



The Belarus Public Policy Fund

(project of the Pontis Foundation and the Belarusian Institute for Strategic Studies)

presents

**Belarus external debt:
Sustaining Levels in a Time of Global Crisis¹**

by

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Minsk, Spring 2009



¹ This policy paper has been prepared with the assistance of the Pontis Foundation and supported by the Belarus Public Policy Fund. The aim of the fund is to provide direct support for Belarusian experts working on issues of strategic importance and thus to stimulate public policy debate in Belarus. The opinions presented in the paper are of the author exclusively, neither necessarily of the Pontis Foundation nor of those of the Belarusian Institute for Strategic Studies.

Belarus external debt: Sustaining Levels in a Time of Global Crisis

Summary

This paper analyzes the sustainability of Belarus external debt and examines predictions for its growth. Concrete measures to optimize the structure of this debt are also investigated. Although compared to other Central and East European countries, the level of the current external debt of Belarus is relatively low, the structure of the debt, which is composed of mainly short-term trade and bank loans, makes the costs of its servicing high. In addition, growing exchange rate risks and increasing interest rates – both effects of the global financial crisis – make prospects for successful servicing of the debt uncertain.

The government can hardly do anything about the global crisis. But it can act to prevent dire scenarios from occurring; a situation which remains highly possible post-crisis. Simplification of registration procedures for businesses, the adoption of international financial accounting standards, swift actions enabling Belarus to enter the Eurobonds market and privatization are some of the concrete steps the government should take to ensure external debt does not overload the country's servicing possibilities and harms its economic standing abroad.



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The paper is prepared with the support of the Belarusian Public Policy Fund. The content of this publication is the sole responsibility of the author and does not necessary reflect the views of the IPM Research Center or other institutions the author may be affiliated to.

1. Introduction

The current global financial crisis has brought the question of whether external debt promotes or hampers economic growth to Central and Eastern Europe (CEE) and to the Commonwealth of Independent States (CIS).

The impact of the global economic crisis is already being felt in Belarus. The country's economy is highly dependent on oil prices and the economic performance of Russia. The fall in export revenues due to a reduction in the prices for petroleum products and a steep drop in demand for Belarusian investment goods in Russia, have both resulted in a growing current account deficit. To prevent further devaluation of the Belarusian ruble, the government needs to attract substantial external loans of at least USD 5 bn before the end of this year².

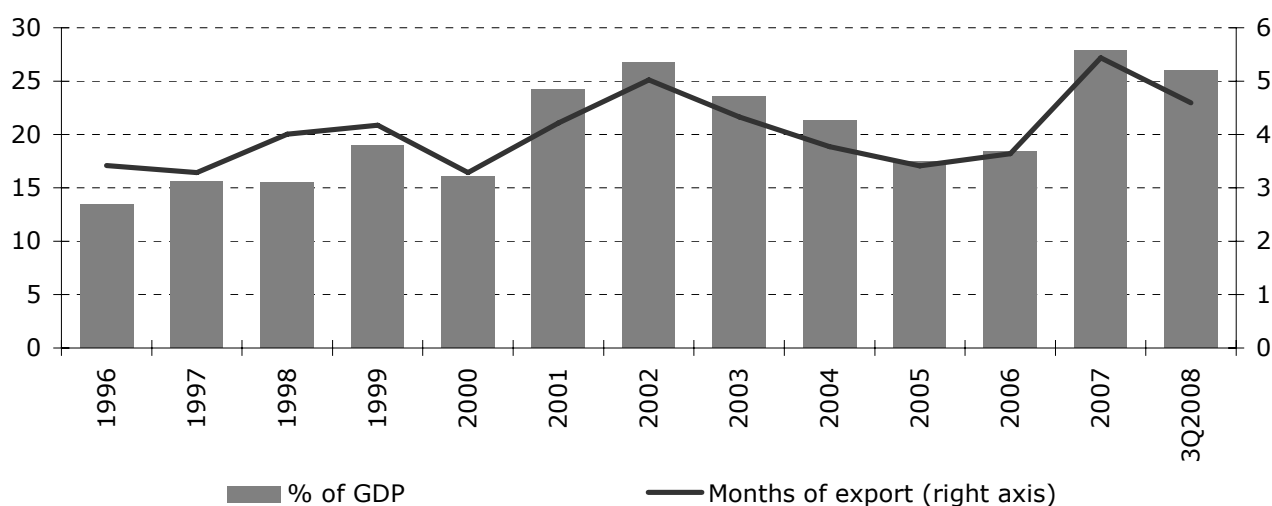
2. Belarus external debt: Volume and structure

2.1. Volume of Belarus external debt

In previous years, Belarus gross external debt was low. Since 2003 the level of external debt was falling (see Figure 1), partly due to economic growth fueled by privileged prices on Russian energy goods (Chubrik, 2005). Indeed, until 2007, it exceeded the level of 25% of GDP only once (in 2002). The situation radically changed in 2007, when gas prices rose more than twofold. The current account deficit grew from 1.4% of GDP in 2005 to 6.7% of GDP in 2007 whilst investment growth rates began to dwindle from 31.6% in 2006 to 15.1% in 2007.

To compensate for this decline, the government began to rely on external financing, especially on external borrowing. Consequently, Belarus 2007 external debt grew from 18.4% to 28.5% of GDP and reached USD 12.7 bn in absolute terms (compared to USD 6.8 bn at the beginning of 2007). While favorable external economic conditions – high prices for petroleum products and depreciation of US dollar – prevented debt accumulation until October 2008, the economic crisis resulted in a rise in debt. Nevertheless, the current level of Belarus gross external debt is lower than other CIS and CEE countries, where in some states it exceeds 100% of GDP (see Annex, Figure 1A).

Figure 1. Belarus gross external debt dynamics



Note. Data at the end of the period.

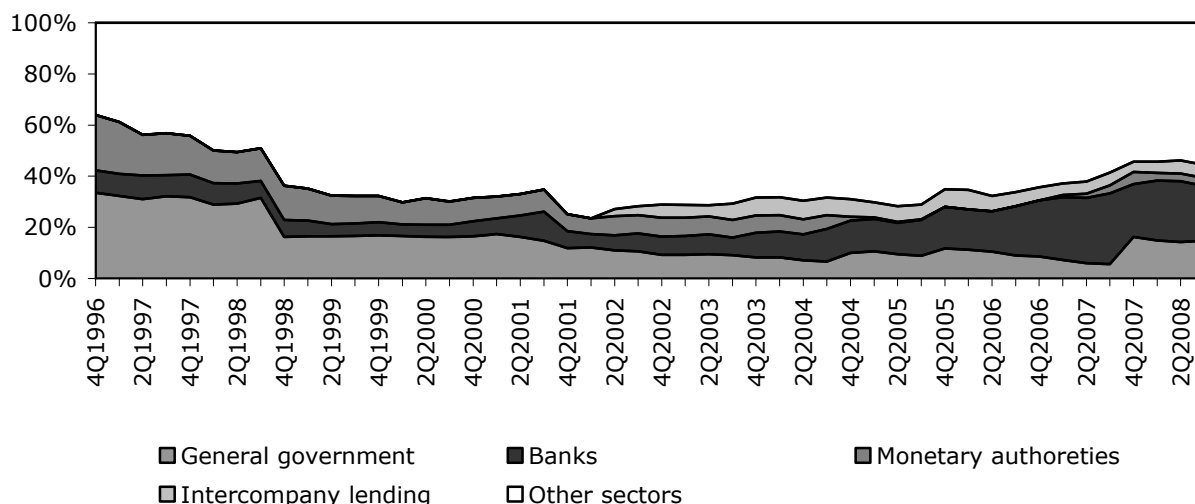
Source: National Bank of Belarus (NBB), Belarusian National Statistical Committee (Belstat).

² See also Shymanovich, G. (2009). Belarus External Debt: Experience of the Post socialist Countries, *IPM Research Center's working paper WP/09/01*, IPM research center (Russian language).

2.2. External debt structure

The greatest share of external debt is formed by “other sectors”, i.e. the external borrowing of enterprises and individual loans. This has not changed significantly from 1999. Its slight reduction in 2007 is explained by the growing loans of banks and the public sector (see Figure 2). By the end of Q3 2008, the share of “other sectors” reduced to 55.5% of gross external debt. However, data shows that these “other sectors” became the main factor of the increase in Belarus external debt in 2007.³

Figure 2. Structure of Belarus gross external debt by sectors



Source: NBB.

In addition to “other sectors”, banks and the public sector have also contributed to an increase in gross external debt.

Banks have used external borrowing to maintain high investment growth rates. Enterprises also borrowed from abroad to compensate for the lack of their own resources. In 2007, the external debt of banks grew by 16% (20.6% of the external debt share). While it continued to grow in the first half of 2008, due to the global financial crisis it has started to fall again (21.4% in Q3). As the end of the crisis is not anticipated in the short-run, it can be assumed that the share of the banking sector in Belarus gross external debt will continue to decrease.

Importantly, as Belarus received USD 1.5 bn loan from the Russian government towards the end of 2007, the share of public debt soared from 5.7 to 16.3%. Expecting additional intergovernmental loans from Russia, the Ministry of Finance raised the limit of public external debt from 2% to 6% of GDP. In November 2008, Belarus obtained USD 1bn as the first tranche of a new USD 2bn loan from the Russian Federation. These loans were meant to compensate the negative trade balance and support the exchange rate of the Belarusian ruble. To the same purpose, Belarus applied for a USD 2.5 bn loan from the IMF, which was approved in December 2008 and again, approached Moscow to apply for another loan of 100bn Russian rubles in 2009.

Compared to other CIS and CEE countries, the structure of Belarus external debt shows some peculiarities:

Firstly, in addition to the highest share of “other sectors” in its gross external debt in the region (see Annex, Table A1), in Belarus, there is almost no inter-company lending. This is mainly due to a small number of subsidiaries of foreign companies operating in the country. At the same time, the share of banks’ gross external debt is within the regional average, which is explained by a rapid growth of bank lending in the last 2 years.

Secondly, the maturity of lending within external debt is also uncommon for the region. In 2004, short-term debt constituted about 71% of gross external debt. By the end of 2007 its

³ See Shymanovich, G. (2009). Belarus External Debt: Experience of the Post-socialist Countries, *IPM Research Center's working paper WP/09/01*, IPM research center (Russian language).

share fell to 57.7%, which is still high for the region. The slight reduction of short-term debt is determined by the attraction of the Russian loan and development of long-term borrowing by banks. The first time Belarusian banks attracted long-term loans was in 2005. By the end of 2007 their share had already reached 42.3%.

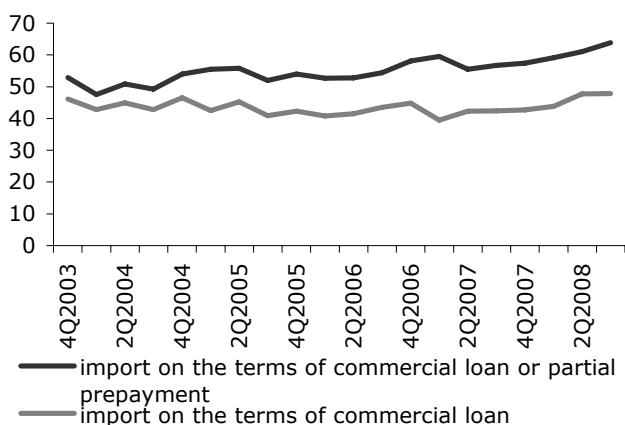
Thirdly, "loans" and "trade loans" (see Box 1) prevail as main instruments of borrowing. At the end of Q3 2008 they constituted 52.1% and 36.0% of the gross external debt respectively. Banks also used "currency and deposits" as another source of external borrowing; but they represent only 1.4% of gross external debt. The share of the debt attracted by money market instruments, bonds and notes, did not exceed 0.1%. Other debt instruments accounted for the remaining 10.4%, including 4.4% of arrears. While the level of arrears is lower compared to the previous year (5.1%), its increase is expected as the financial situation in Belarusian companies worsens⁴.

Box 1. Belarus trade loans

The term "trade loan" (synonym in this case of "commercial loan") describes the situation when a payment for a product is postponed. In 2007, Belarus imported 41.9% of goods on such terms. During Q1-3 2008, the share of these goods grew to 46.7%. In addition, 14.9% of imports were completed on the terms of a partial commercial loan and partial prepayment (15.3% in 2007). This structure of import payments remained stable over the last few years (Figure 3). The only change is related to the growing share of imports on the terms that include partial commercial loan and partial prepayment. Around 60% of imports are accomplished via commercial loans, partly or fully. The external debt on trade loans represents non-paid out commercial loans and its growth is fully explained by imports.

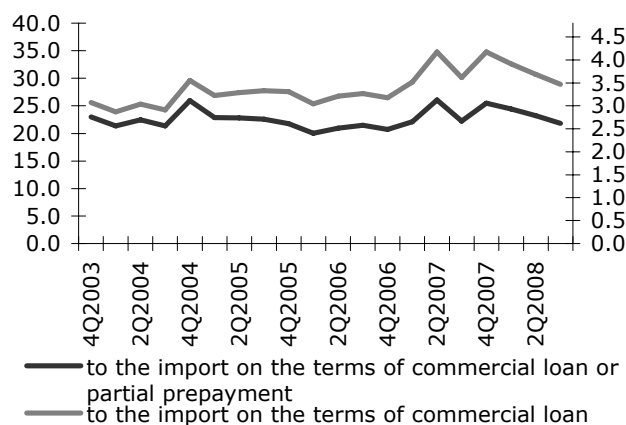
Comparison of external debt attracted via trade loans and the volume of import on the terms of commercial loans shows that the ratio between them is around 0.23. Thus 23% of products imported on terms of commercial loan remains in the form of current external debt (Figure 4). This means around 2.7 months of the import remains unpaid, thus representing the average period of payment on commercial loans. In 2008 this characteristic fell from 3.1 months at the beginning of the year to 2.6 by the end of the 3rd quarter, as import growth rates exceeded growth rates of external debt in the form of trade loans. The negative sign, within the debt in the form of trade loans, is a growing overdue debt: it increased from 8.7 to 9.4% of the debt of "other sectors".

Figure 3. The share imports on the terms of commercial loans in the total imports of Belarus



Source: Belstat.

Figure 4. The ratio of external debt on trade loans to imports on the terms of commercial loans



Source: NBB, Belstat.

⁴ The companies are expected to not cut volumes of production and maintain employment levels, despite drops in demand. The goods either go to inventories or are sold on credit terms.

3. Sustainability of the external debt

3.1. External debt servicing

While external debt remains on a moderate level compared to other countries of CIS and CEE, its current structure and prevalence signalizes potential problems. Costs of servicing this kind of external debt are high: between 2003 and 2007, these amounted to 7.5–10.0% of GDP (8.8% of GDP in 2007). This figure is close to the external debt service payments of Hungary, Latvia and Lithuania (see Annex, Figure A1), even though the gross external debt in these countries (95.9, 142.5, and 78.4% of GDP respectively) is much higher compared to Belarus (28.5% of GDP). Principal repayments constitute almost 95% of Belarus external debt servicing. In 2007, total debt servicing rose up to USD 3965.4 million, including USD 3728.0 million debt principal repayments. Interest payments alone amounted to USD 237.4 million.

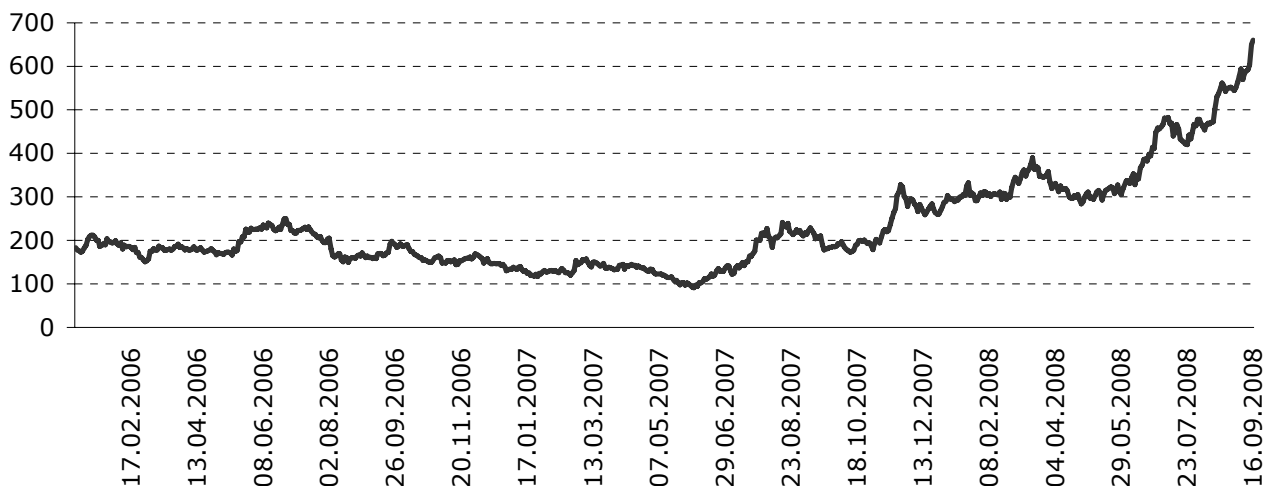
Belarus international reserves cover only 55.4% of short-term debt, which is less than in other post-socialist countries (see Annex, Figure A2). This negative aspect, that undermines debt sustainability, is mitigated by the fact that short-term debt is formed mainly by trade loans, which has been further complicated by the global economic crisis. Belarusian enterprises are obliged to follow strict production plans despite the current crisis. As the demand for their products – especially on Russian markets – shrinks, companies pile up their products in warehouses. With their assets frozen in the form of finished goods inventory, enterprises currently face a risk of a shortage of assets to repay trade loans.

3.2. Interest rates

Public external debt is almost completely formed by loans from the Russian government at the end of Q3 2008. The loan of USD 1.5 bn was provided on favorable conditions for 15 years. The terms of another Russian loan, the first tranche of which was received in Q4 2008, differ only in an increased interest rate spread of 300 base points. Public external debt also consists of other intergovernmental loans (from China, Venezuela) which have similar re-payment schemes.

Therefore, existing public external debt is not vulnerable to interest rate fluctuation. On the other hand, interest rate growth limits possibilities for further borrowing from abroad. In 2007, Belarus declared its interest in issuing Eurobonds and even managed to obtain two sovereign credit ratings from Standard & Poors and Moody's. No other activity in this direction was held, partly due to the increased costs of taking out loans. The growth in the interest rates can be tracked via the dynamics of the spread for Ukraine, taken as EMBI+ index (Kruk, Kirchner, Giucci (2008)⁴. Figure 6 depicts that interest rates tripled from 200 to 600 base points from September 2007 to September 2008.

Figure 5. EMBI + spread for Ukraine



Source: www.cbonds.info.

In 2007 and in Q1/2 2008, Belarusian banks attracted mainly syndicated loans with a fixed schedule of repayment. Interest rates for these loans were quite stable (around 300–350 base points). Starting from the second half of 2008 no syndicated loans were attracted as there was a lack of liquidity on international markets. Other kinds of loans by Belarusian banks were also limited due to the same reason.

Normally, this would mean that gross external debt is not exposed to interest rate fluctuation. But the growth of the latter in a crisis environment and the global lack of liquidity have significantly constrained possibilities for the further attraction of loans from abroad. Furthermore, it has also limited the possibilities for refinancing current external debt. This applies both for banks' syndicated loans which are usually obtained for a period of 1-1.5 years, as well as loans by enterprises ("other sectors").

3.3. Currency of borrowing

Another significant risk factor is currency fluctuation. As in other CIS countries, Belarus is highly dollarized. This implies that the bulk of its external debt is nominated in US dollars. The exchange rate of USD to Belarusian ruble, which had been stable since 2003, has been an anchor of monetary policy and has helped to stabilize price levels and sustain favorable conditions for economic growth. Despite the fact that the international reserves of Belarus were rather low, there was no reason to anticipate any depreciation of Belarusian ruble in the last years.

The situation has dramatically changed in Q4 2008. The global financial crisis and the rise in Russian energy prices have become serious threats to currency stability. The crisis has hampered Belarus' trade balance as the demand for Belarusian investment goods in Russian markets dropped. The decrease in prices of Belarus petroleum products which usually export to the EU is another factor of risk⁵. Even though gas prices for 2009 eventually settled at lower levels than expected, this did not prevent Belarus from experiencing a 20% devaluation on 2nd of January 2009. The devaluation was one of the conditions attached to the IMF loan to minimize the impact of the global financial crisis. However, the poisonous mix of a drop in demand for Belarusian goods and the falling prices for oil products, along with the growing dollarization of the economy, puts further pressure on the exchange rate of the ruble, thus risking another devaluation.

If the government opts for maintaining a fixed exchange rate regime, it can only do so through further external borrowing. Another devaluation of the Belarusian ruble would lead to an increase in the country's external debt. Whichever option the government decides to pursue, in the upcoming period the external debt of Belarus will grow.

4. Conclusions and recommendations

Despite the fact that Belarus' external debt almost doubled in 2007, it remains at a relatively low level compared to other countries of CIS and CEE. But the global financial crisis and short-term nature of this debt have posed serious threats to the sustainability of Belarus' gross external debt. Today, servicing of the debt is exposed to the following risks:

- Belarus' gross external debt structure, characterized by the prevalence of short-term debt, casts doubts over its sustainability. This debt is formed mainly by trade loans of enterprises, the servicing of which can be difficult in a crisis. Despite decreases in demand, enterprises that have to follow production plans are supposed to maintain volumes of production. This results in a growth of inventories and a shortening of circulating assets, which complicates trade loan servicing further;

⁵ At the moment this paper was prepared, the data on the 4th quarter of 2008, that could support this hypothesis was not available.

- Exchange rate risk. An increasing current account deficit due to the fall of the export of investment goods to Russia and the decrease in prices for petroleum products, have put pressure on the exchange rate of the Belarusian ruble. As foreign investments are currently limited, the only way to offset this deficit is by increasing the volume of public external debt. In turn, a devaluation of the ruble leads to an increase in the dollarized external debt. Appreciation of the US dollar leads to a corresponding debt increase;
- Interest rate risk. The intensifying crisis has transformed into a problem of absence of resources on the financial markets. Existing external debt is only slightly exposed to the risk of interest rate growth. However, the lack of liquidity on the global market makes the refinancing of this debt almost impossible. Current debt repayment will lead to further pressure on the balance of payments. Had the global economic crisis not unfolded, Belarus would have been able to cover the current account deficit by attracting foreign direct investment and external borrowing. This option is no longer so easily available.

Accumulation of external debt, in particular public external debt, by Belarus is provoked by the desire to protect the Belarusian ruble from devaluation. A stable exchange rate was a key part of the National Bank policy of fighting inflation and stabilizing the economy. However this policy had a drawback of a growing trade deficit. The global financial crisis saw this deficit soar in 2008 to 8.4% of GDP. Devaluation, carried out on January 2, 2009 only helped slightly, as it did not provide the necessary competitiveness for Belarusian goods in Russian markets (the Russian ruble also depreciated by 20% within January 2009). Steeper devaluation, followed by a floating exchange rate and an inflation targeted policy, could have been more productive, thus limiting demand for foreign loans. But there are also several obvious drawbacks to this approach. First of all, devaluation and a floating exchange rate may lead to distrust in the banking sector and an outflow of deposits (both in national and foreign currency), that could paralyze the financial sector and leave business without credit financing. Current devaluation led to the outflow of deposits only in the form of national currency (in January they were reduced by 13.8%). These were immediately exchanged into US dollars and largely returned to the banking system (deposits in foreign currency grew in January 2009 by 10.3%)⁶. Secondly, the policy of floating the exchange rate requires a strong and fully independent National Bank; a complicated process in Belarus.

The current policy of a fixed exchange rate can be sustainable without further rapid external debt accumulation only in the case that Belarusian goods are allowed into the Russian market, along with leasing and other anti-crisis programs. But this does not seem likely.

Alternatively, a number of possible economic policy recommendations may be beneficial, putting aside the global economic crisis. These include the following:

- The share of short-term debt should be decreased, thus long-term lending should increase. This observation is relevant first of all for “other sectors” and banks. In turn, the long-term lending of enterprises is possible only after introducing transparent financial accounting, which meets international requirements. The stability of the legislation that regulates the business environment should be guaranteed. The development of long-term lending by banks also depends on the transparency of their activities and the role of the state (i.e. presence of guarantees and limited intervention into banks’ activities);
- Instruments of external borrowing should diversify via an increased role of financial market instruments. This means that besides the introduction of international financial accounting, the implementation of an existing governmental program of financial market development should continue;
- The marginal share of inter-company lending is explained by the small number of subsidiaries of foreign enterprises in Belarus. A simplification of their registration procedure and the creation of a favorable business environment will lead to an inflow of foreign capital into the country, thus decreasing the necessity for external borrowing;

⁶ This change in the structure of deposits created additional pressure on the currency market. As a result, national reserves moved into the banking system. NBB is gradually recovering the reserves, forcing banks to sell foreign currency (to finance imports from their own reserves, limiting the opportunity for buying currency to finance import operations on the Stock exchange).

- Work on entering the Eurobonds market should be carried out by the Ministry of Finance. The issue of Eurobonds (post-global financial crisis) will allow on one hand, the diversification of the means of lending abroad, and on the other, to trace the dynamics of interest rates for Belarus, thus creating an instrument for the monitoring of the solvency of Belarus' public sector and the sustainability of economic growth in the country;
- Another source of external financing – foreign direct investment – should be used more actively in the future. Privatization and the participation of foreign capital will allow the attracting of resources necessary for the leveling of the balance of payments and the servicing of external debt, which is being accumulated at the time of the crisis.

*Minsk, Spring 2009.
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Annex A. External debt of the CIS and CEE countries

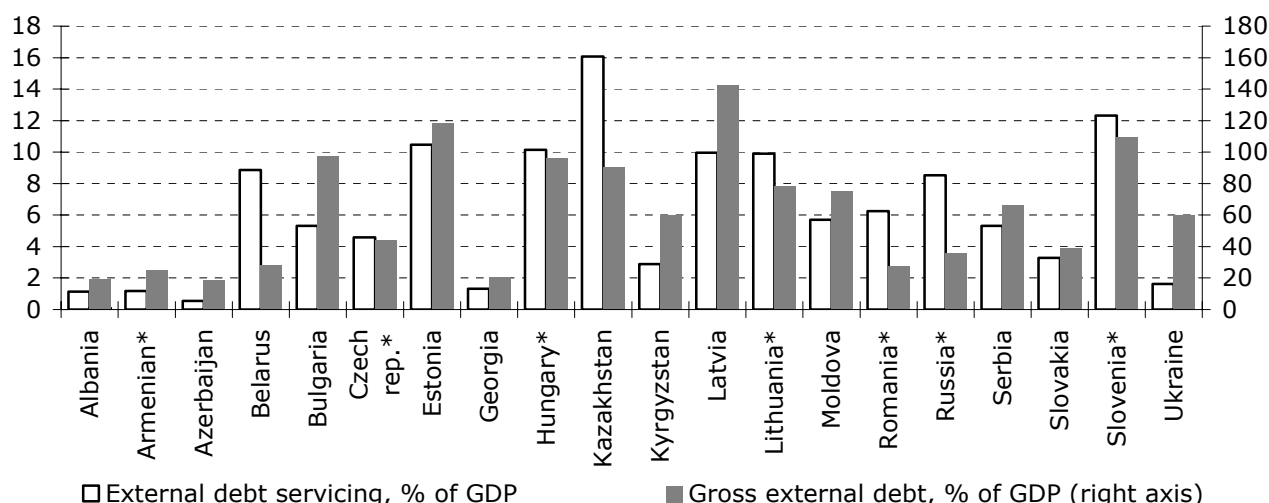
Table A1

Gross external debt structure of Belarus and of the CIS and CEE countries, %

	General government	Monetary authorities	Banks	Other Sectors	Direct inter-company investments	Short term debt	Long term debt
Armenia	43.3	6.6	18.7	14.2	17.1	15.8	84.2
Belarus	16.1	4.7	20.4	54.8	4.0	57.7	42.3
Bulgaria	10.8	0.0	20.4	34.7	34.1	33.9	66.1
Czech Republic	20.2	0.1	28.4	39.3	12.0	31.0	69.0
Estonia	1.3	0.5	57.0	22.6	18.7	30.5	69.5
Georgia	29.8	4.8	24.4	9.4	31.7	12.3	87.7
Hungary	29.2	0.6	27.6	13.4	29.2	13.2	86.8
Kazakhstan	1.5	0.1	47.7	19.6	31.0	12.0	88.0
Kyrgyz Republic	60.7	4.7	7.2	12.0	15.4	9.9	90.1
Latvia	4.0	0.1	68.1	20.8	7.0	43.1	56.9
Lithuania	15.8	1.5	47.7	24.1	10.8	25.8	74.2
Moldova	23.2	4.8	11.0	44.6	16.4	35.4	64.6
Poland	34.2	3.6	16.9	25.1	20.3	19.3	80.7
Russian Federation	8.1	1.9	35.0	49.1	5.8	22.9	77.1
Slovak Republic	20.9	0.5	32.2	22.2	24.2	39.2	60.8
Slovenia	8.8	10.4	47.2	22.0	11.6	31.1	68.9
Ukraine	17.4	0.5	36.6	41.8	3.6	26.9	73.1

Source: Quarterly External Debt Database, World Bank.

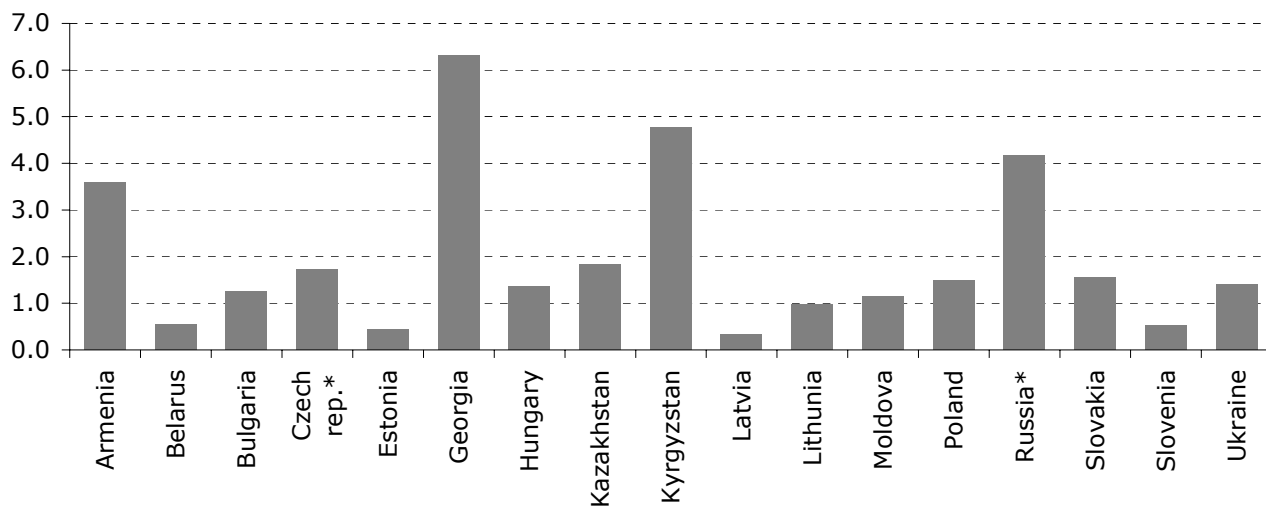
Figure A1. Gross external debt and its servicing costs in CIS and CEE countries, 2007



Note. * data on debt servicing is of 2006.

Source. EBRD.

Figure A2. Reserves to short-term gross external debt ratio, 2007



Note. * - data of 2006.

Source. EBRD.