Research Report on Belarus

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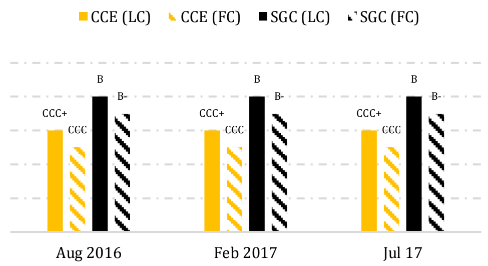
Ratings

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	31,2	47,7	50,8
Nominal GDP, BYR bn	80,6	89,9	97,2
Real GDP growth, %	1,8	-3,8	-3,0
Gross gov. debt/GDP, %	38,8	53,0	52,3
Deficit (surplus)/GDP, %	1,0	1,4	1,4
Inflation rate, %	16,2	12,0	10,6
Current Account Balance/GDP, %	-	-	-3,6
External debt, USD bn	-	-	22,4

Development indicators	2015
Inequality adj. HDI	0,74
GDP per capita, USD th	18,1

Default indicator	28.07.2017
10Y Gov Bond Yield, %	6,6

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 elevated debt metrics, risk of potential materialization of contingent liabilities, persistent banking sector risk and, despite positive dynamics, continued high levels of inflation and dollarization. Moreover, the rating assessment is still restrained by a dismal external position and negligible progress in structural reforms.

However, the high levels of debt are mitigated by the new agreement with the Russian government and a positive debt structure. In addition, the fiscal balance has been positive and we expect it to remain at surplus in the mid-term perspective.

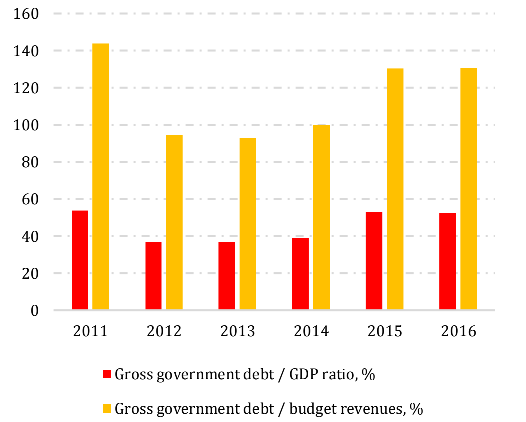
Government debt remains high but at favorable conditions. The IMF's revised debt metrics showed that the gross government debt of Belarus stood at 52% of GDP and 130% of budget revenues as of the end 2016 (see graph 1), which means a downward reassessment as compared to the previous data. However, this revision did not lead to the rating downgrade, which was mentioned as potential rating action in our previous research report[1], due to the new agreement with the Russian government in April 2017 and issuance of Eurobonds in June 2017.

The Russian and Belorussian governments reached the agreement on debt repayment which includes USD 300 m tranche from the Eurasian Fund of Stabilization and Development (EFSD), obtained in 2Q 2017, as well as new cross-government loans of USD 1 bn and refinancing of the current liabilities. These will keep the Russian government and Russian-led Fund as key creditors of the country. However, Belarus continues its policy on creditors' structure diversification having negotiations with IMF and European Investment Bank on new loans.

In addition, in June 2017 the Belorussian government issued USD-denominated bonds with a total volume of USD 1,4 bn and maturity in 2023 (USD 800 m) and 2027 (USD 600 m). Demand on these bonds was more than twice higher than the total supply. This issuance offsets the risks of repayments of USD 800 m on previously issued Eurobonds which will mature in January 2018.

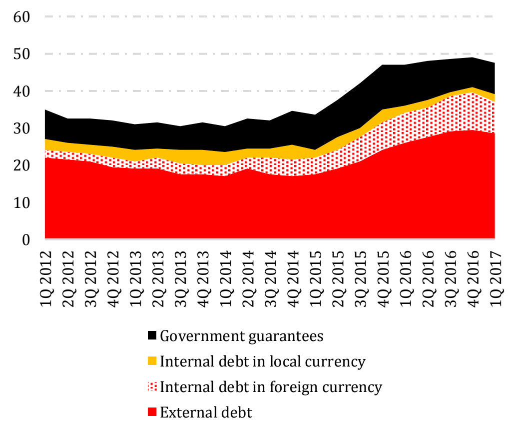
[1] Research Report on Belarus from 3 February 2017 https://raexpert.eu/reports/Research_report_Belarus_03.02.2017.pdf

Graph 1: General government debt metrics



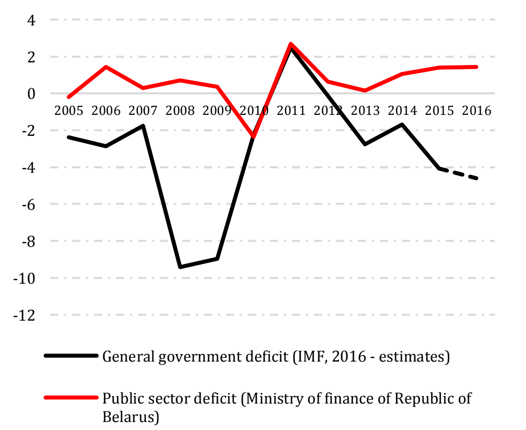
Source: RAEX (Europe) calculations based on data from the IMF and MFRB

Graph 2: Government debt structure, % of GDP



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

Graph 3: Fiscal balance, % of GDP



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

These two factors mitigate the risks of debt non-repayment in 2017 and support the rating assessment. However, the high share of FX-debt (see graph 2) as well as contingent liabilities of the government related to banking system recapitalization create long-term risks for the country's debt load. An additional risk factor that arose in 2016 is a new mechanism of bad loans replacement by local governments' bonds (see below).

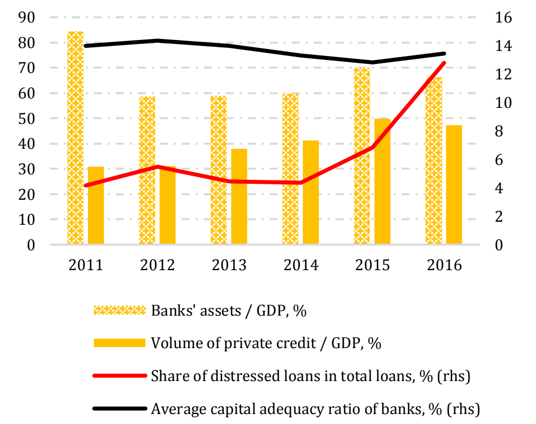
Fiscal balance to remain positive in 2017 while levels of off-budget operations are high. The Belarusian government confirmed its commitment to fiscal consolidation reporting a fiscal surplus equal to 1,4% of GDP by the end 2016 and 1,8% of GDP by the end 1Q 2017. These levels were reached due to an increase in tax revenues as well as public costs containment (mostly subsidies, wages and capital expenditures).

At the same time, the fiscal surplus reported by the Ministry of finance of Republic of Belarus (MFRB) is traditionally higher than the figures reported by IMF for overall public sector balance (see graph 3) due to widespread quasi-fiscal operations, such as directed lending. Despite the fact that the government announced a reduction of directed lending limits by 30% in 2017, the share of such loans remains as high as 44% of total banks' assets according to recent estimates. The poor financial stance of most SOEs indicates that the risk of government contingent liabilities materialization, which is related to subsidies to SOEs and banking system recapitalization, remains in place and, therefore, restrains the rating assessment.

The fiscal position of the government for 2017 can be supported additionally due to the agreement between Belarus and Russia in regard to oil import volumes and redistribution of duties on oil-products. With this agreement, the Belarussian government can obtain up to USD 900 m from duties and additional taxes. However, the Agency keeps on watch the fiscal budget execution, due to the fact that the mentioned potential revenues are very sensitive to the position of the Russian government as well as the oil price.

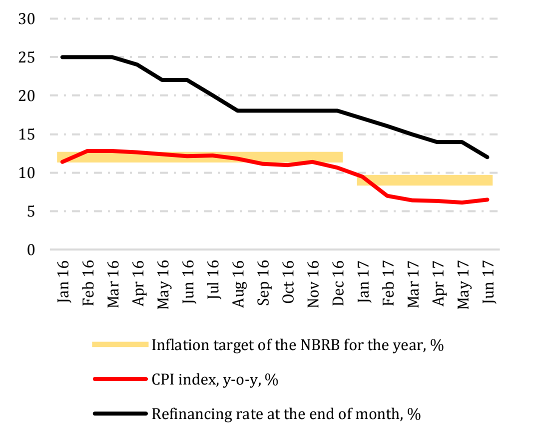
Banking system risks keep increasing and can trigger additional fiscal problems. In line with our expectations, the level of NPLs in Belarus was reassessed by the World Bank upward to 13,5% by the end of 2016, as compared to the previous assessment at 11,5% for the same period (see graph 4). The steep increase in the share of NPLs was driven not only by poor performance of the local enterprises (especially SOEs), but also by the impact of the National Bank of the Republic of Belarus's (NBRB) policy. A significant part of this policy was the creation of the "Agency of Assets Management" (ASM) in July 2016 in order to reduce the level of NPLs in

Graph 4: Banking system performance



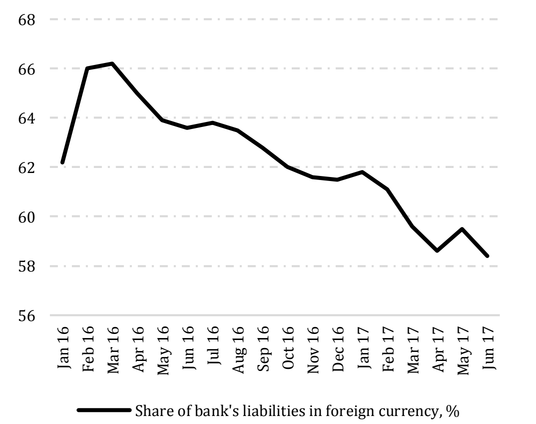
Source: RAEX (Europe) calculations based on data from the WB and NBRB

Graph 5: Monetary policy metrics



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

Graph 6: Share of FX-liabilities/assets of the banking system, % of total liabilities/assets



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

the banking system by transferring them from the banks' balance sheets to the special government led entity.

The mechanism of the ASM's functioning is not fully transparent; however, the original regulation presumes the exchange of bad loans by local governments' bonds with a nominal value. In the Agency's view, the widespread use of this scheme can create a significant debt pressure on local public finances and, as a result, on the general government debt position. Given the high level of bad loans transfers to off-balance accounts of banks and the potential underestimation of the loans quality by local banks, the real level of NPLs is higher than the official figure.

Moreover, despite the NBRB introducing new measures to restrain the NPLs growth and the announcement of privatization of government owned banks, the main problem, in our view, has not been tackled: the chronic insolvency of local enterprises. The Agency notices that the worst case scenario can lead to widespread non-payment crisis.

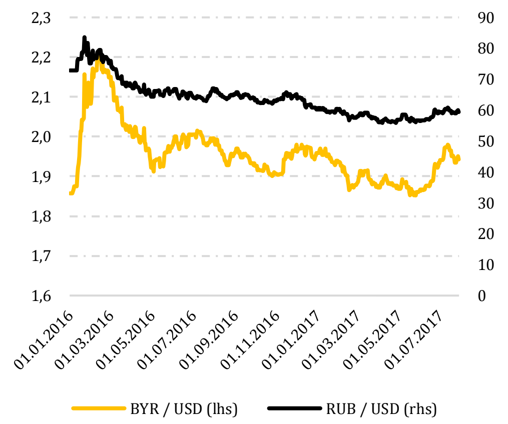
The NBRB is gradually reducing the reference rate, while the transmission mechanism remains weak. Since our last revision in February 2017 the NBRB reduced its interest rate five times following the sharp decrease in inflation levels (see graph 5) which was driven by lower consumption and appreciation of the BYR along 2016 and 2017. The latest interest rate cut was done on 19 June 2017 setting the metric at 12% which is the lowest level since March 2011.

The share of FX-denominated assets and liabilities declined by 3 p.p. since December 2016 and reached 58,4% of corresponding portfolio by June 2017 (see graph 6). This is a significant improvement as compared to figures from the last year. However, current dollarization levels still have a severe adverse effect on the monetary policy. In addition, taking into account the uncertainty about oil-price and, therefore, Russian ruble exchange rate (see graph 7), the Agency expects dollarization levels in Belarus to increase by the end of 2017.

The second factor distorting the monetary policy comes from the high share of loans issued with subsidized interest rate (directed lending). According to recent estimates, these loans accounted for around 40% of total loans as of March 2017, which limited the NBRB's ability to influence banks' market interest rates by using monetary policy tools.

External position remains vulnerable despite positive dynamics. In line with our expectations, the current account deficit widened in 2016 as compared to 2015 and reached -3,6% of GDP, mainly due to the less favorable conditions on the oil market for Belarus as well as disputes with

Graph 7: Dynamics of the exchange rates of BYR and RUB



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

Graph 8: External position metrics

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

Russia on volumes of oil import, decreased prices on potash and lower external demand on Belarusian exported goods.

The external position of the country measured by the ratio of net foreign assets to GDP remains risky despite the positive dynamic: the ratio reached a reading of -0,9% by the end 2016 which is the highest level since 2012 (see graph 8).

The Agency believes that the external balance of Belarus in 2017 will be partly supported by the new agreement with the Russian government (see above). However, it remains very sensitive to its counterparties' position as well as oil prices dynamic.

Progress in structural reforms is meager. The Agency's concerns about the structural reforms in the country remain in place. With a few exceptions, none of the large SOEs were privatized within the observed period. The results of comprehensive inventory of SOEs performed by the authorities were not disclosed, and therefore the potential share of bankrupt entities is still not clear.

The recent announcements on delay of utilities prices liberalization as well as the announced investment programs for big manufacturing SOE's financed by the fiscal budget and directed lending can be considered as signs of continuing delay of structural reforms.

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_28.07.2017.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.