimension of systemic risk stems from interlinkages among financial institutions and common exposures.

[2] This dimension of systemic risk stems from the pro-cyclicality between banking activity and business cycle.

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