Research Report on Belarus

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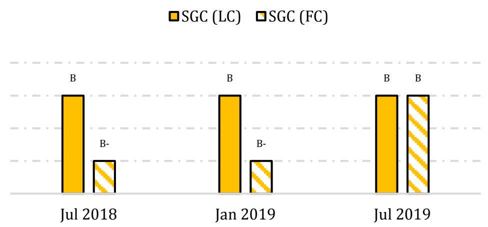
Ratings

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	2016	2017	2018
Gross gov. debt, BYN bn	50,8	56,2	58,1
Nominal GDP, BYN bn	94,9	105,7	121,6
Real GDP growth, %	-2,5	2,5	3,0
Gross gov. debt/GDP, %	53,5	53,2	47,8
Deficit (surplus)/GDP, %	-1,7	-0,3	0,2
Inflation rate, %	10,6	4,6	5,6
Current Account Balance/GDP, %	-3,4	-1,6	-0,5
External debt, USD bn	37,5	39,9	38,7*

Development indicators	2018
Inequality adj. HDI	0,75*
GDP per capita, USD th	20,0

Default indicator	11.07.2019
5-Year CDS spread, Bp	316,2
12Y Gov Bond Yield, %	5,5**

Source: RAEX-Europe calculations based on data from WB, IMF, NBRB, MFRB, Belstat, Cbonds. Gross government debt for 2018 according preliminary estimations of IMF; Deficit/GDP for 2018 according estimations of MFRB based on the IMF methodology; *Data for 2017; **Maturity in 2030.

Summary

The Agency upgraded the credit rating of the Republic of Belarus to ‘B’ in foreign currency and confirmed at ‘B’ in national currency with a positive outlook on both ratings. This improvement reflects the strengthening of the external position with growing international reserves, reduction of the exchange rate volatility and the completed liberalization of the foreign currency regime with no restrictions for FX-operations. Along with this, the ratings remain supported by stable economic growth, lower government debt burden and improvement of the fiscal policy’s quality.

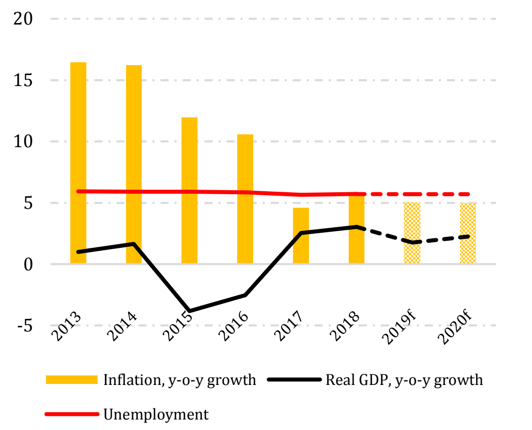
However, the rating is restrained by high contingent liabilities of the government, hidden risks in the banking sector and the underdeveloped local financial market, which restricts the efficiency of the monetary policy.

We kept the positive outlook on both ratings reflecting the high probability of upgrading the ratings in the near future. We can raise the ratings in the case of a partial or full resolution of the uncertainty in regard to additional financial support from Russia together with the overall decrease of dollarization levels.

Economy's performance goes from steady growth and full recovery in 2018 to a slowdown in the medium term. The economy recovered after the 2015-2016 recession, showing a strong growth of 3% in real terms in 2018 compared to 2,5% in 2017 (see graph 1). The GDP growth accelerated in the 1H 2018 mainly driven by consumer activity of households on the back of rising real incomes, as well as positive dynamics in major industries, encouraged by lending and the weakening of BYN. However, already in the second half of 2018, slowdown began as consumer demand was degrading and the economy reached equilibrium. Furthermore, the agricultural sector's yearly production was lower than the 2017 levels caused by adverse weather conditions.

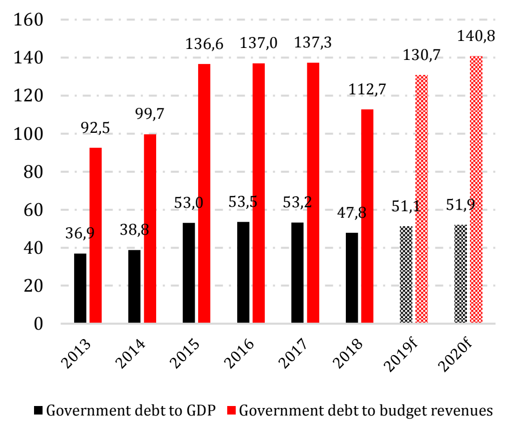
GDP growth in January-May 2019 continued to decline to 1,0% aggravated by a decrease in the hydrocarbon processing caused by technical problems related to oil supplies from Russia. We anticipate real GDP growth by the end of 2019 in the range between 1,5% and 1,8% (lower than previously expected), on the background of deceleration in the economies of Russia and the Eurozone and constrained by the current structural problems of the Belarussian economy. We can consider further

Graph 1: Macroeconomic indicators, %



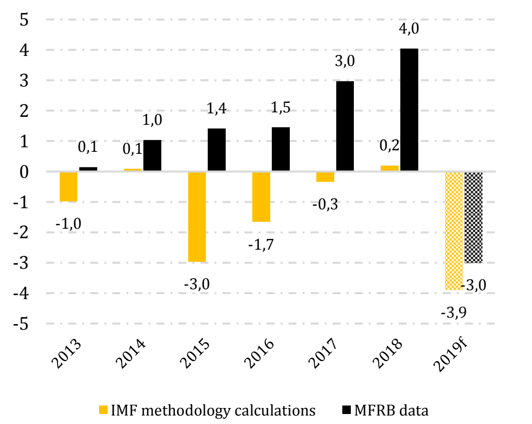
Source: RAEX-Europe calculations based on data from the IMF and Belstat

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, Ministry of finance of the Republic of Belarus (MFRB)

worsening of the forecast in the short-term period in case of a boost in price and demand volatility for the main exported commodities were to occur, as well as direct costs' hike in oil refining in the absence of compensations for Russia tax maneuver consequences[1].

The government's focus is on decreasing the debt burden and diversifying borrowing sources. In 2018, the government pursued a restrained debt policy, limiting new external financing under the level of yearly disbursements. As a result, the ratio of government debt fell to 47,8% to GDP and 112,7% of budget revenues compared to 53,2% and 137,3% in 2017, respectively (see graph 2). Expected obligations to repay and service public debt amount to an average of BYN 7 bn per year during 2019-2021, an acceptable level of 5,8% of GDP and 13,6% of budget revenues, with international reserves' coverage of 2,2x.

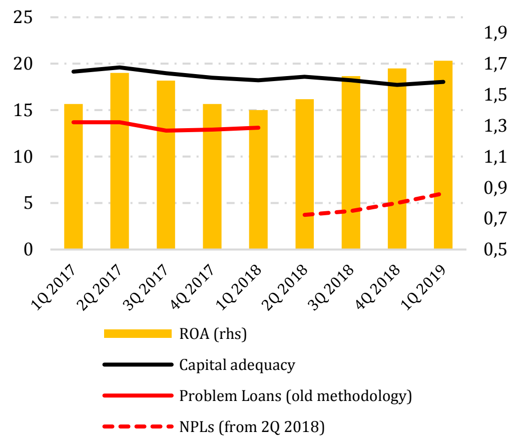
Russia and Russia-related institutions dominate in the structure of creditors with over 60% of external claims. Despite the long and positive credit history, there is still high sensitivity to changes in relations between the two countries, which may affect current and future loan agreements. Thus, in our opinion, there is still uncertainty about the provision of a bilateral loan at amount of USD 600 m from Russia to refinance current liabilities. Forced by the current repayment obligations, the government intends to expand sources of borrowing being active in the capital markets, which is confirmed by current plans to issue RUB 30 bn worth of government bonds on the Moscow Stock Exchange.

Additionally, other factors that have a negative effect on the country's creditworthiness are high exposure to currency risk, given the significant share of foreign currency-denominated debt, as well as the potential materialization of contingent liabilities in the event of a deterioration of the financial stance of the state-owned banks and enterprises. Moreover, the unfavorable forecast for budget revenues gives reasons to anticipate a slight increase in public debt in the short term.

Emerging risk of budget deterioration, despite the short-term improvement. The increase of the budget revenues in 2018 combined with the loosening of the main government expenditures has led to a surplus of 4% of GDP[2]. Albeit, the estimates based on the IMF methodology[3], show a narrower fiscal surplus of 0,2% of GDP, as the latter takes into account the off-balance costs and expenditures on the construction of the Belarusian Nuclear Power Station (see graph 3). From 2019 in order to eliminate discrepancies, the methodology of the Ministry

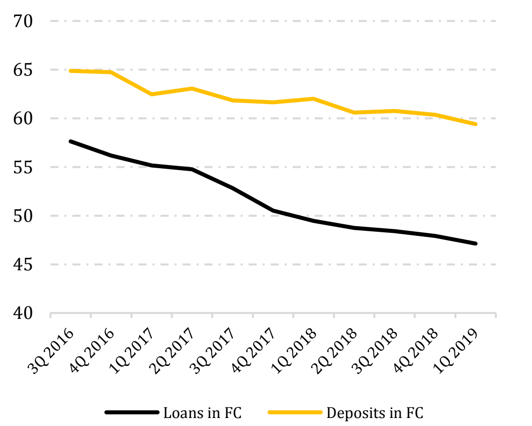
[1] See our previous research report from 18 January 2019: https://www.raexpert.eu/reports/Research_report_Belarus_18.01.2019.pdf
[2] MFRB calculations based on the national methodology.
[3] MFRB calculations based on the methodology of IMF.

Graph 4: Financial soundness indicators, %



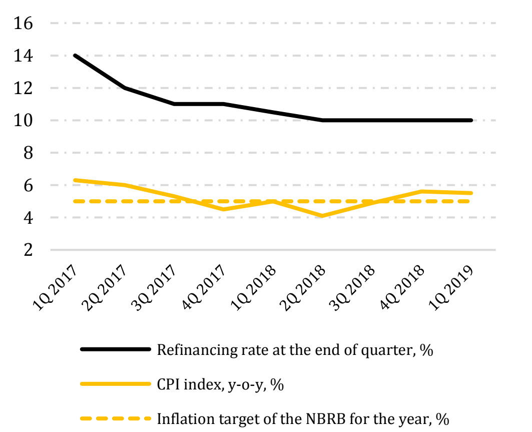
Source: RAEX-Europe calculations based on data from the IMF, NBRB *Starting from 1 April 2018 NBRB changed the rules and definitions for the non-performing loans and assets in order to harmonize them with the internationally accepted principles.

Graph 5: Financial dollarization, % of total



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

Graph 6: Base rate vs CPI, %



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

of Finance of the Republic of Belarus (MFRB) is aligning with the IMF, which we view as a positive signal to improve the quality of the authorities' fiscal policy.

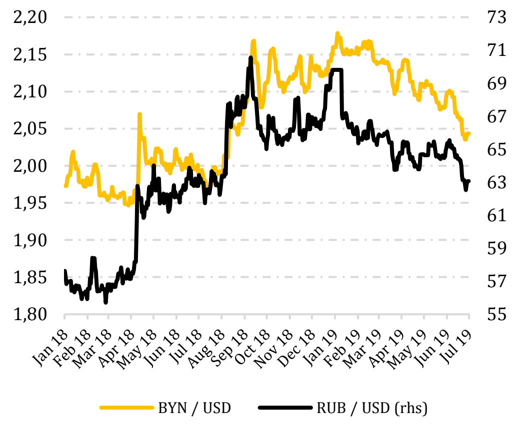
Despite the positive dynamic, our outlook for the budget balance is negative for 2019, which is consistent with the MFRB's forecast deficit of 3%. As mentioned in the previous research report, in the medium term, the quality of the Belarusian budget is expected to deteriorate due to Russia's gradual implementation of the oil tax maneuver, as the authorities preliminary assess significant losses of up to USD 400 m in 2019 with an expansion to USD 2 bn until 2024. Although there are still negotiations to receive compensation from Russia, we estimate the chances of direct full compensation for losses as low and, as a result, the possible diversion of budgetary resources to cover the costs of state oil refineries. In this regard, we believe that the imbalance will escalate, and in order to keep social spending at the required level, fueled by presidential elections in 2020, an increase in the government debt burden is more than possible.

The banking system is stable but remains constrained for further development. A positive dynamic of the main indicators of the banking system was achieved during 2018. Assets grew in 2018 by 10,1% compared with 3% in 2017, thanks to the revitalization of retail and corporate lending. The capital adequacy ratio decreased slightly from 18,5% in 2017 to 18,1% as of 1Q 2019, but remains moderately high. The efficiency of banks improved with an increase in ROA from 1,4% in 2017 to 1,7% in 1Q 2019 (see graph 4).

In 2019, the banking sector is expected to grow more moderately. The dominance of state-owned banks with a share of 63,2% at the end of 1Q 2019 and the risks of concentrating on lending to SOEs continues to limit further development and competition. Despite abandoning the practice of preferential directed lending, the share of such loans is estimated around one third of all corporate portfolios, and their impact on the financial sector persists. The percentage of NPLs on the banking system doubled from 3,7% at the end of Q2 2018 to 6% at the end of 1Q 2019 mainly due to SOBs. Taking into account the pressure of external factors, as well as the continued high dollarization of loans and deposits at 47,1% and 59,4% as of end 1Q 2019 (see graph 5), we assume a possible further deterioration in asset quality.

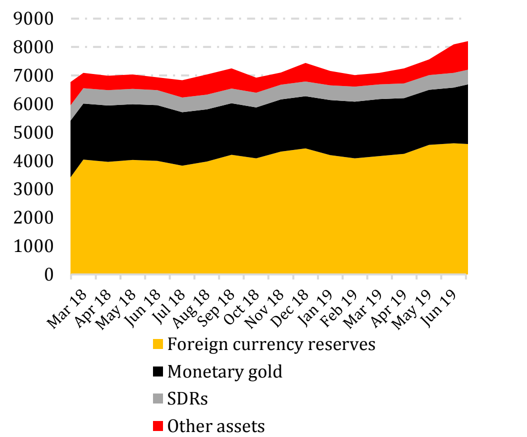
The National Bank adheres a neutral monetary policy on the background of moderate inflation acceleration. The main priority of the monetary policy of Belarus over the past few years is to achieve macroeconomic stability with the gradual implementation of inflation

Graph 7: Dynamics of the exchange rates



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

Graph 8: International reserves structure and dynamics, USD m



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

targeting, liberalization of the foreign exchange regime, and a further decline of the role of foreign currency in the economy. At the end of 2017, progress was made in reducing inflation to a minimum historical level of 4,6%. However since 2Q 2018, against the background of rising inflation, the National Bank of the Republic of Belarus (NBRB) started to apply a moderately tight policy, keeping the base rate unchanged at 10% after two years of gradual decline (see graph 6).

In June 2019 inflation accelerated to 5,7% y-o-y under pressure from prices for agricultural and petroleum products and we expect by the end of the year inflation within the range of 5%-5,5% with sensitivity to inflation's dynamic in Russia. In order to keep inflation at the level of 5%, monetary policy easing is not expected with the key rate remaining at a neutral level. Despite the rejection of directed lending, the impact of the NBRB interest rate policy on the economy still limited by the weakness of the banking system and a high level of financial dollarization.

The signs of external position's improvement supported by robust export, increasing of international reserves and less volatile national currency. Despite the IMF's negative forecasts for 2018, the current account deficit is gradually decreasing, reaching 0,5% of GDP in 2018 compared to 1,6% in 2017. Positive dynamics ensured by an increase in export revenues due to favorable oil and potash fertilizers prices, as well as an increase in the export of IT services. As a result, foreign trade surplus amounted to 1,1% of GDP, although imports also increased by 13% and amounted to almost 70% of GDP. In the midterm period, the slowdown of the economies of the main trading partners creates uncertainties about the stability of the balance of payments.

Remaining highly correlated with the RUB the BYN is gradually strengthening since the beginning of 2019 (see graph 7). At the same time, reducing the sensitivity of the Russian currency to the oil prices had also a spillover effect on lowing volatility of the BYN. After fluctuation close to average level of USD 7 bn in 2018, since the beginning of 2019 country's international reserves are increasing at an accelerated pace and have reached USD 8,3 bn as of 1 July 2019, which are equivalent to 30,8% of gross government debt and cover slightly more than two months of imports (see graph 8). Hence, the stability of the national currency and the growth of reserves, along with the elimination of all legislative currency restrictions, allow us to equalize the probability of default in national and foreign currencies.

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_12.07.2019.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.