Research Report on Belarus

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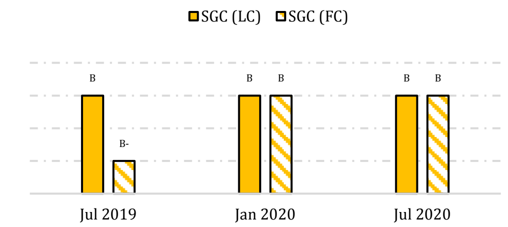
Ratings

Sovereign Government Credit (LC)	B
Sovereign Government Credit (FC)	B
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Belarus

Macro indicators	2017	2018	2019
Gross gov. debt, BYN bn	56,2	58,2	56,3
Nominal GDP, BYN bn	105,7	122,3	132
Real GDP growth, %	2,5	3,1	1,2
Gross gov. debt/GDP, %	53,2	47,5	42,7
Deficit (surplus)/GDP, %	-0,3	1,8	0,6
Inflation rate, %	4,6	5,6	4,7
Current Account Balance/GDP, %	-1,7	0	-1,8
External debt, USD bn	39,9	39,3	40,7

Development indicators	2019
Inequality adj. HDI	0,77*
GDP per capita, USD th	20,6

Default indicator	10.07.2020
10Y Gov Bond Yield, %	6,75**

Source: RAEX-Europe calculations based on data from WB, IMF, NBRB, MFRB, Belstat, Cbonds.
* Data for 2018; **Maturity in 2030.

Summary

The Agency confirmed the sovereign credit ratings of Belarus at ‘B’ with a change in outlook from positive to stable. The adjustment in the outlook mostly reflects the impact of the coronavirus crisis on the economy, external position and government finance. We expect the contraction of the Belarussian economy in 2020, whereas the fiscal balance will be in deficit, and the current account will deteriorate. Meanwhile, the rating is still restrained by the inefficient state sector, high economic and financial dependence on Russia, and elevated levels of financial dollarization in the economy.

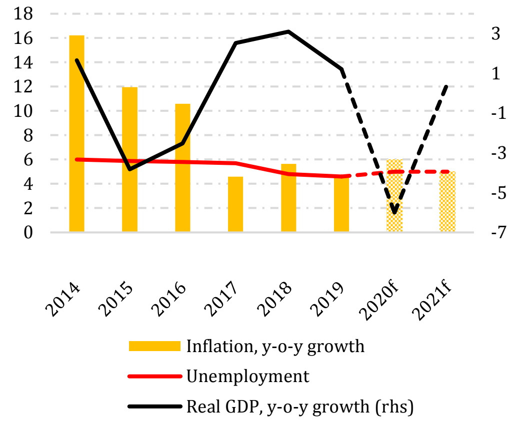
The ratings are supported by improvements in macroeconomic policy-making and government finance’s management, as evidenced by successes in curbing inflation, strengthening international reserves, and reducing the public debt burden, coupled with the manageable debt refinancing.

Coronavirus and oil shocks significantly worsen economic forecasts. The slower economic growth of 1,2% in 2019 was primarily due to disruptions in oil refining and a global slowdown in external demand, while the contribution of final consumption to economic growth began to decline (see graph 1). The restriction of Russian oil supplies at the beginning of 2020 further aggravated the situation in industrial production, which in the first 5M 2020 decreased by 3,9% y-o-y, although partially compensated by a surge in IT services and construction input. Accordingly, the real GDP fell by 1,8% y-o-y as compared with the corresponding period of 2019.

We expect that the Belarusian economy will contract deeper to 6% this year, as the continuing shock of the oil market and COVID-19 affect the core of the Belarusian economy - exports, and significantly worsen the already weak economic performance. The government implemented measures to support the economy, which mainly include tax holidays, while direct financial support is likely to be available only for state-owned enterprises.

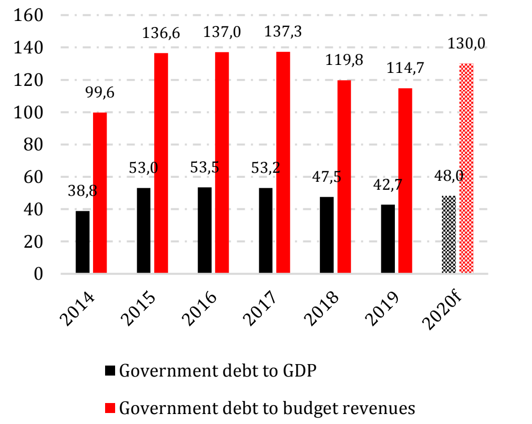
Debt load decreased while FX risk remains. The government's debt position remains favorable, supported by a conservative policy on new borrowings and a reduction of government guaranteed debt. In 2019 the

Graph 1: Macroeconomic indicators, %



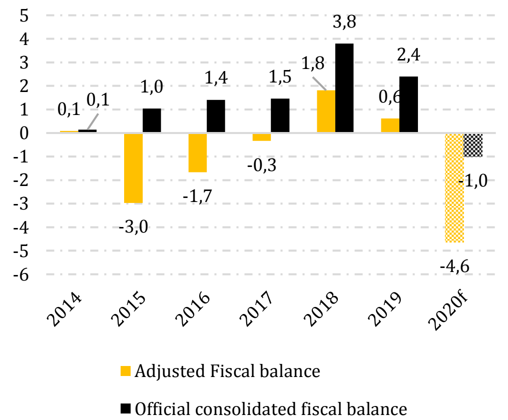
Source: RAEX-Europe calculations based on data from the IMF and Belstat

Graph 2: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from the IMF, Ministry of finance of the Republic of Belarus (MFRB)

Graph 3: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF, MFRB

net increase in new debt was USD 0,2 bn, and the ratio of gross government debt to GDP and budget revenues fell to 42,7% and 114,7% in 2019, respectively, following the strengthening of BYN (see graph 2). Government debt has favorable contractual maturities, consisting predominantly of multilateral and bilateral agreements with sovereigns and supranational institutions. In 2020, taking into account currency revaluation, short-term debt obligations are estimated at a favorable levels of around 7% of GDP.

The government has access to international markets. In 1H 2020 2 placement of the government bonds were done: RUB 10 bn on the Russian capital market and Eurobonds in the amount of USD 1,25 bn. Last Eurobonds issue was placed with fourfold oversubscription, which indicates a high demand for the national debt of Belarus. However, the growing spread between US dollar-denominated Belarusian bonds and U.S. government bonds shows that international investors are increasingly aware of the country's risks.

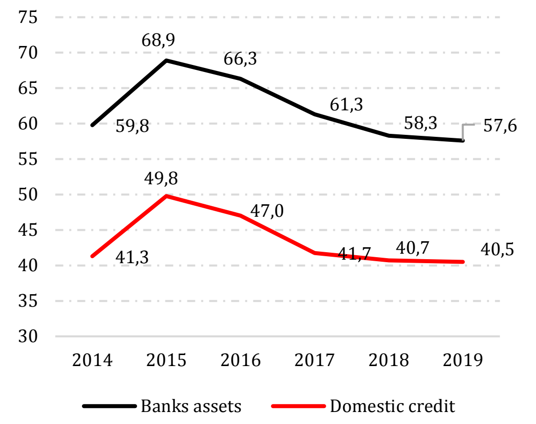
We anticipate moderate growth of the government indebtedness this year, taking into account the exposure to exchange rates fluctuation, as the share of FX obligations amount to 98% of the direct public debt. Under the influence of the weak BYN in 2020, we consider that the total government debt can rise up to 47% of GDP. In addition, Russia and the associated EFSD[1], account for over 60% of external debt, making further refinancing strongly dependent on the state of political relations between the two countries.

Moderate worsening of fiscal position with the transition to the deficit. Due to the fiscal consolidation policy, government spending was gradually declining, while the revenue side was increasing. In 2019, the officially reported consolidated budget surplus amounted to 2,4% of GDP, while adjusted[2] budget surplus was 0,6%. Despite the decline compared to 2018, the budget execution exceeded our forecasts, as it was carried out in conditions of lower export customs duties on oil products. We observed improving fiscal expenditure management with reduced government guarantees and subsidies, as well as the cut-off of capital investments related to the Belarusian NPP.

Amidst the current disruption from the COVID-19 for the economy and considering the losses from the Russian tax maneuver, we expect the officially declared consolidated budget deficit at 1% of GDP in 2020.

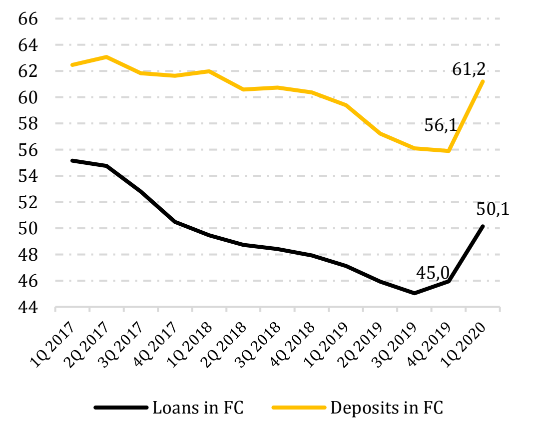
[1] Eurasian Fund for Stabilization and Development.
[2] Consolidated budget net of off-balance expenditures.

Graph 4: Credit to economy dynamics, % of GDP



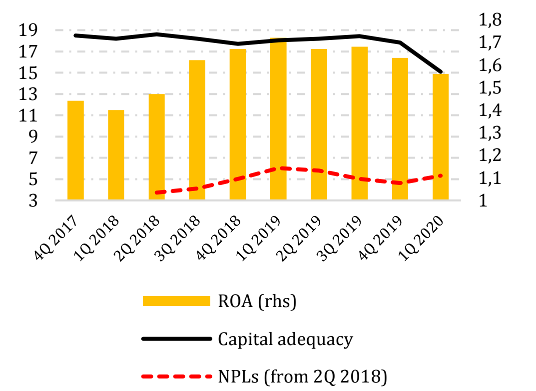
Source: RAEX-Europe calculations based on data from the NBRB

Graph 5: Financial dollarization, % of total



Source: RAEX-Europe calculations based on data from the NBRB

Graph 6: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the IMF, NBRB.

However, the adjusted budget deficit may reach 4-5%. The scale of the expansion will largely depend on the government's plans to allocate funds for infrastructural projects and support to state enterprises. Given the current economic situation, we anticipate that the government will carry out a conservative fiscal policy, primarily financing the social sphere and healthcare.

Monetary policy is flexible; however, the transmission mechanism is still constrained. The National Bank of the Republic of Belarus (NBRB) remains consistent with achieving price stability and adheres to inflation targeting and floating exchange rate regime. The regulator's policy combined with a slowdown in inflation in Russia and weaker demand, contributed to a decline of inflation to 4,7% in 2019, within the target of 5%. In the 2H 2019, the regulator launched a relaxation, reducing the refinancing rate by 1 p.p and continued easing in 2020 with cutting the refinancing rate further reduced by 1,25 p.p. to 7,75% as of 1 July 2020.

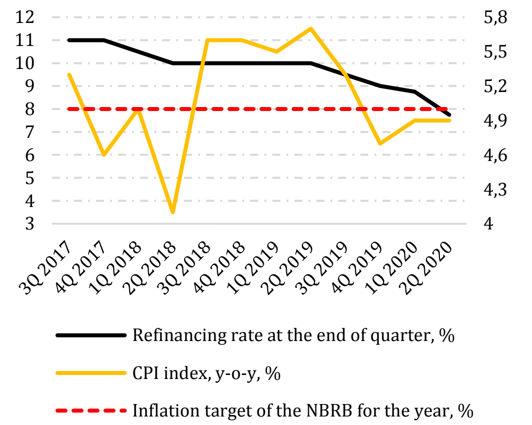
We expect the inflation slightly above to the target in the range between 5%-6% in 2020 given the disinflationary effect of weakening demand and conservative fiscal policy. However, high dollarization of the banking system (see graph 5) and shallow domestic capital market are constraining factors for the efficiency of the transmission mechanism. Moreover, monetary authorities are still limited in their independence and are subject to political influence.

The banking system shows stability, while the long-term structural problems create risks. Last year the banking sector demonstrated a positive dynamic of its main indicators. In 2019 the loans grew by 10,4% supported by the decline of market lending interest rates and excess of bank's liquidity. Financial soundness indicators remain robust: as of 1Q 2020, the capital adequacy ratio remains at 15,1% that is higher than regulatory requirements[3], and the ROE and ROA were 10,4% and 1,6% respectively for the same period (see graph 6). Along with that, the regulator introduced a number of measures to curb the impact of the Covid-19 pandemic on the banking system sustainability. The key measures include credit holidays for banks and clients, mitigation of prudential requirements and partially releasing the capital conservation buffer.

The NPL dropped to 4,6% as of end 2019, however, taking into account the current economic downturn we consider that the long-term structural problems, such as the high share of FX's assets and concentration on the SOEs create heightened risks of deterioration of loans' quality, which was

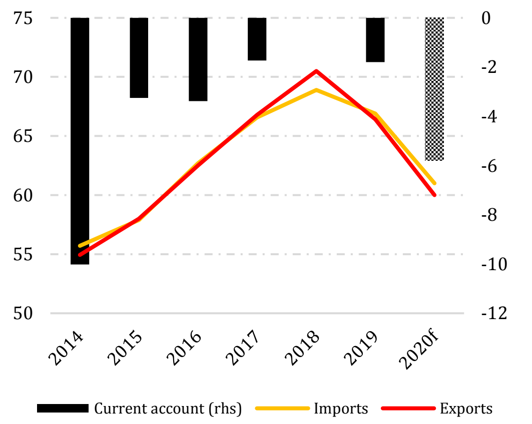
[3] NBRB minimum threshold 10,0% (including the conservation buffer – 12,5%)

Graph 7: Base rate vs CPI, %



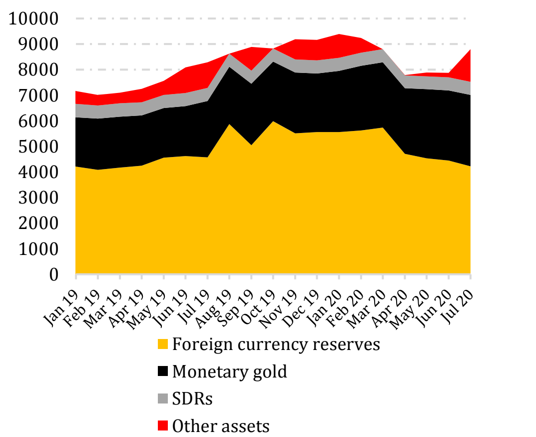
Source: RAEX-Europe calculations based on data from the NBRB

Graph 8: External sector indicators, % GDP



Source: RAEX-Europe calculations based on data from the IMF, NBRB

Graph 9: International reserves structure and dynamics, USD m



Source: RAEX-Europe calculations based on data from the NBRB

already partially reflected by NPL growth up to 5,3% as of 1Q 2020. Moreover, the state-owned banks account for 62% of banking system assets, which may require diversion of significant government funds for support in case of a deterioration of loans.

The risk to the external position comes from the uncertainty in relations with Russia. At the end of 2019, the balance of payments of the Republic of Belarus was in a surplus of 2,8% of GDP, supported by the inflow of FDI and reduction of payments on the financial account. At the same time, the current account deficit amounted to 1,8% of GDP mainly due to weak export affected by oil industry shocks[4] (see graph 8).

International reserves, after reaching a peak in early 2020, declined in June to USD 8,8 bn (see graph 9), as the NBRB carried out currency interventions to mitigate the volatility caused by the sharp depreciation of the Russian ruble. However, we expect that the current level of reserves with a significant share of liquidity assets will be maintained, supporting the external position in case of possible shocks. By our estimates, international reserves cover 2,5 months of imports of goods and services.

In the medium term, the external position of Belarus will be largely exposed to the continuing deep contraction of its main trading partners, primarily Russia, and the instability of world oil prices. In this regard, we expect the current account deficit to expand to 5-6% in 2020. We assess the direct and indirect dependence on the relationships with Russia, as the main risk for the external position. Although trade tensions over oil supplies and pricing have so far been neutralized, this will remain a key point in further integration negotiations between the two countries.

[4] The contamination of the oil in Druzhba pipeline and the implementation of the Russian tax maneuver.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Belarus_10.07.2020.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.