Research Report on Belarus

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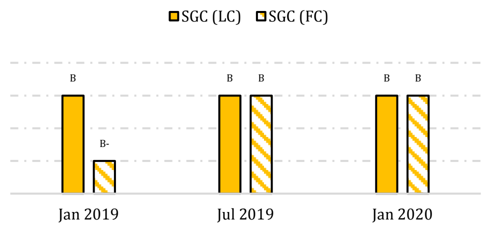
Ratings

Sovereign Government Credit (LC)	**B**
Sovereign Government Credit (FC)	**B**
Outlook (LC)	**Positive**
Outlook (FC)	**Positive**

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Belarus

Macro indicators	2017	2018	2019e
Gross gov. debt, BYN bn	56,2	58,1	56
Nominal GDP, BYN bn	105,7	121,6	131
Real GDP growth, %	2,5	3,0	1,2
Gross gov. debt/GDP, %	53,2	47,8	43
Deficit (surplus)/GDP, %	-0,3	0,2	-3
Inflation rate, %	4,6	5,6	5
Current Account Balance/GDP, %	-1,7	-0,4	-0,9
External debt, USD bn	39,9	39,3	39,7*

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

Default indicator	10.01.2020
10Y Gov Bond Yield, %	5,2***

Source: RAEX-Europe calculations based on data from WB, IMF, NBRB, MFRB, Belstat, Cbonds.
* As of September 2019; **Data for 2018; ***Maturity in 2030.

Summary

The Agency confirmed the credit ratings of the Republic of Belarus at 'B' with a positive outlook. These are supported by improved macroeconomic stability, as evidenced by the success in containing inflation, reduced volatility of the exchange rate as a result of the introduction of the floating exchange rate regime and strengthened international reserves. In addition, we observe prudent fiscal policy and reduced government indebtedness.

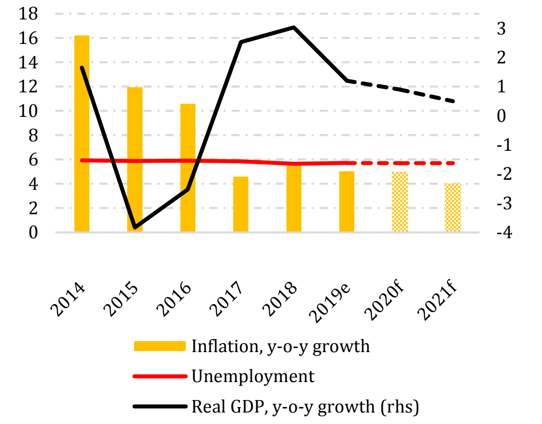
Nonetheless, economic growth is slowing down with weak medium-term prospects amid the uncertainty about the compensation of losses caused by the Russian tax maneuver. The consequences of higher oil import costs will also weigh negatively on the government budget and balance of payments. The rating continues to be constrained by a weak local financial market, which, along with still high dollarization levels, limits the monetary transmission mechanism.

We keep a positive outlook on the ratings, reflecting the high probability of an upgrade, while maintaining macroeconomic stability, continued decline in dollarization, and the absence of shocks to the budget and external position in case of changes in the character of the current economic ties with Russia.

Economic slowdown latent after the recovery phase. After active growth in 2017-2018, the economy has recovered from the recession reaching equilibrium. Since the end of 2018, the growth rate has been slowing down amid the decrease in external demand from key trading partners (see graph 1). In 2019, the GDP was supported by domestic demand driven by stable consumer activity and expanding capital investment. On the production side, a meaningful contribution of 0,5% came from the IT sector, which has been growing rapidly in recent years, becoming one of the main drivers. However, according to the official statistics, GDP growth in January-November 2019 fell to 1,1% y-o-y affected by the temporary disruption in the hydrocarbon processing caused by contaminated Russian oil. In this regard, we have reduced our forecast of real GDP growth for 2019 from 1,8% to 1,2%.

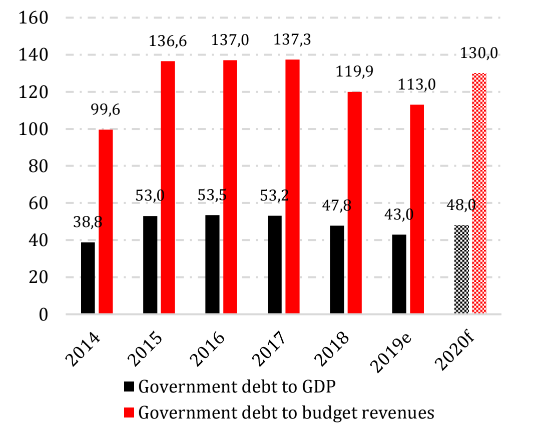
In the mid-term perspective (2020-2021), we see subdued prospects for accelerating growth, due to a number of downward factors. Firstly, there is a low probability that an agreement will be reached on compensation

Graph 1: Macroeconomic indicators, %



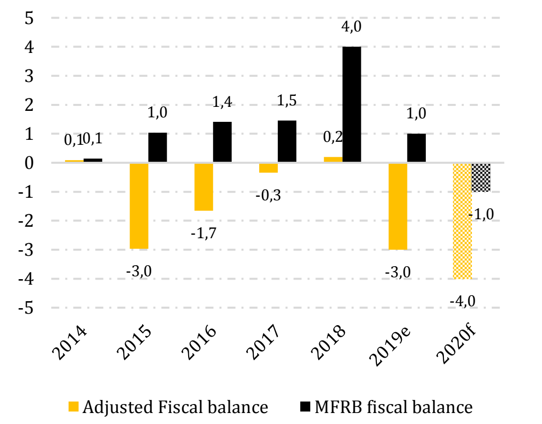
Source: RAEX-Europe calculations based on data from the IMF and Belstat

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

for losses of refineries induced by Russia's tax maneuver[1]. According to the officials' estimates, from 2019 to 2024 the expected losses of refineries, if the world price of USD 60 per barrel remains, will amount to about USD 5,8 bn. Secondly, consumer activity will slow down as the growth of real disposable income of the population sinks and the deferred demand of households is depleted. Economic development is also constrained by long-term structural problems arising from the excessive footprint of the state covering almost 50% of the workforce and value-added. The prevalence of inefficient and loss-making state companies combined with the absence of decisive reforms and privatization is holding back productivity growth and foreign investment inflows.

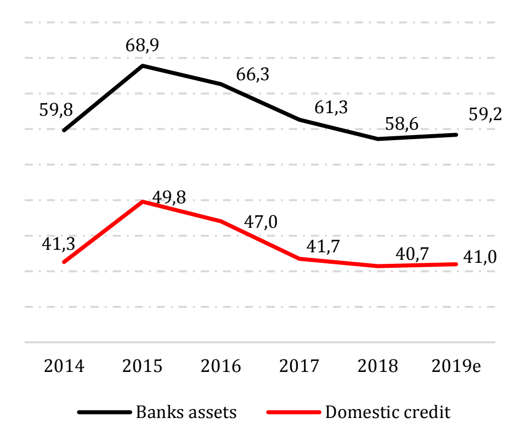
Government debt is managed, however, significant currency risk persists. The government's deleveraging continued in 2019. The strengthening of the BYN, the reduction of guarantees, and a conservative policy towards new borrowings, supported the reduction of the debt. Thus, as of 11M 2019, the repayment exceeded the volume of new borrowings. As a result, the government debt net of guarantees has decreased by 3,6% since the beginning of the year. The estimated ratio of gross government debt to GDP and budget revenues stands at 43% and 113% in 2019, compared to 47,8% and 119,9% in 2018, respectively (see graph 2).

The debt service was manageable in 2019 despite the disruption of planned tranches by Russia and the EFSD[2] for a total amount of USD 800 m. In 2020, the expected disbursements and servicing were favorably estimated at 5,8% of GDP; however, the authorities will be under pressure from the shrinking capacity of the budget and uncertainty of the further bilateral support from Russia. Nevertheless, the government feels confident in its creditworthiness, being able to place bonds on foreign and domestic markets, and having a liquidity buffer in the form of accumulated FX reserves, which have increased by 32% since the beginning of 2019.

In the medium term, we anticipate moderate growth of the government indebtedness, as there are plans to increase the loan for the construction of the Belarusian NPP[3]. Along with that, we emphasize high exposure to currency risks given the share of FX obligations, which amount to more than 91% of government debt. The depreciation of the national currency may lead to an increase in budget expenditures for debt servicing. Besides, the risks of potential materialization of contingent liabilities in case of a

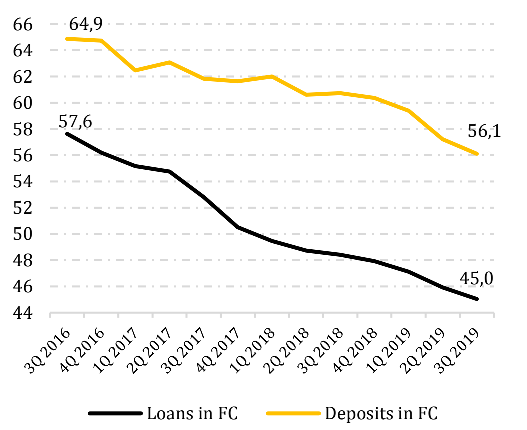
[1] See our research report from 18 January 2019: https://www.raexpert.eu/reports/Research_report_Belarus_18.01.2019.pdf
[2] The Eurasian Fund for Stabilization and Development.
[3] Belarussian nuclear power plant.

Graph 4: Credit to economy dynamics, % of GDP



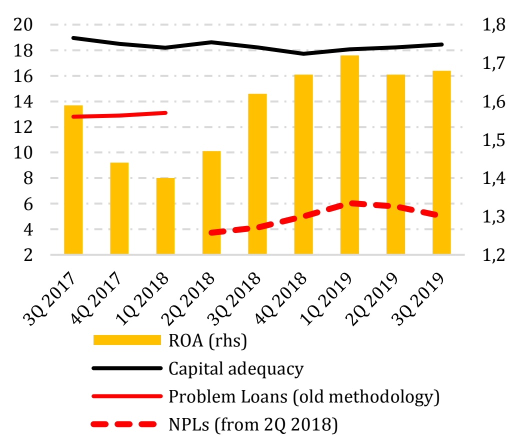
Source: RAEX-Europe calculations based on data from the NBRB

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 *Starting from 1 April 2018 NBRB changed the rules and definitions for the non-performing loans and assets in order to harmonize them with the internationally accepted principles.

deterioration of the financial condition of state-owned banks and enterprises remain.

Neutral fiscal policy with a shift to deficit. At the beginning of 2019, the planned execution of budget revenues was jeopardized by lower export customs duties on oil products. However, favorable revenues from potash exports and the recovery of oil refining volumes had a compensatory effect. In these conditions, the fiscal policy was neutral and we observe improving fiscal expenditure management with reduced government guarantees and subsidies and conservative implementation of infrastructure projects.

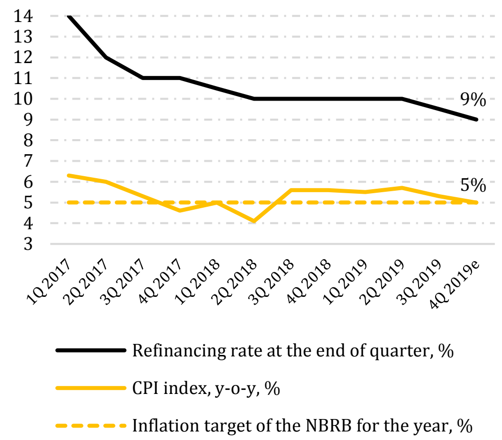
Given the current situation, we expect the officially declared consolidated budget net of off-balance expenditures, to remain moderately in surplus at 1% of GDP in 2019. However, taking into account investments in Belarussian NPP (planned at 3-3,5% of GDP in 2019) and off-balance expenditures, the adjusted consolidated budget deficit may reach 3% of GDP (see graph 3). We anticipate that the state of public finances in the medium term may deteriorate caused by the negative impact of the Russian tax maneuver on oil revenue, which was the main source of government debt repayment.

Decrease in dollarization and maintaining the stability of the banking system. The banking sector maintained the previous year's dynamics, with total assets growing by 8,1% y-o-y as of 3Q 2019, still driven by active lending in the retail segment. However, corporate lending lags far behind and the size of the banking sector remains depressed, with estimated assets at 59% of GDP in 2019 (see graph 4). Concentration risks persist, as the three largest banks comprise just over 60% of total assets, and the share of state-owned banks is elevated at 62% as of September 2019.

Along with that, we emphasize the positive accelerated decline in dollarization, yet it is still one of the highest in the region at 56% of deposits and 45% of loans for 3Q 2019 (see graph 5). The financial soundness indicators remain robust with capital adequacy ratio at 18,4%, and stable profitability with ROA at 1,7% as of September 2019. The share of non-performing loans stabilized at around 5% due to the improvement in the quality of private banks' portfolios (see graph 6). However, we consider the real quality of loans to be worse than officially stated given the high concentration on state-owned companies whose troubled loans are covered by the government.

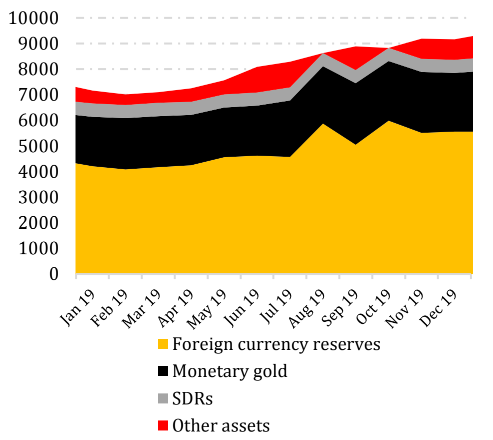
Prudent and efficient monetary policy, although the transmission mechanism still limited. Over the past few years, the monetary

Graph 7: Base rate vs CPI, %



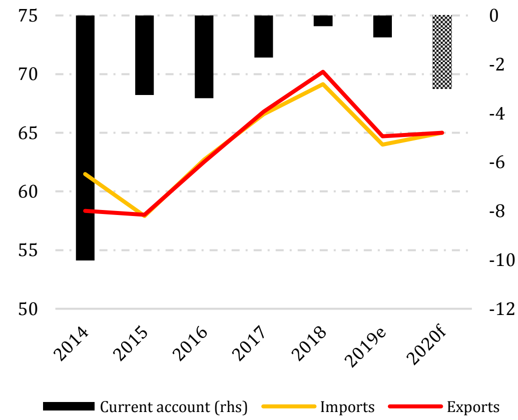
Source: RAEX-Europe calculations based on data from the NBRB

Graph 8: International reserves structure and dynamics, USD m



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

Graph 9: External sector indicators, % GDP



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

authorities have made significant progress in achieving price stability by adhering to inflation targeting, a floating exchange rate regime, liberalization of currency legislation and abandonment of preferential directive lending to SOEs. After a slight spike at the end of 2018 – 1H 2019, inflation is gradually returning to 5%, driven by moderate dynamics of domestic demand. As a result, the National Bank of the Republic of Belarus (NBRB) has switched its policy from a neutral measure to an accommodative stance, reducing the refinancing rate twice from 10% to 9% (see graph 7).

We anticipate inflation to be around the 5% target in 2020 on the back of subdued domestic demand, neutral fiscal policy and less external pressure on prices. However, a number of factors, such as high dollarization, a shallow capital market, and a weak banking sector, limit the effectiveness of the monetary transmission mechanism.

The risk to the external position comes from the uncertainty in relations with Russia. The considerable strengthening of international reserves is a positive signal to reduce the volatility of external positions and mitigate possible shocks. Thus, international reserves have grown by 32,4% over the year, reaching USD 9,4 bn as of December 2019 (see graph 8). In the absence of a current account surplus, the main sources of reserves' growth were purchases of foreign currency by the NBRB and the increase in gold prices. We estimate the country's international reserves to cover 2,5 months of imports of goods and services.

Although the global economy slowed down and exports contracted in the first half of the year due to oil industry shocks[4], the trade balance is expected to be positive in 2019. Exports were supported by favorable prices and demand for potash fertilizers, as well as the buoyant IT sector, which has been steadily growing every year. According to our estimates, the current account deficit in 2019 will be up to 1% of GDP with the expansion in the medium term to 3-4% of GDP considering the rising oil import prices, acceleration of spending on Belarusian NPP (see graph 9).

We assess uncertainty in integration negotiations and current economic issues with Russia as the main current risk for the external position. This concerns both possible compensation of losses from the tax maneuver and agreements on prices of oil and gas supplies. Given the strong dependence on Russia, the change in the format of bilateral relations will harm the Belarusian economy. Moreover, as Russia is the main creditor, the debt position remains highly sensitive to the relationship 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_10.01.2020.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.