Research Report on Belarus

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

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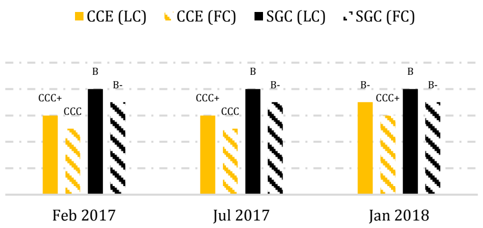
Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Belarus

Macro indicators	2015	2016	2017
Gross gov. debt, BYN bn	48	51	57*
Nominal GDP, BYN bn	90	94	103*
Real GDP growth, %	-3,8	-2,6	2,4
Gross gov. debt/GDP, %	53,3	53,9	55,1*
Deficit (surplus)/GDP, %	1,4	1,5	1,7*
Inflation rate, %	12,0	10,6	4,6
Current Account Balance/GDP, %	-	-	-2,6*
External debt, USD bn	-	-	40**

Development indicators	2016
Inequality adj. HDI	0,74
GDP per capita, USD th	18,1

Default indicator	26.01.2018
5-Year CDS spread, Bp	355
10Y Gov Bond Yield, %	5,5

Source: RAEX-Europe calculations based on data from the IMF, World Bank, MFRB, NBRB, Belstat, Cbonds.
* Forecast for 2017 ** Figure for 3Q 2017

Summary

The upgrade of the country credit environment (CCE) ratings of Belarus was driven by the positive dynamics of the real interest rate, the recovery of the national economy after two years of recession as well as the government's newly introduced programs to support new businesses. However, the ratings remained restrained by the absence of structural reforms related to inefficient SOEs, wide spread directed lending and poor development of national financial markets.

On the other hand, the sovereign government credit (SGC) ratings remained unchanged due to the elevated debt metrics, risks of potential materialization of contingent liabilities, persistent banking sector risks and, despite positive dynamics, continued high levels of dollarization along with a vulnerable external position.

However, the high debt levels are partially mitigated due to the new debt refinancing 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 a surplus in the mid-term perspective.

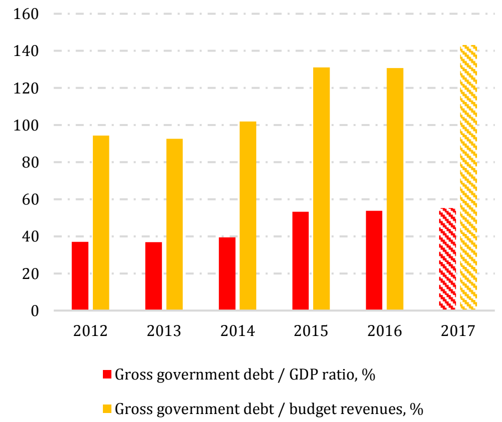
Government debt increased but non-repayment risks are partially mitigated in the mid run. According to the latest IMF assessment the general government debt of Belarus is forecast to have ended 2017 at 55% of GDP and 143% of budget revenues (see graph 1), which means an increase by 6 and 12p.p. respectively as compared to 2016 metrics.

The currency structure of the government debt (see graph 2) remains worrisome with the share of FX-denominated debt equal to 47% of GDP, 124% of budget revenues and more than 90% of total government debt as of 3Q 2017. In addition, the ratio of FX reserves to FX debt was as low as 29%, despite the positive dynamic of the former in 2017.

However, as it was mentioned in our previous research report[1], the successful agreement with the Russian government and Russian led Eurasian Fund of Stabilization and Development (EFSD) on debt restructuring in April, as well as the Eurobonds issuance in June 2017, mitigated the debt repayment risks for 2017. Taking into account the forecast debt repayment schedule for 2018, the Agency does not expect significant risks within the observed period. However, the Belarusian debt

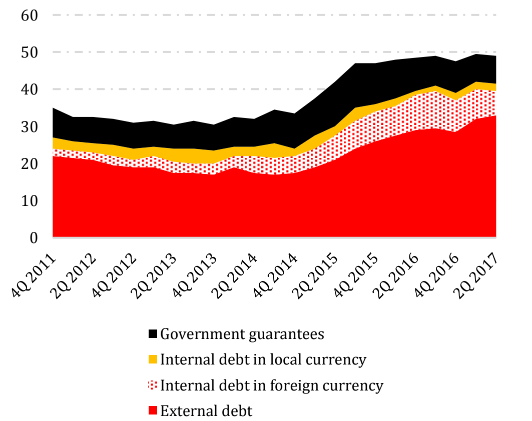
[1] Research Report on Belarus from 28 July 2017 https://raexpert.eu/reports/Research_report_Belarus_28.07.2017.pdf

Graph 1: General government debt metrics



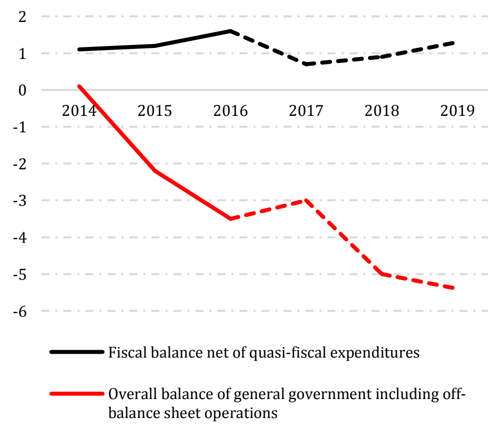
Source: RAEX-Europe calculations based on IMF, MFRB data.
2017 - estimates.

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 IMF, WB.
2017-2019 - estimates.

position remains very sensitive to politically motivated decisions in relation to Russia as we expect the new round of debt discussions by the end of 2018.

In addition, the Agency still considers the big amount of contingent liabilities related to the banking system recapitalization as a long-term risk factor, which can trigger an increase in debt levels.

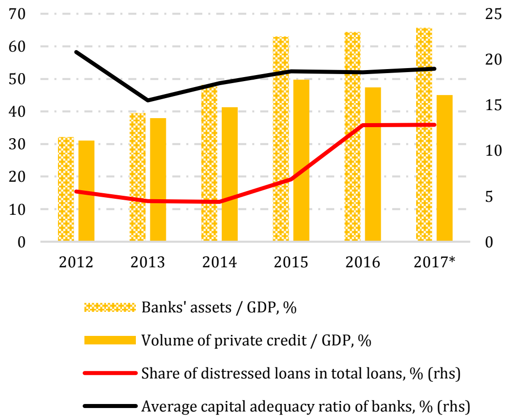
Fiscal balance remained positive in 2017 while levels of off-budget operations are high. Taking into account the higher than expected fiscal surplus for the first 11 months of 2017 (around 4,6% of GDP), the Agency believes that the final general fiscal surplus in 2017 will reach the projected level of 1,7% of GDP or even exceed this figure. From the revenues side, a positive result was reached due to a recovery of the domestic economy and a retention of duties on refined oil sales according to the agreement with the Russian government. The expenditure policy of the government remained restricted during most of the year.

At the same time, the wide gap between fiscal balance net of quasi-fiscal expenditures and overall balance of general government in IMF definition remains in place (see graph 3). This indicates widespread off-balance sheet operations from the government, which include guarantee payments, bank and SOE recapitalizations as well as SOE debt restructuring. The previously announced reduction of such transactions was not confirmed by reliable sources, and therefore restrains the rating assessment.

The government's commitments to the fiscal consolidation were confirmed by the recently approved fiscal plan for the 2018 Republican budget which targets a surplus equal to BYN 733 m (around 0,6% of forecast GDP for 2018). However, many announcements done by the authorities in 2017 can be interpreted as a return to an expansionary fiscal policy in the future. In particular, the government confirmed new plans for a budget support of the machinery industry and a subsidized development of residential buildings as well as new infrastructure objects. Therefore, we will follow closely the official levels of the 2017 fiscal balance as well as the budget execution during 2018.

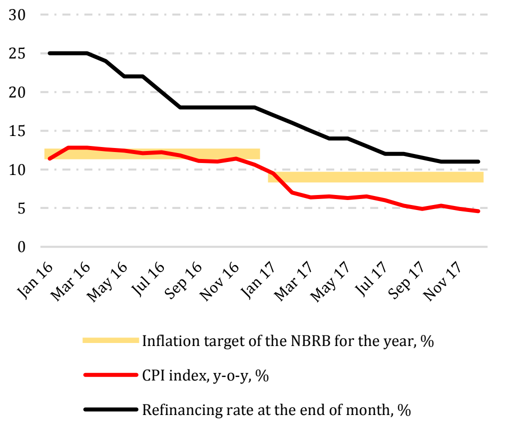
Banking system risks are elevated. After a sharp increase in 2016, the level of NPLs in Belarus remained stable during 2017 according to the National Bank of the Republic of Belarus's (NBRB) (see graph 4). The Agency considers that this stabilization was mostly driven by the increase of new credit driven by the economic recovery in 2017 and an increase of subsidized or guaranteed loans issuance on various government programs, including the loans issued by the Development Bank of the

Graph 4: Banking system performance



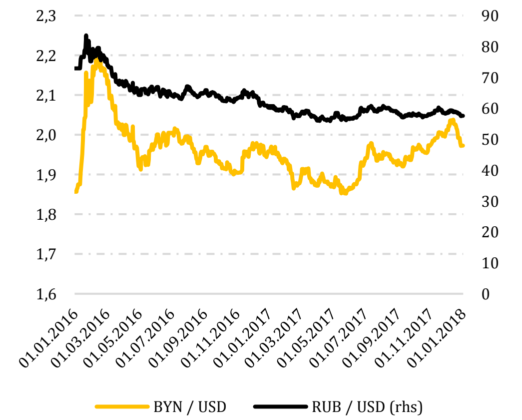
Source: RAEX-Europe calculations based on data from IMF, WB, NBRB. 2017 - estimates.

Graph 5: Monetary policy metrics



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

Graph 6: Exchange rates' dynamics of BYN and RUB



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

Republic of Belarus (DBRB) and new loans to the largest enterprises. We still consider that the quality of the loan portfolio can deteriorate further in the mid run as the key problem – chronical insolvency of SOEs – remains in place. Therefore, the Agency still considers the risks of NPLs increase and needs for banks' recapitalization as high which, as a consequence, creates pressure on the fiscal of the government restricting the rating assessment.

In 2017 the NBRB continued to implement various measures that should solve the problem of NPLs and "hidden" bad loans. In particular, according to the recommendations from the European Bank of Reconstruction and Development (EBRD), Belinvestbank's assets related to the government programs were transferred to the balance of DBRB. "Localization" of all "bad" assets of the system can take several years and shall be coupled with the increase of transparency of DBRB's financials. This policy has a positive effect on the banking system stability. However, without structural reforms focused on currently insolvent SOEs and decrease of directed lending, the NBRB's will hardly succeed.

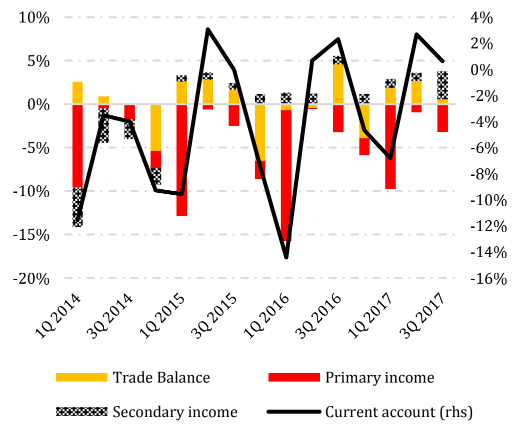
The NBRB reduced the interest rate several times in 2017, while the transmission mechanism remains weak. Since our last revision in July 2017 the NBRB reduced its interest rate three times following the sharp decrease in inflation levels (see graph 5) which was driven by appreciation of the BYR along 2016 and 1H 2017 (see graph 6). The latest interest rate cut was done on 18 October 2017 setting the metric at 11% which is the lowest level since March 2011. At the same time, in November 2017 representatives of NBRB announced that the interest rate will remain on current levels within 2018, which can be considered as moderately tight monetary policy.

Transmission mechanism remains weak due to still high levels of dollarization, despite the positive dynamic over the last two years. This trend was supported by the stable exchange rate of BYN and additional actions, implemented by the NBRB. In particular, the NBRB increased the obligatory reserve rate[2] for FX bank deposits from 11% to 15% in July 2017. In addition, restrictions for FX transactions were introduced at the insurance market and some other consumer markets.

The Agency does not expect further decrease of inflation in 2018 due to the influence of several factors which include the restoring of consumption in 2H 2017 after wage and lending increases, rise of utilities tariffs and moderately high inflation expectations according to the NBRB's forecast. In this regard, we believe that inflation in 2018 will be close to

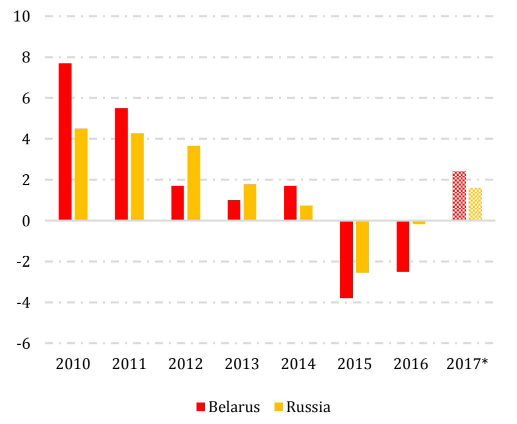
[2] Obligatory reserve rate means the share of funds that shall be transferred by the bank to the Obligatory reserve fund of the NBRB.

Graph 7: Current account balance, % of GDP



Source: RAEX-Europe calculations based on data from NBRB

Graph 8: Real GDP growth in Russia and Belarus, %



Source: RAEX (Europe) calculations based on data from Belstat and Rosstat.
2017 – preliminary data

the National Bank's target of 6% if the external environment remains stable.

External position in 2017 improved but remains vulnerable in the long run. Recovery of key trade partners' economies, reaching the agreement with Russia on the oil and gas import prices, as well as positive conditions on key markets, supported Belarusian exports during 2017 (see graph 7), while imports remained restrained by stagnated consumption. We expect that this will lead to a positive trade balance figure for the whole year and improved current account balance as compared to the 2016 results.

However, the external position remains very sensitive to the position of the Russian government on oil and gas import prices, as well as on debt restructuring.

Economic recovery and real interest rate dynamic in 2017 triggered the CCE upgrade. After two years of recession, the real GDP of Belarus increased by 2,4% in 2017 according to the latest Belstat's estimates (see graph 8). This dynamic was driven by the recovery of Russia's economy, which remains the main trade partner, the restoring of oil refining in Belarusian factories after the dispute with the Russian government and increase of internal consumption in 2H 2017.

Driven by low inflation the real interest rate was significantly reduced over the last two years and reached a level of around 10% by the end of 3Q 2017.

Together with the several actions implemented by the government in order to support new SMEs and facilitate FDI, as well as the above mentioned economic recovery, the interest rate dynamic triggered the upgrade of country's CCE ratings while SGC rating remained unchanged. However, the further upgrade is restrained by the absence of structural reforms related to inefficient SOEs, widespread directed lending and poor development of national financial markets.

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_26.01.2018.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.