KEY FACTORS TO FURTHER DECREASE BELARUS’S REFINANCING RATE

SPECIAL REPORT
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The monetary policy of the National Bank of the Republic of Belarus is aimed at supporting all market interest rates at a level that enables it to target inflation in order to ensure financial stability and sustainable economic development. The current inflation targets are to keep growth in consumer prices to within 6% in 2018, with a decrease to 5% by 2020, and to reduce it to 4% in subsequent years.

The refinancing rate set by the National Bank is a key tool to regulate all financial market interest rates and is used as a benchmark to set interest rates on loans provided to banks to maintain their liquidity. It determines the lower limit for interest rates on instruments to maintain banks’ liquidity and the upper limit for instruments to drain liquidity from the banking system.

There are many factors that determine the optimal level of the bank refinancing rate, including both domestic and external ones, fundamental and cyclical factors. At the same time, domestic factors play a major role in the process. The most important of these are inflationary expectations, the deviation between the forecast and target rates, the output gap, the risk premium and potential changes in the real exchange rate balance. It must be added that if these factors remain stable their contribution to changes in the refinancing rate will depend on current economic and monetary conditions.

The nominal refinancing rate decreased by 7.5 p.p. to 10.5% over the last two quarters. At the same time, annual inflation measured by the Consumer Price Index (CPI) decreased by 5.2 p.p. and amounted to 5.4% in March 2018. Thus, the real refinancing rate calculated based on actual inflation decreased over 2017 and 1Q 2018 by 1.9 p.p. and amounted to 4.8% in March 2018. This indicates that the decrease in the nominal refinancing rate in this period resulted in a decrease in its real level, thus determining the extent of easing for the monetary policy pursued by the National Bank (see Figure 1).
Note: The real refinancing rate is calculated based on the actual annual inflation rate.
Source: National Statistical Committee and National Bank of the Republic of Belarus

The real refinancing rate reached its neutral level of 4.5–5.5% in 1Q 2018. That is why its further rate changes will depend, firstly, on how inflationary expectations react to pro-inflationary factors and cause changes in prices, and, secondly, on changes in the neutral rate itself.

Inflationary expectations of Belarusian households remain quite high — they were estimated at 11.6% in February 2018 [1]. The convergence of inflationary expectations with the medium term inflation target takes time, because, as both foreign and domestic experience suggests, the process of decreasing inflationary expectations is slow in developing countries. This is explained by the sluggishness of expectations and their high sensitivity to temporary volatility in the national currency.

It must also be noted that the monetary policy easing in 2017 and 1Q 2018 by decreasing the refinancing rate was possible not only due to a slowdown in inflation, but also due to the fact that the economy did not function to its full capacity. The output gap gradually closed during this period, yet remained negative (Figure 2). Monetary policy had a stimulating effect supporting economic recovery. This disinflatonary effect is expected to disappear as early as this year. When the output gap turns positive, that will become a pro-inflationary factor and economic growth will cease to be stable.
In these circumstances, only higher labor and capital productivity will enable faster economic growth. This requires a set of structural reforms to increase the performance of state-owned companies and their competitiveness in non-price terms, to improve the effectiveness of investments in education, infrastructure and technology, to diversify international trade, to improve the business climate, to upgrade traditional industries, and to develop corporate governance, small and medium businesses, legal institutions, etc.

It must also be realized that the recession in the Belarusian economy in 2015–2017 was caused not by monetary policy, but by the inability of many local companies to resist external shocks — to adapt rapidly and effectively to a changing environment where the RUB exchange rate plummeted and demand in Russia shrank in 2015–2016. This resulted in devaluation of the BYN in early 2015 and higher inflationary expectations of economic agents [3].

There are also higher risks of inflationary pressure from the labor market this year. Objectives to raise wages increase the risk that wages will unjustifiably grow at a faster rate than productivity. On the one hand, increased wages mean higher costs for employers. On the other hand, faster consumer demand growth boosted by increased wages whose growth exceeds that of goods and services creates conditions for the emergence of excess consumer demand and acceleration in inflation.

Real interest rates can also be reduced by lowering their neutral level, which is determined solely by fundamental factors. According to the interest rate parity concept, such factors include a balanced real interest rate abroad, expected changes in the balanced real exchange rate and a balanced risk premium tied to exchange rate movements.

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**Figure 2. Output gap in Belarus**

Source: National Bank of the Republic of Belarus
The balanced real interest rate abroad is estimated at about 1.5–2%. It was calculated using a weighted estimate of the neutral level of balanced interest rates set by the Bank of Russia, the European Central Bank and the US Federal Reserve System [3]. The level of the weighted balanced interest rate abroad is highly unlikely to change over the next year or two.

The balanced risk premium for foreign investors that protects them from the risk of BYN exchange rate changes in the short term is estimated at about 0.5–0.8 p.p. This component is also unlikely to materially reduce its contribution to the neutral interest rate in the coming years. The balanced risk premium for short-term exchange rate fluctuations is a positive value for the majority of developing countries and amounts to at least 1 p.p. It also highly depends on the liquidity position of the country in foreign exchange terms and the maturity of its financial market.

Unfortunately, Belarus's foreign exchange reserves are insufficient, while the country's need for foreign currency is high. Borrowings are the main source for covering the balance of payments current account deficit. As of January 1, 2018, total external government debt amounted to 73.4% of GDP (it is recommended to be under 55% of GDP to ensure economic safety), while Belarus’s net international investment position amounted to –76.3% of GDP (it is recommended by the EU to be no lower than –35% of GDP). This large negative net international investment position indicates additional risks to the balance of payments being balanced and, thus, to national currency stability. Consequently, Belarus’s credit rating⁴ is insufficient, despite its recent upgrades by international rating agencies and the Organisation for Economic Co-operation and Development (OECD).

Further, the Belarusian financial market is not mature enough to enable non-financial organizations to properly hedge their currency risks. The regulatory framework requires amendments to regulate and detail the process under which non-financial organizations execute and account for hedging operations, as well as amendments regulating how currency hedging operations profits should be taxed, including tax treatment of costs of such operations. Improving the quality of the risk management function of businesses and benchmarking returns on long-term financial instruments are also required. Furthermore, other constraints include the fact that there are no risk taking players in the financial market to take buying or selling positions in currency forward contracts, as well as other factors [2].

As to the balanced real effective exchange rate (REER), it is known that it is determined by a country’s economy’s productivity compared to other countries which are this country’s trading partners (the Balassa–Samuelson effect). In the short-term, the REER of BYN is expected to decrease by 2.5–2.7% per year. This indicates a continuing lag in Belarus’s economic development required to ensure high economic growth and, as a result, to raise the neutral interest rate level. The REER can be strengthened by implementing structural reforms to overcome structural restrictions, to promote economic growth and to decrease dependency on global market conditions.

⁴ In October 2017, Standard & Poor’s for the first time since 2011 upgraded its long-term sovereign credit rating for Belarus’s foreign currency liabilities to B with a stable outlook. The country’s sovereign ratings were also upgraded by Moody’s and Fitch in early 2018. In January 2018, Belarus was upgraded from group 7 to group 6 in the OECD’s Country Risk Classification.
Thus, the real refinancing rate is currently at its neutral level of 4.5–5.5% and its further movements will depend on inflationary expectations and changes in fundamental factors which determine the bank refinancing rate’s neutral level itself and do not depend on the monetary policy of the National Bank. If pro-inflationary risks materialize, interest rates could again increase above the neutral level.

REFERENCES

