Research Report on Belarus

INTERNATIONAL GROUP OF RATING AGENCIES
RAEX EXPERT RA RATING AGENTUR EUROPE
Moscow - Ekaterinburg - Almaty - Minsk - Frankfurt - Hong-Kong

3 February 2017

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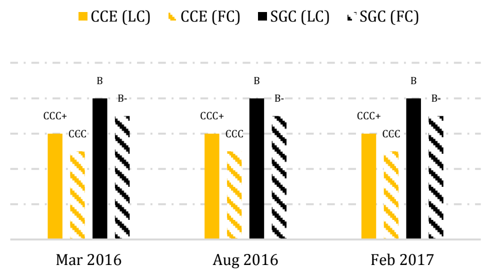
Ratings

Sovereign Government Credit (LC)	B
Sovereign Government Credit (FC)	B-
Country Credit Environment (LC)	CCC+
Country Credit Environment (FC)	CCC

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Belarus

Macro indicators	2014	2015	2016
Gross gov. debt, BYR bn*	290475	467342	444845
Nominal GDP, BYR bn*	778095	869702	943214
Real GDP growth, %	1,7	-3,9	-2,6
Gross gov. debt/GDP, %	37,3	53,7	47,2
Deficit (surplus)/GDP, %	1,1	1,5	1,5
Inflation rate, %	16,2	12,0	10,6
Current Account Balance/GDP, %	-	-	-4,9
External debt, USD bn	-	-	22,5

Development indicators	2015
Inequality adj. HDI	0,74
GDP per capita, USD th	17,5

Default indicator	03.02.2017
7Y Gov Bond Yield, %	6,2

*Non-redenominated BYR.
Source: RAEX (Europe) calculations based on data from the IMF, World Bank, MFRB, NBRB, Deutsche Börse.

Summary

The confirmation of the SGC and CCE ratings of Belarus reflects the Agency's opinion about the country's elevated default risks despite the improvements in some major indicators.

Inflation and dollarization levels remain high despite the positive dynamic over the last years. Off-budget operations remain widespread and real GDP contracted for the second year in a row. In addition, banking system risks increased substantially over the last year.

Gross government debt stood at acceptable levels. However, these metrics can increase in the mid run fueled by the potential materialization of contingent liabilities. The debt structure remains satisfactory in regard to the type of creditors and debt maturity; however, the FX share of the government obligations is substantially high.

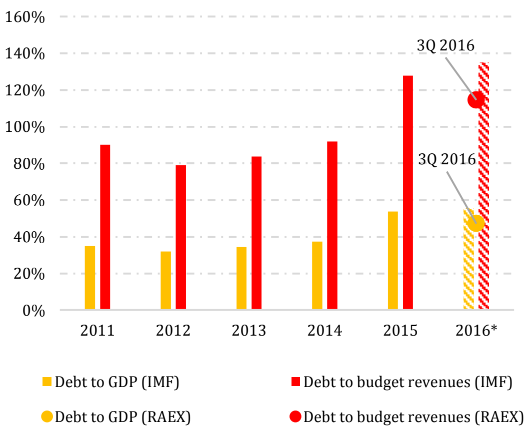
Elevated debt risks still mitigated by the creditors and maturity structure. According to the Agency's estimation, gross government debt stood at 47,2% of GDP and 114% of budget revenues as of the end of 3Q 2016, an important decrease as compared to the 2015 readings.

However, these figures could be reassessed upward within the next rating revision as the latest IMF assessment shows that debt to GDP and debt to revenues ratios could reach 55,5% and 126,1% respectively by the end 2016 (see graph 1). Taking into account the high volatility of the debt metrics, different approaches to their calculation and large amount of contingent liabilities (see below), the Agency acknowledges that the final results of 2016 may lead to a rating downgrade within the next rating revision in July 2017.

In the long run the Agency expects a further increase in government and government guaranteed debt due to the high amount of contingent liabilities that may arise as a result of the banking system recapitalization, widespread government guarantees to SOEs and potentially higher than expected quasi-fiscal liabilities.

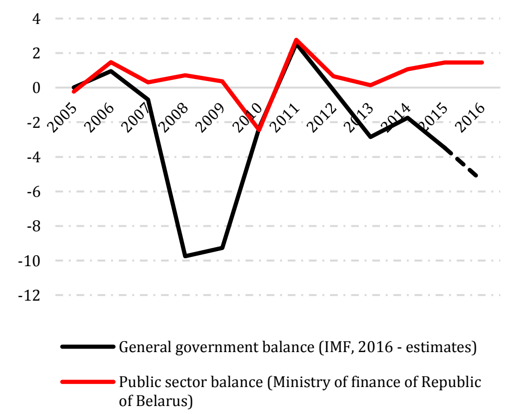
The currency structure of the government debt remains unfavorable with the share of FX-denominated debt standing at more than 80% by the end of 2016. However, these risks are slightly mitigated by the decreased volatility of the BYR, the positive dynamic of international reserves and by the debt structure in regard to creditors and maturity.

Graph 1: General government debt metrics



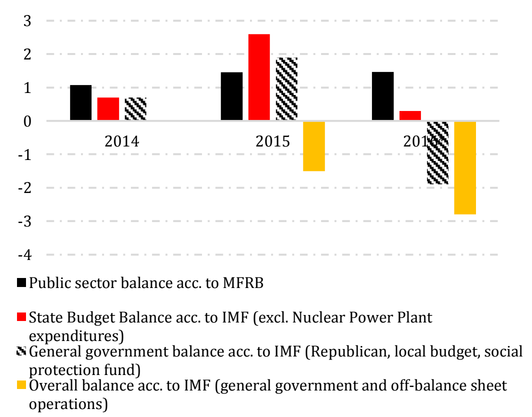
Source: RAEX (Europe) calculations based on data from the IMF and MFRB
*IMF estimates for the year

Graph 2: Fiscal balance of Belarus, % of GDP



Source: RAEX (Europe) calculations based on data from the IMF and MFRB

Graph 3: Fiscal stance in different definitions, % of GDP



Source: RAEX (Europe) calculations based on data from the IMF and MFRB
*Results of January-December 2016 for Public sector deficit according to the MFRB, projections for all IMF indicators.

The Russian government, banks, and the Russian-led "Eurasian Fund for Stabilization and Development" remain the largest creditors of Belarus. In regard to maturity, the short-term external debt represented 7,6% of GDP and 18,5% of budget revenues by the end of 3Q 2016.

Fiscal consolidation is underway while off-budget operations remain high. According to the state budget execution for January-December 2016[1], the balance showed a surplus equal to 1,47% of GDP, a stable metric when compared to the 2015 figure of 1,46% of GDP (see graph 2). However, the wide gap between parameters of the above mentioned state budget, the IMF estimates for general government deficit and the overall fiscal balance[2] (see graph 3), raises concerns about the final execution of the state's off-budgetary funds and the scale of off-budget operations.

The government's fiscal policy consolidation has been supported by a second round of tax increases in addition to a set of measures implemented in previous years (see our previous report[3]). In 2016, fiscal authorities increased export taxes on potash, oil and fuel, excise and property taxes, while budget expenditures have been cut mainly through a decrease in capital spending and a freeze in public sector real wages. In addition to tax increases, the government continues to execute structural fiscal reforms. These actions vary from establishing an obligatory 3-year planning period for the fiscal budget and tighter fiscal targets for debt and deficit to gradual increases in the retirement age.

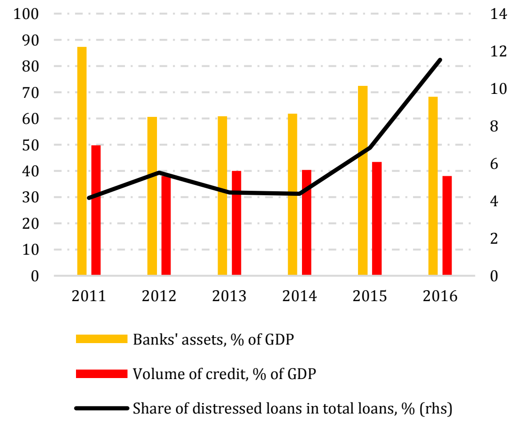
The government's commitment to the fiscal consolidation was confirmed by the republican budget plan for 2017 approved in October 2016, which is based on the oil price at USD 35 per barrel and expected GDP growth at 0,2% in 2017. Parameters of the approved republican budget include a surplus equal to redenominated BYR 1 496 m or 1,5% of the projected GDP. However, the executed state budget surplus for 2017 could be lower as a result of the local and off-budget funds expenditures.

Banking system risks increased substantially. Driven by two years of recession and shrinking government directed lending, the ratios of bank's assets and volume of credit to GDP decreased to 68,3% and 38,0% respectively by the end 2016 as compared to 72,5% and 43,4% a year ago (see graph 4).

The share of distressed loans, by WB definition, almost doubled in 2016 and reached 11,5% compared to 6,8% a year before. This was triggered

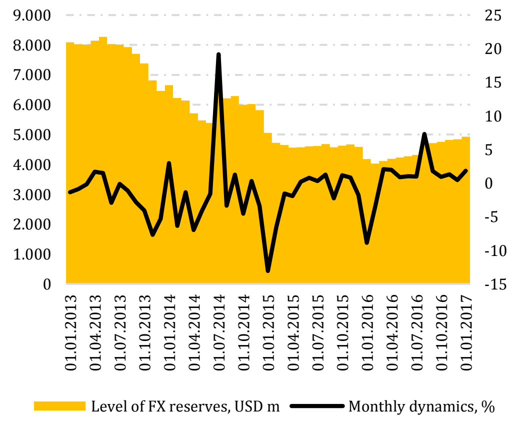
[1] State budget in the definition of the Ministry of finance includes: republican budget, local budgets, state extra-budgetary fund of social protection of Republic of Belarus, the state off-budget Universal Service Fund of the Ministry of Communications and Information, the state extra-budgetary fund of civil aviation and state extra-budgetary fund of the Department of Penitentiary.
[2] According to the IMF definitions: general government budget – sum of republican, local and social protection fund budgets; overall fiscal balance – balance of general government budget with inclusion of off-balance sheet operations.
[3] Research Report on Belarus from 5 August 2016 (http://raexpert.eu/reports/Research_report_Belarus_05.08.2016.pdf) .

Graph 4: Banking system performance



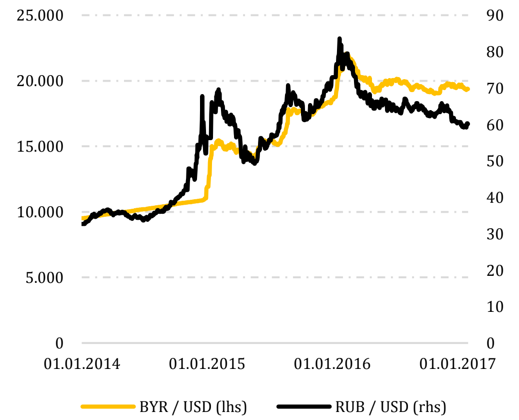
Source: RAEX (Europe) calculations based on data from the WB and NBRB

Graph 5: International reserves dynamic



Source: RAEX (Europe) calculations based on data from NBRB

Graph 6: Dynamics of the exchange rates of BYR* and RUB



*Dynamic of exchange rate of non-redenominated BYR to USD
Source: RAEX (Europe) calculations based on data from the CBR and NBRB

not only by continuing GDP decline and the deteriorating financial stance of borrowers, but also due to a more strict policy of the National Bank of the Republic of Belarus (NBRB) which initiated independent diagnostics of the top nine banks in 1H 2016. This policy may lead to further deterioration of the banks' portfolio by uncovering defaulted loans, previously "hidden" by roll-overs and prolongations.

Despite positive improvements in the banking system regulation (such as established Financial Stability Department of the NBRB and Financial Stability Council), the system remains characterized by substantial structural imbalances. The share of the 3 largest banks stood at 64,6% in 3Q 2016 and the share of state-owned banks remained above 65% of banks' assets. In addition, after the finalization of the asset reassessment process, the largest banks of Belarus could need additional capitalization, which most likely would increase the pressure on public finances.

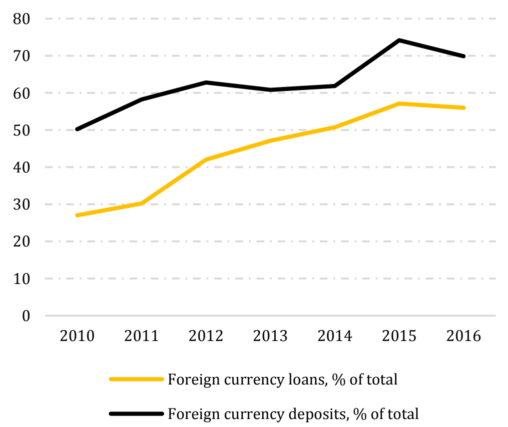
Monetary policy is improving but remains distorted by directed lending and high levels of dollarization. As it was mentioned in our previous research reports, the NBRB replaced its crawling peg with a de jure managed floating exchange rate regime and money aggregate targeting in 2015. This positively affected the dynamic of international reserves which resumed an upward trend throughout 2016 after two years of decline (see graph 5).

The inflation rate has gradually decreased within the last five years. According to the national statistical service (Belstat), CPI in December 2016 rose by 10,6% y-o-y, compared to 11,9% in December 2015. This level is below the recent IMF expectations (12,9%) and the NBRB target for 2016 (12,0%). Such a positive dynamic was driven by lower consumption, together with tight monetary and fiscal policy conditions and slight appreciation of the BYR through 2016 (see graph 6).

Declining inflation and the stabilization of the exchange rate allowed the NBRB to reduce the interest rate gradually from 25% as of 1 January 2016 to 17% as of 18 January 2017. At the same time, the levels of financial dollarization remain as high as 56,0% of loans and 69,9% of deposits as of 1 January 2017, despite the positive trend: these shares reduced by 1,1p.p. and 4,3p.p. as compared to the previous year (see graph 7). These levels of dollarization, combined with the still high share of directed lending, weaken the interest rate transmission mechanism.

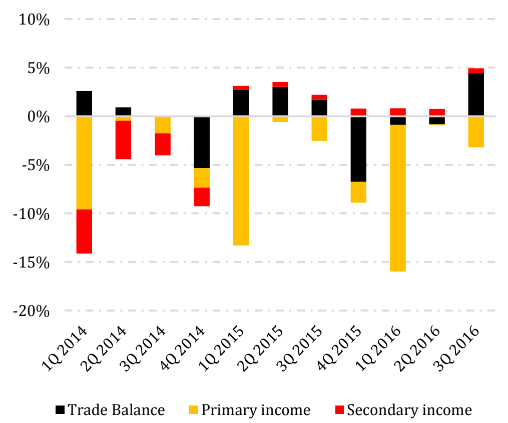
The external position of Belarus remains vulnerable. The Belarusian economy is heavily exposed to external risks. The current account balance improved significantly from -11% of GDP in 2013 to -4% in 2015, however the preliminary data of 2016 is worrisome. Despite the high surplus in the

Graph 7: Financial dollarization in Belarus, %



Source: RAEX (Europe) calculations based on data from the NBRB

Graph 8: Current account balance, % of GDP



Source: RAEX (Europe) calculations based on data from the NBRB

trade balance in 3Q 2016 (see graph 8), the final current account deficit for 9M 2016 widened to USD 1,3 bn compared to USD 0,9 bn for the same period of 2015. This dynamic was mostly driven by the less favorable conditions on the oil market for Belarus, decreased prices on potash and lower external demand on Belarusian exported goods.

Internal structural imbalances remain in place despite the recently implemented reforms. The Belarusian government and the NBRB implemented a set of measures to reduce the government's influence on the economy and to liberalize the exchange rate regime. Along with the reforms mentioned in our previous research report, the authorities have been compiling a comprehensive inventory of SOEs with key financial and employment indicators. In addition, the steps have been taken to strengthen the SOE efficiency by introducing new corporate government regulations and replacement of the production targets of SOEs with objectives such as profitability, efficiency, and export competitiveness.

Despite this progress, the state still accounts for around 50% of employment and gross value added in the economy according to the latest IMF assessments, while the share of state-owned banks remains high and direct lending is widespread. The main Agency's concerns about structural reforms are related to the slow path of privatization process in the economy. The authorities are still announcing large privatization actions, but only few small SOEs were privatized within the recent years. In addition, there is no evidence about the commitment of the government to privatize the main corporates of the country in chemical, oil-refining and manufacturing industries.

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:

http://raexpert.eu/reports/Press_release_Belarus_03.02.2017.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.