

## Economics

30 June 2011 | 11 pages

# Belarus Macro View

## Market is Under-Pricing Belarus Risk – Trip Notes, 23-24 June

- **Market is under-pricing Belarus risk** — is our main conclusion from our trip to Minsk on 23-24 June. The current exchange rate appears unsustainable even with EvrAzES support and further risks stem from the banking system. Structural reforms needed to halt the balance of payments crisis appear in contrast with the political model of high growth, full employment, and preservation of key assets in national (public) hands. For these reasons, we believe an IMF programme is also unlikely.
- **Shortage of FX liquidity persists** — Central bank reserves remain negative on a net basis (about US\$4.4bn in gross reserves including EvrAzES loan disbursement of US\$800mn in June and US\$4bn deposited by banks). In our view, it is likely that the authorities will have to impose a freeze on FX deposits that account for about 50% of total deposits in order to shore up FX liquidity.
- **Domestic banks' position seems precarious** — We expect shocks from credit, liquidity and interest rate risks. Some banks estimate that under the baseline scenario, which in our view is overly optimistic (exchange rate at 5000, inflation at 40% and a moderate slowdown of growth), restructured loans could reach over 80%. Furthermore, the cost of funding is likely to increase substantially (banks are paying about 7-9% on FX deposits).
- **Nonetheless, default on Eurobond appears unlikely in the near term** — Belarus has about US\$1.8bn outstanding in Eurobonds, with a modest repayment due of US\$85mn in 2011. We believe the authorities will continue paying on their obligations in the coming months in order not to be blocked out of the market given that the roll-over needs spike to about US\$2bn in 2013 and short-term debt is currently at US\$14bn.
- **Positive triggers that would change our view** — Exchange rate unification, substantial growth contraction, large scale privatisation such as Belaruskali and an IMF programme.

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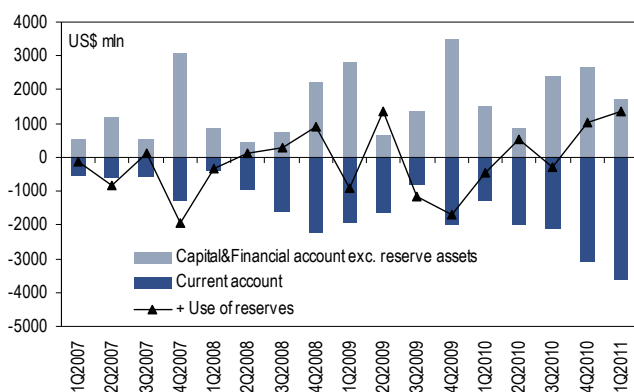
# Market is Under-Pricing Belarus Risk

## Adjustment so far appears insufficient

**Insufficient official devaluation resulted in a multiple exchange rate regime and FX shortages.** The exchange rate devalued by about 66% to 5000 Rubles per US\$ in April from 3000 a year earlier; however, an active fragmented parallel market exists. Exporters are required to sell about 30% of their export proceeds at the official rate, but the central bank estimates that only about 18% of proceeds are being sold at this rate. FX at the official rate can be purchased to pay for gas and medicines and what is left over for repayment of debt by banks and corporates. In practice little is left over – 23 June was the first day in the month that companies looking to repay external debt got access to FX at the official rate. For cash transactions the rate is about 6000-6400, banks and corporates use an exchange rate between 7500 and 10000. The situation is so difficult that Russia has begun suspending electricity supplies to Belenergo (Reuters, 21 June, 29 June).

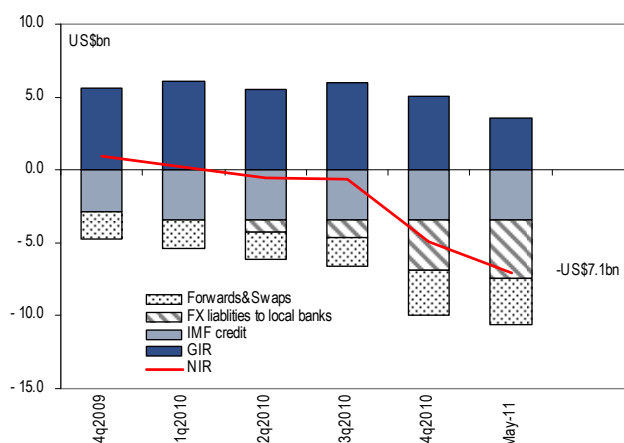
**Reserves of the National Bank of the Republic of Belarus (NBRB) remain negative and a bank deposit freeze can't be ruled out.** In the last six months Belarus used US\$2.3bn in reserves in order to close the balance of payments financing gap bringing gross reserves to US\$4.4bn, including EvrAzES<sup>1</sup> loan disbursement of US\$800mn in June, and net reserves, excluding money the NBRB borrowed from domestic banks and the IMF, possibly down to negative US\$7bn, according to our estimates. There is uncertainty regarding the size of the borrowing from domestic banks. The IMF estimated that in addition to about US\$3bn in FX forwards and swaps, the NBRB borrowed US\$3.8bn in "deposit exchanges" from domestic banks at end-2010.<sup>2</sup> During our trip we heard that "deposit exchanges" stood at about US\$4bn, mostly from state-controlled banks, but little information was provided on the forwards and swaps. The current account deficit was up to US\$3.6bn in 1Q2011 from US\$3.1bn in 4Q2010. Since the devaluation in April, the trade deficit has fallen somewhat to US\$673mn from US\$1bn per month in February and March, but most likely owing as much to the seasonality of gas imports as to contraction in imports. Exports contain a high share of imported components; however, some sectors could benefit from devaluation.

Figure 1. Current account deficit reached US\$3.6bn in 1Q2011



Source: NBRB, Citi Investment Research and Analysis

Figure 2. Driving net international reserves of the NBRB deeply into red

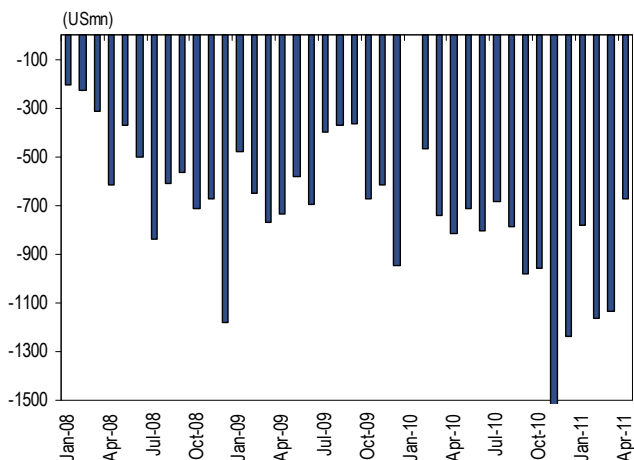


Source: NBRB, Citi Investment Research and Analysis

<sup>1</sup> EvrAzES stands for the Eurasian Economic Community [www.evrases.com](http://www.evrases.com).

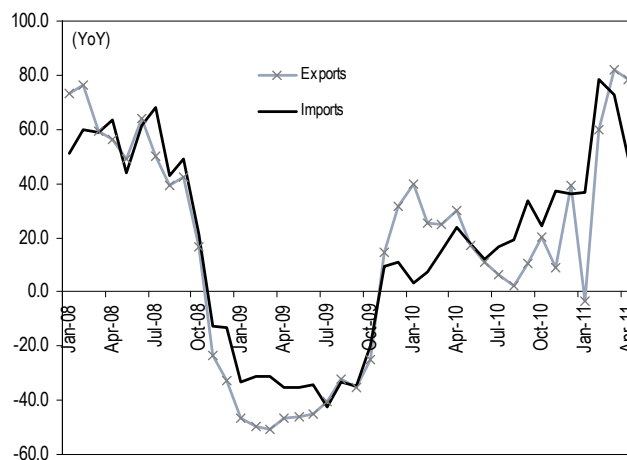
<sup>2</sup> <http://www.imf.org/external/pubs/ft/scr/2011/cr1166.pdf>

Figure 3. In April the trade deficit fell somewhat, likely aided by the lower seasonal payments for gas



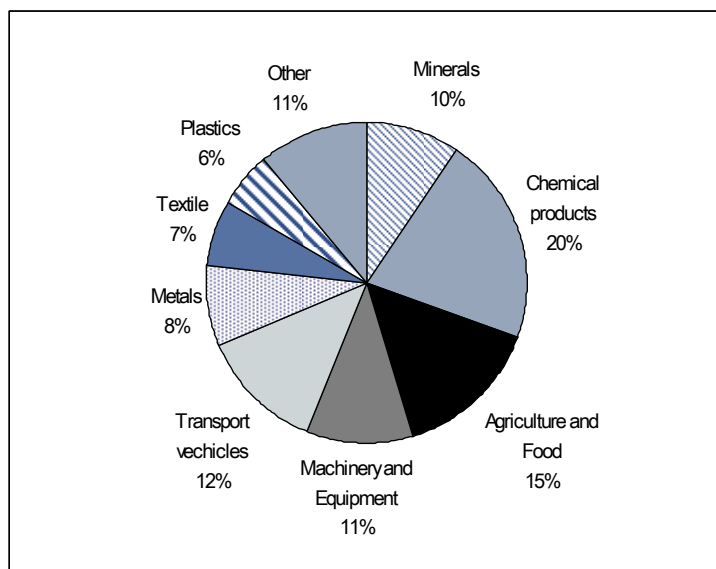
Source: NBRB, Citi Investment Research and Analysis

Figure 4. As well as some slowdown in imports growth



Source: NBRB, Citi Investment Research and Analysis.

Figure 5. Some export sectors could benefit from devaluation (structure of exports, 2010)

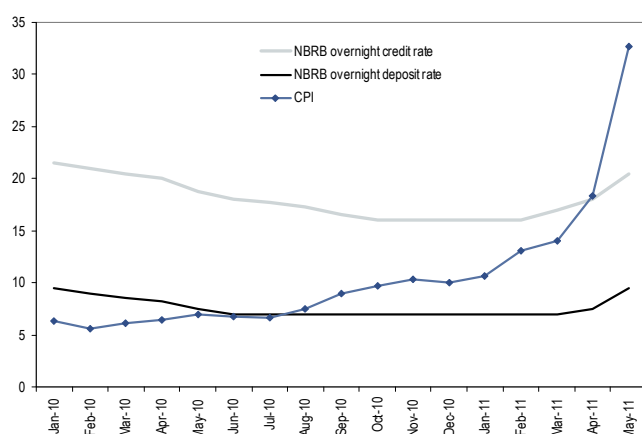


Source: NBRB, Citi Investment Research and Analysis

**Quick pass-through is eroding competitiveness gains, and a devaluation-inflation spiral can't be ruled out.** Inflation spiked to 33% YoY (16% MoM) in May following the April devaluation. Local experts estimate that the pass-through from devaluation to domestic prices may be exceptionally high and rapid in Belarus, possibly with a coefficient of 0.7-0.8 in 2-3 months. This suggests that from the devaluation alone, inflation will reach 46-50% YoY. Anecdotal evidence appears to support this with prices of many staple goods doubling in recent months. Furthermore, the authorities appear to be using the very temporary respite given by the real effective exchange depreciation to impose administrative limits on foreign exchange and prices. Therefore, in our view, without bold steps to restructure the economy or massive financing from abroad, devaluation-inflation could develop.

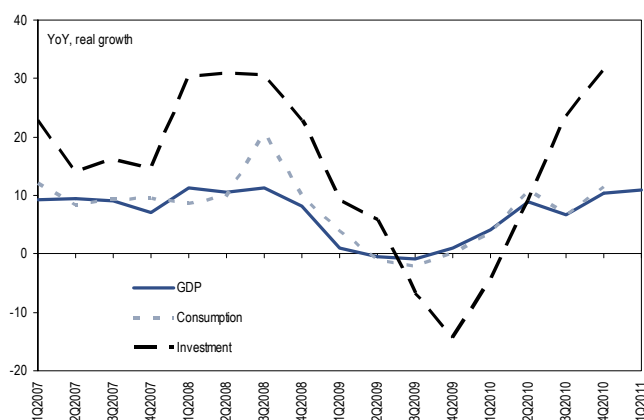
**Domestic demand continued to expand at a brisk pace with GDP up 12.5% YoY in Jan-April.** In May consumption was up 26% and investment 31%. At the same time, local experts estimate that growth would need to contract by 40-60% in order to balance only the non-energy component of the current account deficit. The authorities are committed to reducing the fiscal deficit to 1.5% from 3% in 2011. However, with inflation currently at 33% YoY, a large share of the “adjustment”, in our view, comes from the over-performance of nominal revenues. The NBRB earlier estimated that inflation could reach up to 70% in 2011; however, in agreement with the Ministry of Economy the forecast has been set for now at 36-40%. The Ministry of Finance recently announced that growth could reach 4-5% in 2011, implying a moderate slowdown in 2H2011 (Reuters, 24 June).

Figure 6. Rapidly accelerating inflation is eroding devaluation gains



Source: NBRB, Citi Investment Research and Analysis

Figure 7. Economy is yet to start slowing



Source: NBRB, Citi Investment Research and Analysis

## Banks to come under severe pressure

**Public financing may be required to support state banks, controlling 70% of banking assets (45% of GDP).** State banks were the main participants of the government lending programmes at subsidised interest rates; they also provided about half of the FX “deposits exchanges” within the NBRB (approximately US\$2bn). The NBRB reported capital adequacy ratio for the system as a whole at about 19% as of 1 April. At the same time according to the results of banking system stress tests referred to in the IMF report,<sup>3</sup> state banks are particularly vulnerable to the combined shock of an increase in problem assets, FX depreciation and an increase in interest rates. As loans to state enterprises are about 23% of the total banks’ loan portfolio and state-guaranteed debt in local currency exceeds 15% of GDP (mainly agriculture & construction) we think growing bank NPLs will likely be financed with public funds. At the same time authorities stated they expect foreign-owned banks (25% of banking assets) will get additional capital from their parents.

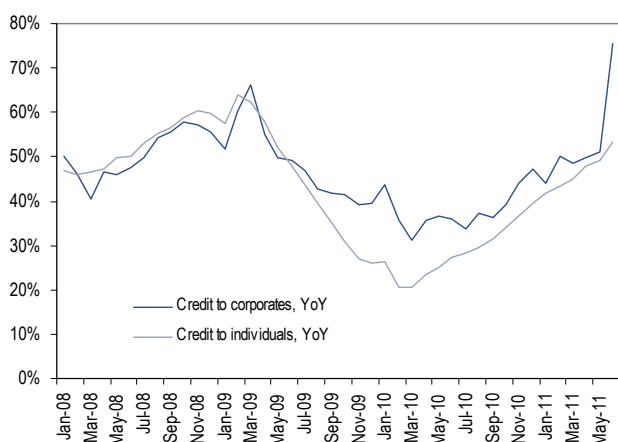
**As the cost of funding increases, banks may find it difficult to increase interest on loans, further curtailing bank operational profits and capitalisation.** Net interest margins are being squeezed and are already negative for retail loans in local currency. While rates on ruble deposits grew to 14-16% for corporates and exceeded 19% for households in May, interest rates on newly issued loans were about 10-18% for corporates and 12-19% for households. At the same time interest

<sup>3</sup> <http://www.imf.org/external/pubs/ft/scr/2011/cr1166.pdf>

rates on FX deposits reached 7-10%. Nonetheless, FX deposits fell by about 11%YTD (by about US\$0.5bn in April and US\$0.4bn in May) and stood at US\$6.5bn at the beginning of June

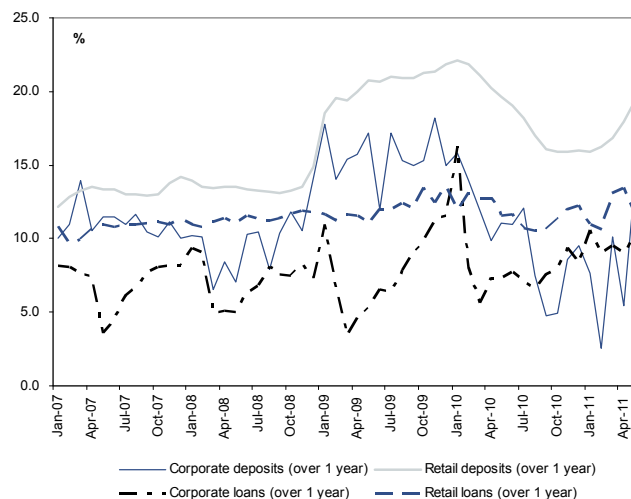
**Bad loans doubled over the last year, with bad loans in foreign currency up six times in US dollar terms.** Growth in problem loans is masked by over 50% expansion of the credit portfolio. Loans in FX account for about 20% of total loans (excluding the devaluation effect). According to NBRB estimates, NPLs (defined only as the amount overdue) remain low at 1.5%, and even then there has been a significant increase in NPLs in the trade sector — from 1.8% to 4% in May. Some banks estimate that under the baseline scenario, which in our view is overly optimistic — exchange rate at 5000, inflation at 40% and a moderate slowdown of growth — restructured loans could exceed 80%.

Figure 8. While credit growth remains strong...



Source: NBRB, Citi Investment Research and Analysis. Note: sharp increase in May is due to the re-valuation effect after the devaluation

Figure 9. ...net interest margins are already being squeezed



Source: NBRB, Citi Investment Research and Analysis

## Debt repayments are increasing

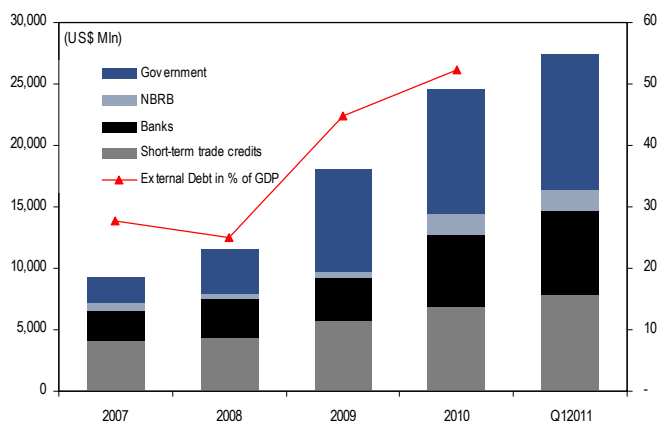
**Default on Eurobonds is unlikely in the near term, but there is a steep increase in financing needs in 2012.** Belarus has US\$1.8bn outstanding in Eurobonds and about US\$250mn in bonds issued on the Russian market with a modest repayment due of about US\$85mn remaining in 2011. We believe the authorities will continue paying on their obligations in the coming months in order not to be blocked out of the market given that the roll-over needs for government debt spike up to US\$2bn per year in 2013 for Eurobonds and the IMF. Total government debt as of end-May was US\$11bn, including US\$3.9bn from the IMF, US\$3.3bn from Russia and US\$1.8bn Eurobonds. In addition, the authorities received in June the first disbursement of US\$800mn from the US\$3bn from EvrAzES and US\$440mn is expected in October 2011.

**Russia holds about a third of the US\$32bn external debt of Belarus.** Russian exposure appears to be almost equally distributed among the government, banks and corporates, and will have a significant bearing on domestic policies. The second-largest creditor country or group of countries is not identified, but is not among the 20 or so Belarus trading partners for which data is available;

nonetheless these “other countries” are among the largest providers of trade credits. The IMF is the third largest creditor.

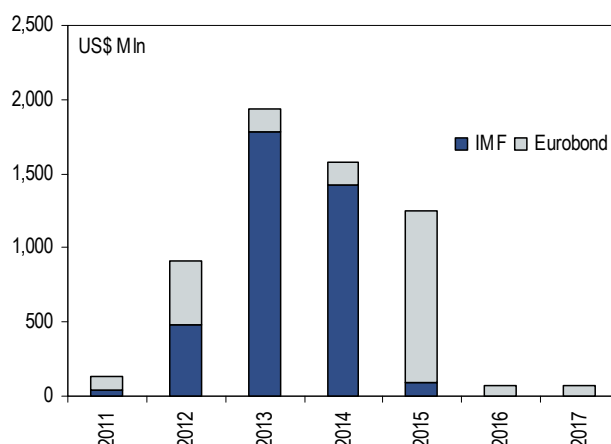
**US\$14bn of total external debt is short-term, almost four times gross reserves of the NBRB.** It appears that for now the immediate neighbours may have to continue supporting Belarus — Russia holds US\$4.8bn and Latvia US\$1.4bn of short-term debt. Corporate short-term debt is mostly short-term trade credits — US\$7.8bn — with US\$2.5bn from Russia and US\$2.5bn from unidentified countries that do not trade actively with Belarus. Banks’ short-term debt of US\$3.2bn is mostly to German/Austrian banks (US\$700mn) and Russian banks (US\$1.6bn). Curiously, the NBRB appears to have also borrowed short-term US\$1.1bn in 2010 from Latvia.

Figure 10. Government accounts for a large share of external debt



Source: NBRB, Citi Investment Research and Analysis

Figure 11. With large repayments scheduled for 2012-2015 (not accounting for bilateral loans)



Source: Bloomberg, IMF, MoF, Citi Investment Research and Analysis

Figure 12. Gross reserves are now about 26% of short-term debt

	2007	2008	2009	2010	Q12011
Total external debt (US\$ mn)	12,497	15,154	22,060	28,512	31,712
Government	2,036	3,597	8,363	10,058	10,998
Government: Short-Term	1	-	-	-	-
Government: Long-Term	2,036	3,597	8,363	10,058	10,998
NBRB	596	430	424	1,855	1,714
NBRB: Short-Term	356	351	146	1,267	1,108
NBRB: Long-Term	240	79	278	588	606
Banks	2,571	3,081	3,553	5,752	6,833
Banks: Short-Term	1,484	1,481	1,621	2,693	3,166
Banks: Long-Term	1,086	1,600	1,932	3,059	3,667
Other Sectors	6,785	7,327	8,922	10,033	11,310
Other Sectors: Short-Term	5,518	5,725	7,306	8,020	9,105
o/w S-T Trade Credits	4,032	4,416	5,693	6,909	7,815
Other Sectors: Long-Term	1,267	1,602	1,616	2,013	2,205
Intercompany Lending	508	719	799	814	858
Memo items:					
GDP (US\$ mn)	45,268	60,794	49,185	54,611	
Reserves (US\$ mn)	4,182	3,061	5,653	5,031	3,761
External Debt in % of GDP	28	25	45	52	
Short-term debt	7,867	8,276	9,872	12,794	14,237
Reserves in % of short-term debt	53	37	57	39	26

Source: NBRB, Citi Investment Research and Analysis

## Positive triggers

**Positive triggers that would likely change our view are** exchange rate unification, substantial growth contraction, and/or large-scale privatisation such as Belaruskali. Based on our discussions in Minsk, we believe that it is likely that Beltransgaz will be sold in the coming month. However, this would provide only a temporary respite. IMF funding also seems unlikely in the near term. The mission in June was originally scheduled as a post-programme monitoring mission; nonetheless, the team left with the authorities' scenarios on 13 June, asking for full disclosure and commitment at the highest level.<sup>4</sup> While the authorities have not yet responded, which in itself is a sign, we believe political constraints will prevent the authorities from giving sufficient commitment to the programme.

<sup>4</sup> <http://www.imf.org/external/np/sec/pr/2011/pr11229.htm> and  
<http://www.imf.org/external/pubs/ft/scr/2011/cr1166.pdf>

## Appendix A-1

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