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MACROECONOMIC TRENDS IN 2010: GROWTH AT ANY COST

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SUMMARY

The year 2010 saw Belarus gradually being pulled out of cyclical recession owing to the revival of external markets and massive incentives provided by the economic authorities. However, the administration set itself a priority task of reaching ambitious GDP and income growth targets while largely ignoring economic requirements for sustainable and fast paced long-term economic development. Moreover, the investment expansion scenario formulated by the government, which envisaged measures to restrain the accumulation of structural disproportions, de facto was not implemented, as some of its prerequisites proved unfeasible. The outcome was twofold: on the one hand, the campaign to reach quantitative indicators resulted in quite impressive GDP and income growth figures; on the other hand, new disproportions in the economy were created, and those already in existence were enhanced. The problems of the foreign account deficit, external debt, money market imbalances, inflationary potential, fragile financial standing of domestic companies had therefore aggravated by early 2011. These problems put a question mark over both current macroeconomic stability and long-term sustainable growth.

Tendencies:

- High GDP and income growth in 2010 was artificially propelled by unprecedented arrangements to stimulate the economy;
- New structural disproportions were accumulated and existing misbalances were enhanced as a result of the campaign to stimulate the economy;
- In the fiscal sector, the “room for maneuver” almost disappeared, which will limit possibilities for the use of fiscal instruments to overcome shocks in the future;
- Stronger imbalances of the current account, widening external deficit, limited possibilities for improving the financial situation at Belarusian enterprises, and low level of savings produce a profound negative impact on prospects of the country’s economic growth.

1. INTRODUCTION

The global recession marked something of a Rubicon for the Belarusian authorities, which can be associated with modifications in the economic expansion model. The chief growth factors Belarus used to have in the lead up to the crisis (that is, prior to 2008) were the special terms of energy trade and preferential access to the Russian commodity markets. The aftermath of the crisis resulted in major adjustments in competition mechanisms on foreign markets, including Russian commodity outlets, and Belarusian exporters saw their positions deteriorate. Furthermore, for Belarus the recession period coincided with a number of unfavorable shocks that appeared to be more political than economic. Those included changes in the terms of trade in Russian crude oil and substantial increases in Russian natural gas fees.

The active economic policy aimed at surmounting the recession in 2009 impeded the development of adaptive reactions in the economy that could have helped the country deal with the accumulated disproportions. The foreign trade deficit remains the cornerstone of these disproportions, leading to stronger/new additional structural misbalances – a buildup in foreign liabilities, increase in financial dollarization, etc. The excessive efforts to encourage domestic demand in 2009 led to new disproportions, including the accumulation of additional risks in the banking system.

The depletion of old growth factors alongside the accumulation of new structural misbalances affecting the growth prospects therefore reduced the potential of the Belarusian economy.

Given those prerequisites, the economy could have done away with misbalances and got closer to the long-term equilibrium level in 2010 if "natural" economic mechanisms had been employed, the "natural" scenario envisaging a relatively modest GDP growth, from 1% to 4% year-on-year, based on various methodologies.

The said scenario did not fit in the plans of the economic authorities, formulated mostly based on political reasons. The forecast for the election year of 2010 had been presented by the economic authorities back in December 2009; the country's top economic managers were eager to target an 11–13% GDP growth and an increase in real personal incomes by 14–15% on the year. Therefore, the economic theme line of the year 2010 was the race for quantitative economic parameters, with economic policy instruments being the chief factors of macroeconomic dynamics rather than natural economic mechanisms.

2. MACROECONOMIC DYNAMICS

The economic policy scenario called for an expansion from the start of the year, similar to what the country saw in 2009. At the beginning of 2010, the Belarusian economy pulled out of cyclical recession, and given that economic position, it is hard to account for the expansionary policy that the country made its priority. The potential points of macroeconomic misalignment emerged at the turn of 2009, indicating the results of the incentives-based economic policy: foreign trade performance deteriorated, the domestic foreign exchange market saw a deficit that rapidly expanded, the ruble exchange rate pressures built up, and so did inflationary pressures. The government was well aware of the corresponding risks and sought a balance between the political reason for boosting GDP growth and the need to minimize the accumulated macroeconomic disproportions. Under the circumstances, in a bid to work out a compromise, the authorities opted for capital investments as a priority component of aggregate demand. Below are the key ideas of the government's macroeconomic dynamics scenario.

Firstly, a growth based on investments had a potential for facilitating a long-term growth in productivity, thus contributing to the resolution of some structural economic problems.

Secondly, a growth in investments seemed the most realistic plan, because the government kept to itself direct instruments to stimulate the investment activity of companies, especially budget financing, promotion of bank credit, etc.

Thirdly, this scenario envisaged restraints of accumulating disproportions at the macro level, primarily the additional foreign trade deficit, through administrative reductions in the domestic demand elasticity of import. For instance, by using its levers to shape the investment policy of the nonfinancial sector, the state is in a position to channel financing primarily into the investment projects that require minimum spending on imported investment products.

Fourthly, the impact of stepped up investment efforts on price is, as a rule, not as significant as that of, say, encouraged consumer demand. The scenario therefore provided for measures to anchor inflation.

Fifthly, the investment growth scenario prioritized foreign investments as the main source of capital investment financing, which by definition was supposed to foster stability on the domestic foreign exchange market.

This scenario, however, was impeded by not only a reduction in the growth potential, but also the relatively unfavorable market situation.

Firstly, the external demand for most Belarusian traditional exports restored only partially, and the process took some time.

Secondly, a new oil shock came at the start of the year, when Russia adjusted its terms of oil trade with Belarus. This automatically affected the country's trade balance (according to our estimates, in terms of the 2009 export mechanism, net export revenue loss[1] amounted to around USD 1.8 billion, or 3.1% of GDP in 2010). Furthermore, the oil shock caused a drop in budget revenues, which shrank by an estimated USD 2 billion in annualized terms, according to the Ministry of Finance's reports.

Thirdly, another prerequisite of the investment growth scenario proved inconsistent later, namely, additional inflows of foreign investments, mainly FDI. The authorities had planned to attract foreign capital investments at least 23–25% in excess of the 2009 level. That major increase called for about USD 4 billion in financing of capital investments from external sources.

The government believed China could become a major investment contributor, enabling this country to meet the ambitious investment targets. Framework agreements with potential Chinese investors and banks make it possible for Belarus to take out up to USD 15 billion in Chinese resources to finance investment projects in various sectors of the national economy. Nevertheless, only a tiny part of those resources was provided. Therefore, the mission to ensure a fast significant growth in gross domestic product was complicated by not only the slow recovery of demand in partner countries, but also a number of additional adverse shocks.

In the first half of the year, a crucial tendency towards a "redistribution" of roles in the structure of domestic demand emerged amid persisting difficulties with the

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[1] We compare the actual results of import and export of crude and refined oil in 2010 with the scenario envisaging unchanged crude oil import terms compared with 2009, and, consequently, identical import and export volumes (at the 2009 level, that is, 21.5 million metric tons of imported crude and 15.5 million metric tons of exported refined oil).

implementation of the investment growth scenario. During that period, a number of factors, such as the adaptation to the crisis, decline in negative expectations about the external environment and acceleration in personal income growth resulted in a faster increase in households' consumption. Throughout most of the year (the trend gradually subsided towards the end of the year) the propensity to consume appeared to grow, that is, households were increasing the share of consumption in their incomes, and consumption growth outstripped the expansion of incomes.

Various schemes can be employed to explain the said trend. On the one hand, we can mention consumer optimism and positive expectations[2], which promoted consumer enthusiasm. On the other hand, the propensity to consume may be partially attributable to negative expectations, for instance, of a rise in prices and curtailment of spending power in the future, which naturally encourages immediate consumption.

We believe both groups of factors account for the increase in propensity to consume. As a result, household consumption became the key factor of GDP growth based on demand from the very start of the year. By October 1, 2010, household consumption had accounted for 5.1 percentage points out of the 6.6% GDP growth in year-on-year terms. In the last three months, propensity to consume stabilized and even decreased a bit amid a substantial growth in household incomes resulting from the directed wage push. In January-December, household consumption remained the key demand-based GDP growth factor.

Another essential element of domestic demand – capital investments – was showing reverse dynamics: they tended to shrink at the start of the year making a negative contribution to GDP growth, however, the second quarter saw the growth in capital investments resume (it picked up pace towards the end of the year). In early 2010, the economic authorities, pinning high hopes on foreign investment inflows, somewhat alleviated the credit boom in the national economy by way of reducing the intensity of directed lending and pursuing a relatively rigid monetary policy. Since bank loans have dominated among all sources of capital investment financing, that policy resulted in limited implementation of some investment projects by non-financial businesses.

[2] The same process may be characterized as consumer behavior getting back to "normal", which is attributed to the exhaustion of negative expectations of the recession period.

The authorities had to resume and broaden the practice of directed lending later in an attempt to promote GDP growth amid shortages of foreign resources to finance investment projects. In order to keep the banks servicing state programs from liquidity shortages and encourage lending by privately owned banks, the National Bank in the second half of the year mitigated its monetary policies and allowed active refinancing of commercial banks. As a result, gross capital formation became the fastest growing element of domestic demand in the final months of the year.

On the back of the state's support for domestic demand came a considerable increase in import demand. Whereas in the first quarter net export contribution to GDP growth was positive, that is, the trade deficit was smaller than in the first three months of 2009, in the final three quarters, the deficit grew. In 2010, the reliance of the Belarusian economy on imports revealed itself stronger than before, as a substantial part of artificially backed demand was for imported commodities rather than domestically made products.

This dependence was manifested both directly and indirectly. In the former case, economic agents showed demand for final products and gave preference to imported commodities. The latter mechanism presupposes a demand for domestically made goods, which on the one hand promotes the real sector's output, but on the other hand ultimately leads to an increase in imports, since many of the Belarusian made commodities rely on supplies of foreign raw materials and components. As a result, net exports' negative contribution to GDP dynamics appeared to be commensurable to the positive contribution of household consumption or gross capital formation.

The economic model of artificial promotion of GDP growth by way of encouraging domestic demand therefore proved inefficient even in the short term, because much of the demand created by the authorities was for imported commodities rather than domestic production. Furthermore, that approach aggravated the problems with financing of the economy's balance of payment deficit.

3. REAL SECTOR

Of all the sectors of the national economy, the manufacturing sector, construction, transport, communication, retail and public catering contributed most to GDP growth in 2010.

Similar to the previous year, the production sector, by far the largest economic sector, expanded faster than the average for the national economy. The fastest developing industries were mechanical engineering and metalworking, with a 16.7% growth year-on-year, the ferrous metals industry with 16%, forestry, woodworking and pulp and paper industry with 14.9%, chemical and petrochemical industry with 13.3%, and electricity industry with 12.9%. The two largest industrial sectors are mechanical engineering and metalworking and the chemical and petrochemical segment. Those two became the key sources of growth, fueling the entire manufacturing sector.

The impressive growth of mechanical engineering was a result of the “recovery” growth in the automotive sector. In other words, following a major drop in partners’ demand and stagnation of 2009, the modest recovery of partner countries and the poor performance in the previous period caused a vigorous growth in year-on-year terms. The considerable expansion of the automotive sector was recorded amid the unsettled problem of excessive inventories: as of early 2011, stocks of finished products of Belarusian automotive companies stood at BYR 643.3 billion, or 154.4% of the average monthly output.

Another important contributor to the overall industrial growth was the food processing industry, despite the modest expansion of 9.5% on the year. The meat industry was the leader in terms of growth with 13.1%, mostly owing to its competitive edge on foreign markets. Another critical subsector – the butter and cheese and dairy industry – showed only a 3.6% expansion year-on-year, despite the strong growth in both export volumes and prices.

The fuel industry suffered more than any other Belarusian industry in 2010 because of the adjusted Russian crude oil import terms and consequent reduction in crude imports. At the start of the year, the economic authorities claimed the deficit of Russian crude would be offset by new deliveries from Venezuela, however, the country imported only 12.9 million metric tons of crude oil from Russia and 1.8 million metric tons of crude from Venezuela in 2010, 14.7 million metric tons in total, which compares with 21.5 million metric tons of crude oil imported in 2009. As a result, the oil refineries were not using their entire capacity, hence a 21.5% fall in output by the oil processing industry and 16.1% drop in production by the entire fuel industry.

Amid the moderate growth in most of the larger industries (at least compared with the original annual targets) and slump in the fuel industry, the overall performance of the industrial sector owed its good results to smaller industries traditionally categorized as "other industries"[3]. It was that group of smaller industries that contributed the most to the Belarusian industrial growth in 2010.

4. CORPORATE FINANCE

A key problem for the financial position of the real sector in 2010 was the increase in labor unit costs, promoted by the policy to support real incomes at the previous level, despite the slump or low growth rates in most economic sectors. The increase in labor unit costs de facto means that compensations paid to workers increased faster than labor productivity. In the first half of 2010, the economic authorities were busy looking for ways to promote economic growth and relaxed their efforts to ensure a wage push (at least compared to the planned rise in incomes), therefore the urgency of that problem decreased. In the first six months, labor unit costs even showed a decrease year-on year, although they remained above the pre-crisis level.

In the second half of 2010, the government intensified the wage promotion policy, which resulted in an increase in labor unit costs and affected the competitiveness of domestic producers. Furthermore, the finances of Belarusian companies were under pressure of the increase in costs resulting from higher tariffs on electricity and other energy types, a natural result of the rise in prices of Russian natural gas. Companies therefore had economic preconditions to raise prices; however, the economic authorities resorted to measures, including administrative levers, to restrain price increases. Under the circumstances, arrangements to promote demand and the consequent increase in costs amid efforts to keep a moderate rise in prices and encourage a growth in output resulted in profit restraints. On the other hand, the marked reduction in inventories in almost every industry had a favorable impact on profitability dynamics.

Therefore, despite the simultaneous sharp increase in domestic demand and growth in the real sector's production, both sales margin (10.1% in 2010 and 9.9% in 2009) and profit margin (6.3% and 6.1%, respectively) indicators remained almost at the level of the crisis year, that is, way below the pre-crisis figures. Furthermore,

[3] Other sectors" also include changes in the structure of relative prices.

throughout the year, there was no evident tendency towards a year-on-year increase in profitability rates. This behavior of key indicators characterizing economic efficiency accounts for the largely artificial nature of the GDP growth in 2010.

5. HOUSEHOLDS

Individual incomes and expenditures

The first grade wage rate, the benchmark for calculating compensations at enterprises, was raised twice in the first half of 2010; however, the total increase amounted to 16.8%, which was not much, considering that wages had been last increased in the second half of 2008. Therefore, wages increased at a moderate rate of 8.1% year-on-year in January-June 2010 (which was not enough to meet the ambitious income growth target set for the entire year). In real terms, individual incomes, which include wages, social transfers, property and business incomes, etc., grew almost at the same rate in January-June, 2010, at 8% year-on-year.

In the second half of the year, the government pursued a more aggressive income policy in a bid to reach the annual target. In September, a special ruling introduced adjusting indices to increase compensations for lower income households.

Two months later, in November 2010, there came a 31.1% hike in the first grade wage rate, which brought the overall annual rise in incomes up to 53.2%. Real personal incomes rose 15.2% in 2010 from the 2009 level, and real disposable incomes (incomes minus taxes) went up 14.9%.

As we mentioned before, the rise in incomes and corresponding expectations resulted in an increase of households' propensity to consume. The hike in consumers' activity was most obvious in the nonfoods sector: trade in foods showed a continuous decrease in volumes in 2010 (as incomes grew), whereas retail turnover of non-foods in the same period was increasing. The same trend was revealed as a result of sample survey of households: acquisition of nonfoods became the key expenditure, and the share of nonfoods in the total spending kept growing.

Therefore, a considerable proportion of the "new demand" that owed its appearance to the government's demand-promotion policy was shifted to the nonfood market, where pressures on price levels increased correspondingly. Another important consequence of the rise in incomes was the increase in companies' propensity to import: the share of imported products went up markedly in almost all groups of nonfood consumer goods. The aggressive income policy thus led to a substantial additional demand for consumer imports.

At the end of the year, the expectations of higher incomes came true, and households' propensity to consume started to decrease. In the twelve months of 2010, the share of consumption of commodities and services in total incomes was almost the same as in the previous year. However, the trend was not accompanied by an increase in savings share (the share of expenditures on taxes and duties went up instead), which would have been a welcome development for the country. On the contrary, the share of savings in incomes was going down throughout the year, to reach 4.5% of incomes, which compares to 5.7% in 2009.

Also noteworthy is the gap between spending and incomes: expenditures were 4.2% above the level of incomes, which was mostly due to the rise in bank credit (by 6.5% of the income level). As a result, the tendency towards a decrease in propensity to save observed throughout the year grew stronger at the end of the year because of the increase in the overall debt under loan agreements, and the population turned into a net borrower of resources from banks, whereas previously households' contributions to the banking system used to be in excess of borrowing. The problem of insufficient savings, which are traditionally required to finance investments, therefore aggravated in the national economy, enhancing current imbalances and blighting long-term development prospects.

Commodity and service markets. Prices.

Consumer inflation totaled 9.9% in 2010 (as of December), which com pares to 10.1% in 2009, and the average annual consumer price increase was at 7.8%, down from 13% in 2009. On the one hand, this indicates a trend towards a slower increase in consumer prices compared to the previous year's dynamics; however, this may be attributed to the high comparative base, especially in the case with the average annual indicator. Furthermore, in early 2010, the "crisis impulse" of the previous year was still felt, when amid slowly growing or decreasing demand prices behaved correspondingly in most markets. On the other hand, if we consider price dynamics in 2010 alone, it is evident that the price rise accelerated in the course of the year. This was a result of a gradual enhancement of measures to shore up the economy, with the use of monetary, fiscal and other instruments, including administrative levers.

Since household consumption was the main growth component of demand during most of the year, the inflation overhang in consumer markets emerged quite fast. However, the economic authorities used countermeasures to restrain price increases; for example, the exchange rate was de facto kept within a narrower band than originally planned in the Basic monetary guidelines for the year. In this connection, producers had to contain the increase in prices despite the substantial increase in demand in order to be able to compete with imports, especially of nonfoods, thus restraining profitability in the real sector.

The government allowed only minor increases in regulated prices in 2010. For instance, utility fees, which make up an important part of the consumer price index (CPI), mostly remained unchanged in 2010 (only heating rates rose 7.8%; utility fees rose only 1.7%).

Therefore, despite the upward pressure that the growing demand produced on the entire range of prices, the economic authorities managed to rein in those trends on nonfood markets, as well as in the segment of chargeable services to the population, with price increases at 7.4% and 6% year-on-year, respectively. To curb the rise in prices on the food market appeared to be much more difficult because of the low crop yields both in Belarus and in the wider region. Under the circumstances, domestic supply restraint, rise in prices of imported products, as well as the likelihood of the failure to meet the domestic requirement (should the price gap with neighboring countries widen too much because of the growth in food export) accounted for the inevitable increase in prices of most foods. It was the food prices that contributed the most in the CPI structure (food prices increased 13.1%).

Producer prices showed a more significant increase in 2010 compared to consumer prices, rising 19.3%. Prices of intermediate materials went up most of the other components of the producer price index (PPI), by 25.5%, which is attributable to higher energy fees. Therefore, branch-wise, the fuel, chemical, petrochemical industries and the electricity sector accounted for most of the price hike. Inflation calculated based on the index of producer prices for consumer goods amounted to 13.5%. The gap between this figure and CPI-based inflation is another indication of the inflation overhang in the economy, which in 2010 was contained chiefly by profitability restraints and additional burden on the consolidated budget.

The inflationary pressure became even more evident in the final months of the year, and additional efforts were required to deal with it. The faster increase in consumer prices, except for December, did not fulfill the inflationary potential, and most of the pressure was passed on to the first few months of 2011, given the unprecedented arrangements to promote domestic demand in the final month of 2010.

6. EXTERNAL SECTOR

Foreign trade

The current account deficit has been one of the most sensitive issues for the Belarusian economy for years. The year 2009 saw truly alarming trends, though, when amid the global crisis and foreign demand drops, the Belarusian commodity trade deficit widened to 14.8% of GDP, whereas in other transition economies it shrank. The adopted scenario of promoting domestic demand left no room for measures to address the trade deficit problems in the post-crisis year. However, early in 2010, the foreign dynamics proved positive, inspiring optimism and expectations of favorable changes and alleviation of the foreign trade predicament: the foreign trade deficit went down both in nominal and real terms. As a result, in the first quarter of 2010, net exports made a positive contribution to GDP, chiefly because of the reduction in Russian oil import at the start of the year, while export of refined oil showed a less significant decrease owing to the crude reserves accumulated in 2009.

At the same time, favorable trends were recorded in trade in other commodity groups (besides energy). However, the positive trends slackened during the second and third quarters, when the foreign trade deficit resumed its steady growth. While in the first six months, the foreign trade deficit remained below the level reported in January June 2009, the first three quarters saw a 19% expansion in the deficit year-on-year, whereas the fourth quarter witnessed an unprecedented growth of 63.2% on the fourth quarter of 2009 due to hikes in domestic demand. In January-December, foreign trade deficit widened 32.7% on the year, reaching 17.6% of GDP.

Since the commodity portfolio is grouped into broad economic categories, we are able to indicate each commodity group's contribution to the growing trade deficit: trade in energy products accounted for 23% of the deficit growth, which is a result of the hikes in import and export prices amid drops in trade volumes; and trade in "other intermediate goods" accounted for 21.4% of the increase. From the perspective of commodity structure, import of intermediate products was increasing mostly due to the overall growth in volumes, as well as rise in ferrous metal prices. In the scope of the entire broad commodity group, trade performance deteriorated largely because of the increment in the volume of imports, and to a lesser degree due to the rise in average import prices (imports rose 26.5% in volume terms, whereas average import prices went up 9.7%). The burden of Belarus' trade in intermediate products, commensurable to the impact of energy trade in the overall deficit, indicates that import consumption of production is very high in the Belarusian economy. This level of import intensity results not only from the need to acquire foreign energy for the production sector, but also from additional import of other raw materials and components.

The expansion in Belarus' foreign trade deficit was also promoted by trade in nonfood consumer goods, which accounted for 5.3 points of the commodity trade deficit growth. This trend is conditioned by the growing households' propensity to consume imported products and is mostly associated with the growth in the physical volume of imports, by 24.9% year-on-year in this commodity group alone.

Trade in foods and investment commodities resulted in improvements in trade figures (that is, made a negative contribution to the deficit expansion) – by 9.9% and 2.3%, respectively. It should be noted that the increase in investment commodity exports (which mostly use imported intermediate products) contributed much less to foreign trade than imported intermediate materials. In other words, the policy to encourage domestic demand also promoted domestic production, which increases import of intermediate products to meet the new demand. At the same time, the growth in domestic output does not lead to increases in exports that would suffice to offset import hikes. As a result, the policy to promote domestic demand and production became a crucial factor in the overall growth of the foreign trade deficit in 2010.

Other foreign flows and balance of payments

In 2010, Belarus' current account deficit amounted to USD 8.5 billion, or 15.6% of GDP. BoP commodity trade deficit reached USD 9.1 billion, 16.6% of GDP, service trade surplus was at USD 1.7 billion, 3.1% of GDP, income balance was in deficit of

USD 1.3 billion, 2.4% of GDP, and current transfers came to a surplus of USD 0.3 billion, 0.5% of GDP.

The negative trends in the external sector were manifested not only in commodity trade, but also in service trade. The service trade surplus as a proportion of GDP went down 0.5 of a point year-on-year in 2010; furthermore, it offset only 18.7% of the commodity trade deficit, whereas in 2009, it was enough to make up for 20%.

The key reason behind the deterioration of relative results of external service trade was the outrunning increase in transport and construction services imports. Despite the poorer “transport services” trade balance, compared to the previous year, it was the transport sector that provided the bulk of the surplus, with around 97% of the entire service trade surplus (the remaining segments performed close to zero).

Income deficit kept widening in 2010, primarily due to the increase in net capital outflows in the “investment incomes” category: in 2010, net capital outflows rose 21.2% year-on-year, commensurable with net FDI inflows in previous years. This attests to the low efficiency of a substantial part of incoming FDI, because at a later phase such investments form a reverse flow of investment incomes. It is getting increasingly important for the economic authorities to offset this effect, which means additional efforts must be taken to facilitate FDI inflows in the projects targeting primarily foreign rather than the domestic markets. Furthermore, it is essential that additional incentives be offered to investors, in order to ensure reinvestment of incomes from FDI and prevent their almost entire outflows as investment incomes.

In 2010, nearly all possible sources were used to finance the record high current account deficit. Most of the financing came from net inflows of loans and credit, at USD 3.5 billion, FDI, at USD 1.3 billion, portfolio investments, at USD 1.2 billion, and commercial loans, at USD 1.1 billion.

Commercial banks were the main borrowers on foreign markets, with net inflows of foreign resources at USD 2.2 billion. Foreign funds were mostly attracted by commercial banks with foreign capital, primarily those with Russian shareholdings, which borrowed from parent structures. Those loans were clearly not enough to finance the current account deficit. Also, most of the funds raised by domestic banks were short-term loans, which could not guarantee stable inflows of finance.

Therefore, not only banks, but also the central government and the National Bank borrowed from external sources.

Early in 2010, Belarus received the final tranche of the IMF loan; however, it was time to start repaying previous loans in the second half of the year, and net inflows of foreign resources thus came to a mere USD 500 million. In July-December, as the foreign trade situation deteriorated, the NBB had to step in; the central bank managed to draw USD 700 million on a net basis. The country owed the substantial inflow of "portfolio investments" to the debut placement of sovereign Eurobonds on foreign capital markets.

Nevertheless, despite the employment of new external borrowing instruments, capital inflows were not enough to cover the current account deficit. The shortage was financed from reserve assets, which fell by USD 800 million in 2010.

Currency market

The changing dynamics of foreign trade performance and expectations of the population had a prompt impact on foreign exchange trade patterns domestically. In the first quarter of the year, foreign trade performance improved because of a reduction in sales of crude oil and oil products. However, in the segment of resident companies the trend resulted in hikes in net demand for foreign exchange, by 57.8% year-on-year, with net demand reaching USD 1.5 billion). This was mostly due to the limited increase in the supply of foreign exchange caused by shorter export of refined oil.

At the same time, demand was growing steadily in this segment, despite the moderate growth in imports, as the share of foreign exchange acquired to service earlier loans markedly increased in the structure of purchases. In other words, active borrowing from external sources by privately owned businesses with a view to financing the current account deficit led to additional demand for foreign exchange from corporate entities.

The first quarter of the year saw major improvements in the balance of cash exchange trade between commercial banks and households compared with the first three months of 2009: net supply of cash exchange reached USD 174 million, whereas in the same period of 2009, net demand for exchange stood at USD 605 million. The deficit that was not offset by trade with individuals was covered by additional currency sales by banks and NBB's interventions. A similar situation was observed in the second quarter, when resident companies remained the main foreign exchange beneficiaries (although their net demand was growing at a much slower pace than in the first quarter). The key donors in that period were commercial banks, which were taking out new loans from external sources, and the National Bank, which continued its efforts to keep the exchange rate stable.

In the third quarter, corporate demand for foreign exchange grew even faster, 57.6% on the third quarter of 2009, or USD 1.2 billion, mostly due to heating of demand and additional demand for imports. Furthermore, foreign exchange trade with households swung to a deficit of USD 56.3 million (from a surplus, or net supply, of USD 131 million). The burden on banks and gold and foreign exchange reserves of the country therefore markedly increased, and banks started performing "double" functions in financing the deficit: they had to form a net supply of foreign exchange on the domestic market while placing currency deposits with the National Bank in order for the latter to be able to stabilize the amount of net foreign assets.

The aggressive economic expansion in the fourth quarter brought about a record high deficit of foreign exchange trade on the domestic market. Firstly, net demand of resident companies more than trebled year-on-year to reach USD 2.8 billion. Secondly, the increase in incomes and less optimistic expectations of individuals stood behind an unusually high net demand in that segment, reaching USD 1.2 billion.

The considerable net supply of foreign exchange by nonresidents, at USD 0.6 billion, was also a statistically important source to finance the deficit. The statistical result was due to the currency swap deal between the National Bank of Belarus and the People's Bank of China; that money was not part of currency supply on the market, but was included in the gold and foreign exchange reserves.

Financing of the record high deficit was mostly by intensifying the scheme tested in the previous quarter: currency supply was formed by commercial banks and NBB, which used depleting foreign exchange reserves. Furthermore, to stabilize reserves of the central bank, commercial banks placed new deposits with the NBB in addition to forming net supply of exchange.

The disproportions on the money market therefore became the first noticeable result of the large scale economic expansion undertaken by the authorities in 2010.

7. PUBLIC FINANCE

The main innovations of the state budget2010 were the abolition of transfers to the agriculture promotion fund, local tax on sales, tax on sales of vehicles and parking fees. To offset the losses, the value added tax was raised to 20% from 18%. Importantly, the Social Security Fund was withdrawn from the consolidated budget.

The new terms of oil trade became a serious shock for the state budget in 2010, as it had been drafted based on the 2009 trade terms. The Ministry of Finance estimated budget losses close to USD 2 billion, which called for additional revenues from other activities or spending cuts; otherwise, the country would have had to put up with a higher budget deficit. All of those options were used, with the dominance of the increased budget deficit (compared with the originally planned figure). In autumn, the Ministry of Finance had to admit that a broader deficit was required, setting the forecast between 2% and 3% of GDP (the deficit had originally been planned at 1.5% of GDP).

Consolidated budget deficit amounted to 2.6% of GDP in 2010, compared to 0.7% of GDP in 2009. Budget revenues were at 29.9% of GDP, down from 34.2% in the previous year, because of drops both in tax-based revenues, to 27.5% of GDP in 2010 from 30.2% in 2009, and nontax revenues, to 2.3% of GDP from 3.9%. The reduction in tax revenues was caused by the cancellation of the export duty on oil products, which stood behind the fall in tax revenues from foreign trade to 3.5% of GDP from 5.8%.The remaining slight reduction in tax revenues was due to the simplification of the tax system.

In 2010, consolidated budget expenditures amounted to 32.5% of GDP, down from 36% of GDP in 2009. The decrease was attributed to the reduction in national economy expenditures, to 7.6% of GDP from 12%, caused by the abolition of subsidies for oil importers. Furthermore, these expenditures fell in December 2010 in year-on-year terms because of the curtailment of bank recapitalization volumes, traditional for the final months of the year since 2008. In December 2010, around BYR 2 trillion was allocated from the budget to support banks (1.2% of GDP), which compares to BYR 4 trillion, or 2.9% of GDP, in December 2009.

The substantial consolidated budget deficit is a new situation for Belarus, as the country used to have either a surplus or a balance close to a zero in the previous five years. The budget deficit may be interpreted as the government's losing the room for maneuver in the fiscal sector and narrowing of possibilities to manipulate fiscal instruments to resist shocks.