

CHALLENGES AND PERSPECTIVES FOR THE NATIONAL ECONOMY

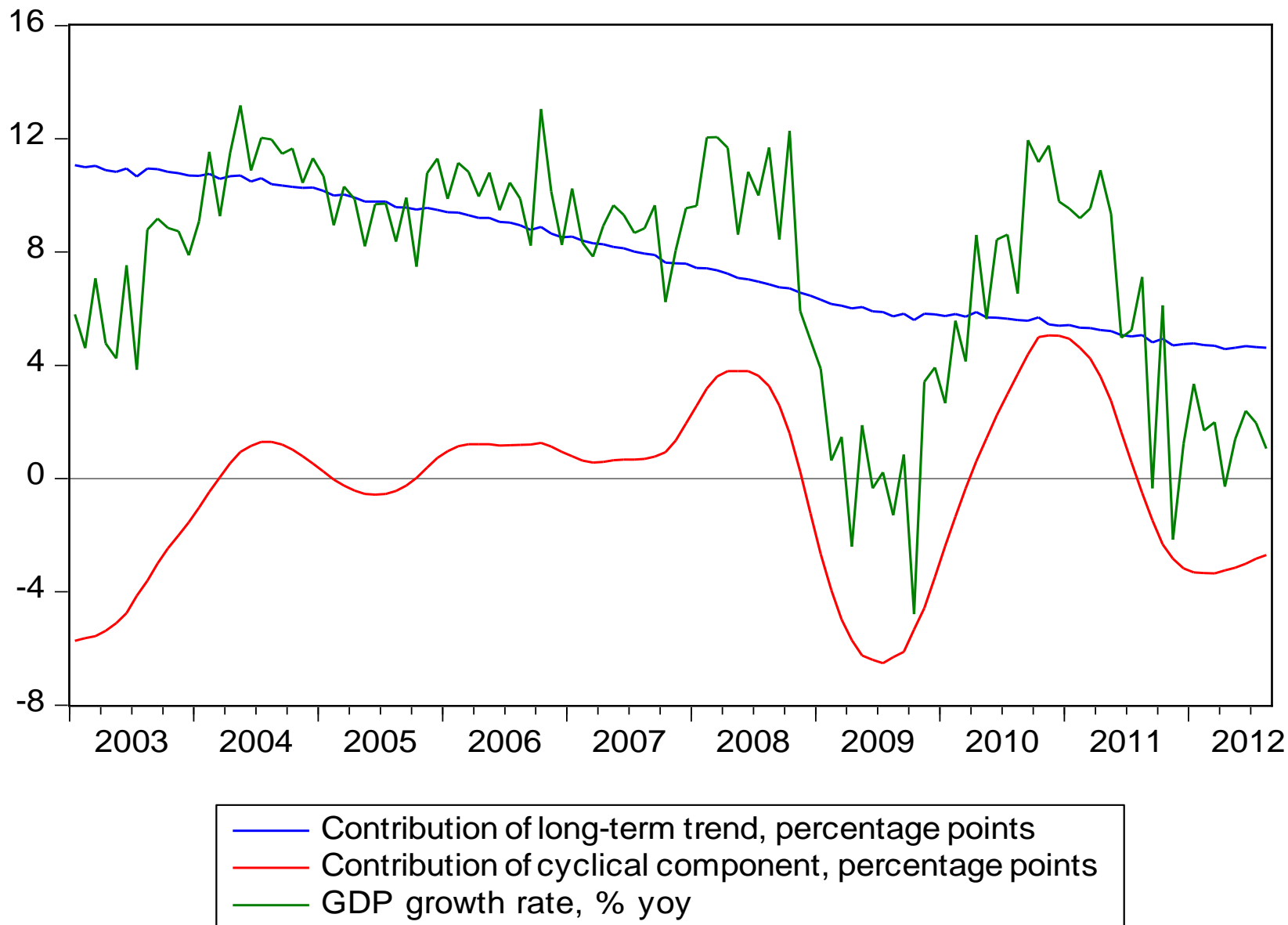
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Long-term Challenges

Different approaches to the estimation of potential GDP (production function, statistical filters) witness that the growth rate of potential GDP is lowering

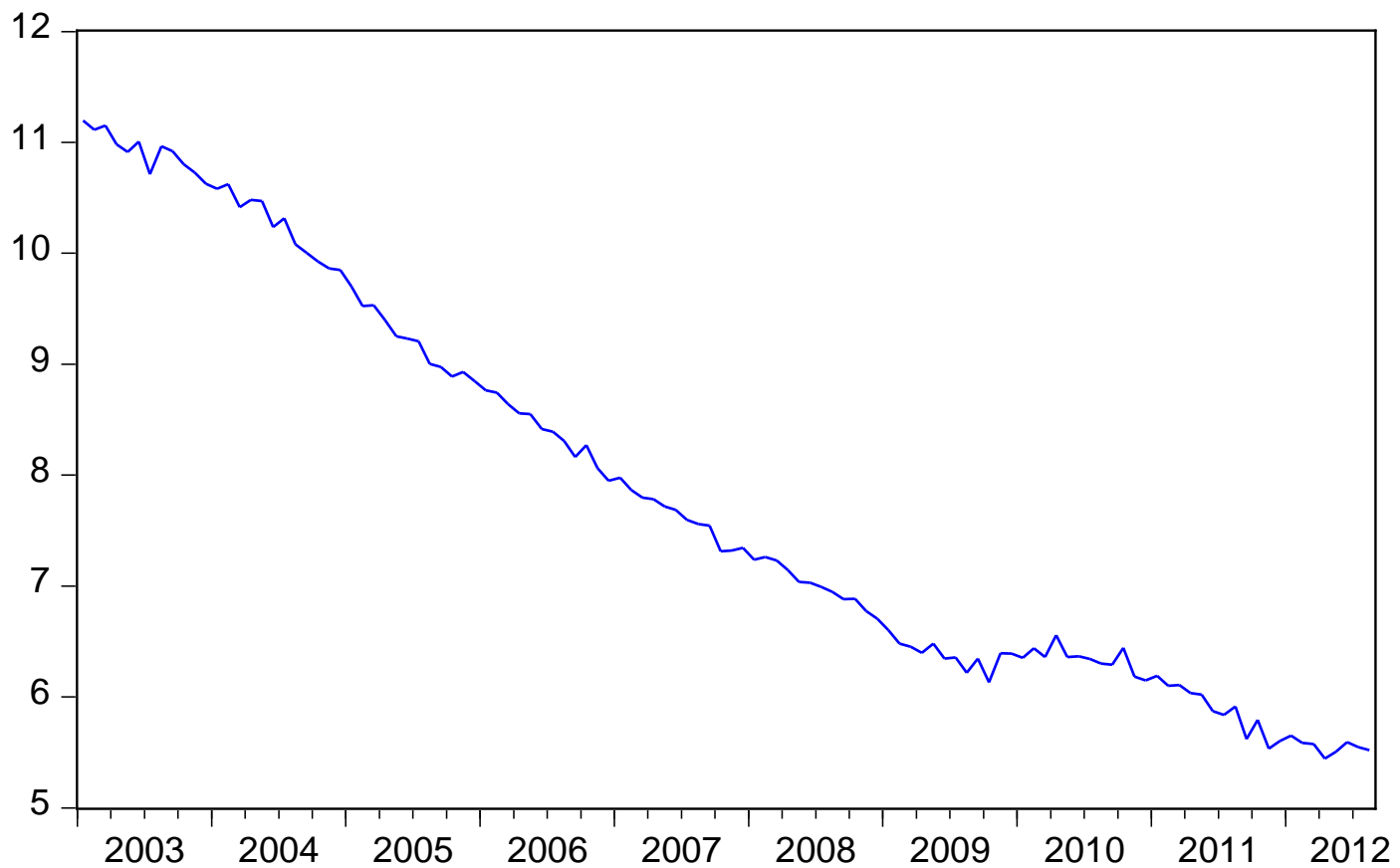
In other words, accepting an environment of low economic growth seems to be inevitable, *ceteris paribus*

Long-term Challenges



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Contribution of long-term trend to GDP growth, percentage points (Kalman filter estimates)



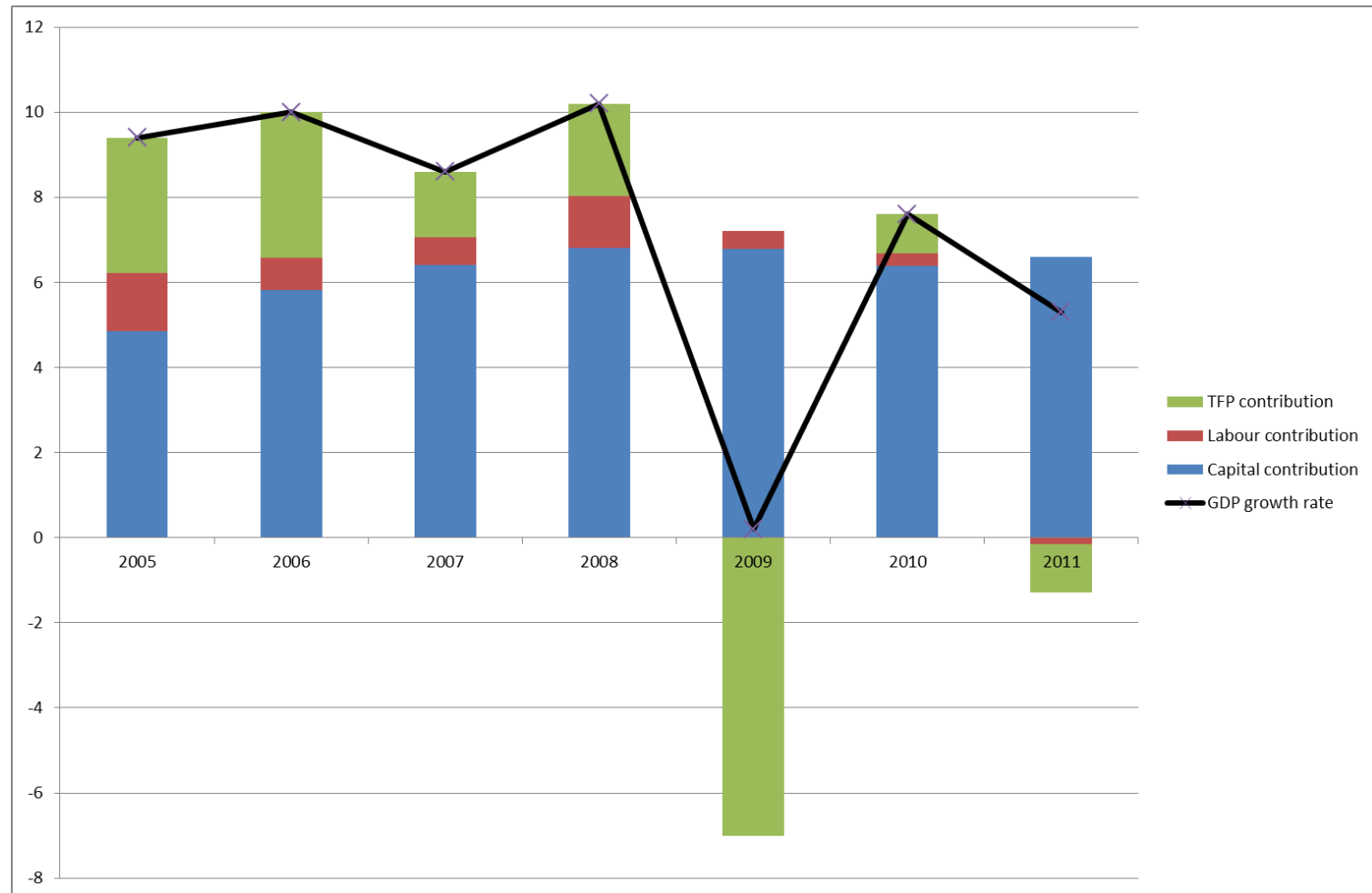
Looking for a diagnosis: why growth perspectives are poor?

Decomposing growth by its factors – capital, labour, and total factor productivity helps to identify the problems of growth more thoroughly.

This standard exercise is hindered by huge problems with the data on capital stock. Official statistics reports modest growth of capital stock despite huge growth in capital investments during the last decade, which is unrealistic. However, if the official data on capital stock is used, one have to recognize that total factor productivity was the engine of growth during the last decade. In other words, a huge progress in efficiency must be recognized.

However, the story is completely different if other methods for generating capital stock are used (herewith perpetual inventory method was run).

Looking for a diagnosis: why growth perspectives are poor?



The diagnosis

Hence, we may argue that the main problem of the Belarusian economy is the lack of productivity growth, given massive capital increase

This trade-off between capital and productivity might be consequent to specific features of the Belarusian economy:

1. Administrative procedures for resources allocation.
2. “Guarantying” domestic demand
3. Regulation of nominal parameters (wages, prices, interest rates).
4. Direct and indirect subsidizing

Thus, the diagnosis is *specific practices of macroeconomic management and government interventions undermine incentives for productivity growth and the economy is losing its competitiveness*

Additional structural distortions

Furthermore, specific policy instruments and distorted incentive lead to additional structural weaknesses:

1. External deficit → external debt accumulation
2. Lack of savings (excessive investments?)
3. Excessive burden on banking sector

If the government intends to provide high GDP growth (given low potential growth and structural imbalances), then there is a room for financial turmoil and macroeconomic shocks. The latter is a story of 2010 and the crisis of 2011.

Inheritances of the Currency Crisis 2011

Currency crisis-2011 vitalized a number of new problems in a financial sphere:

1. High financial dollarization (which limits the space for maneuver for discretionary monetary policy)
2. High level and increasing volatility of inflation expectations

However, National bank is reluctant to a new nominal anchor, which is more appropriate for this environment

Hence, financial sphere suffers from the lack of clarity and the equilibrium at the financial market is fragile

Specifics of XR Dynamics

Despite today's XR policy is treated as flexible XR, it does not guarantee current account close to be balanced. The latter level (i.e. those that provides current account close to balance) is extremely volatile itself, as there may be a huge difference between needed real and nominal depreciation, which is consequent to the high pass-through effect from XR to prices. The latter is associated again with inflation and devaluation expectations, and high financial dollarization as the pattern to hedge exchange rate risk.

Trap for Monetary Policy

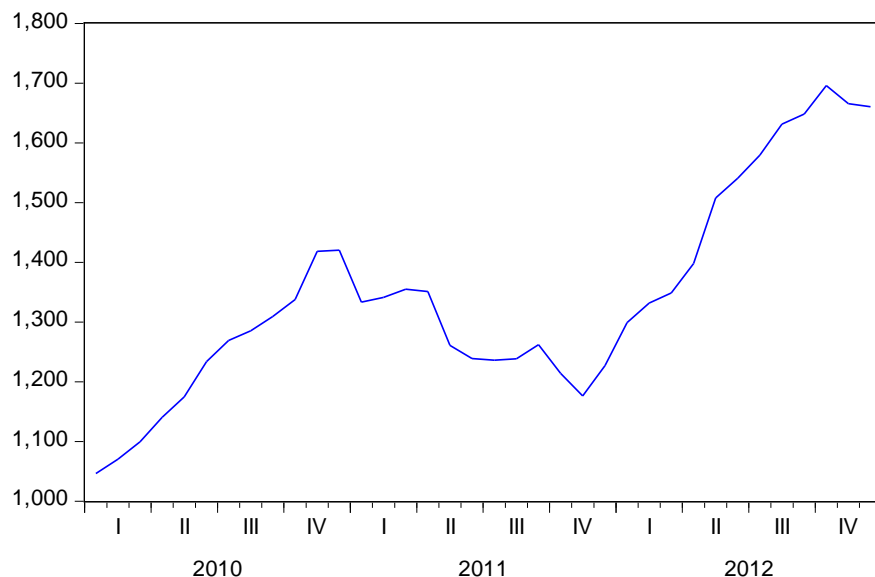
Thus, National bank has to match high inflation/devaluation expectations by high interest rates, which leads to extraordinary high ex post real interest rates (and the volatility of real interest rates ex post rises dramatically), and, in turn, negatively affects real economy. However, high interest rates contribute to a more or less stable nominal XR (households and firms sell partially their savings in hard currency). But the latter contradicts to fundamental need in a flexible XR regime.

Thus, having not found new nominal anchor, the NBB might return (implicitly) to the old one – XR. Thus, monetary policy comes into a trap, and its resistance to shocks is questionable.

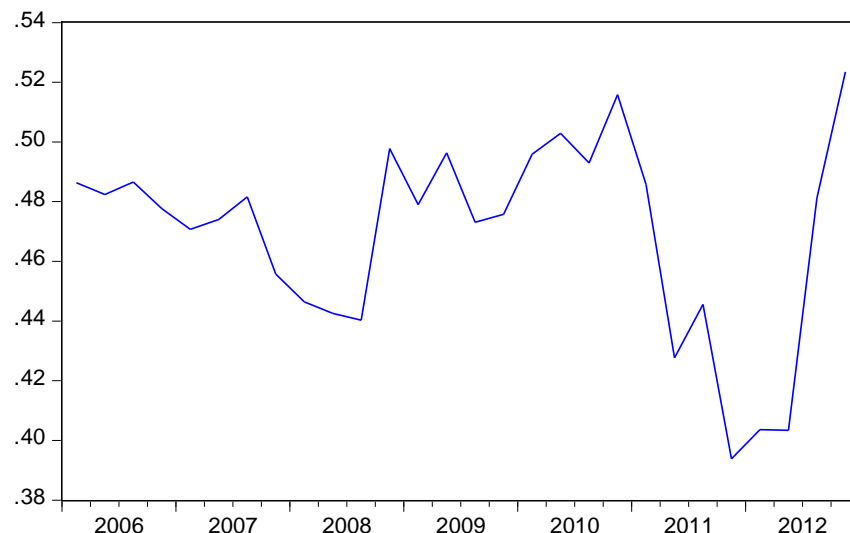
Forecast 2013-2014: Real Economy

Major factors of price competitiveness at external markets have been exhausted during 2012. Furthermore, active wage policy in 2012 brought real unit labour cost up to its medium term level. Hence, there is no more room to increase real wages without deterioration of net exports.

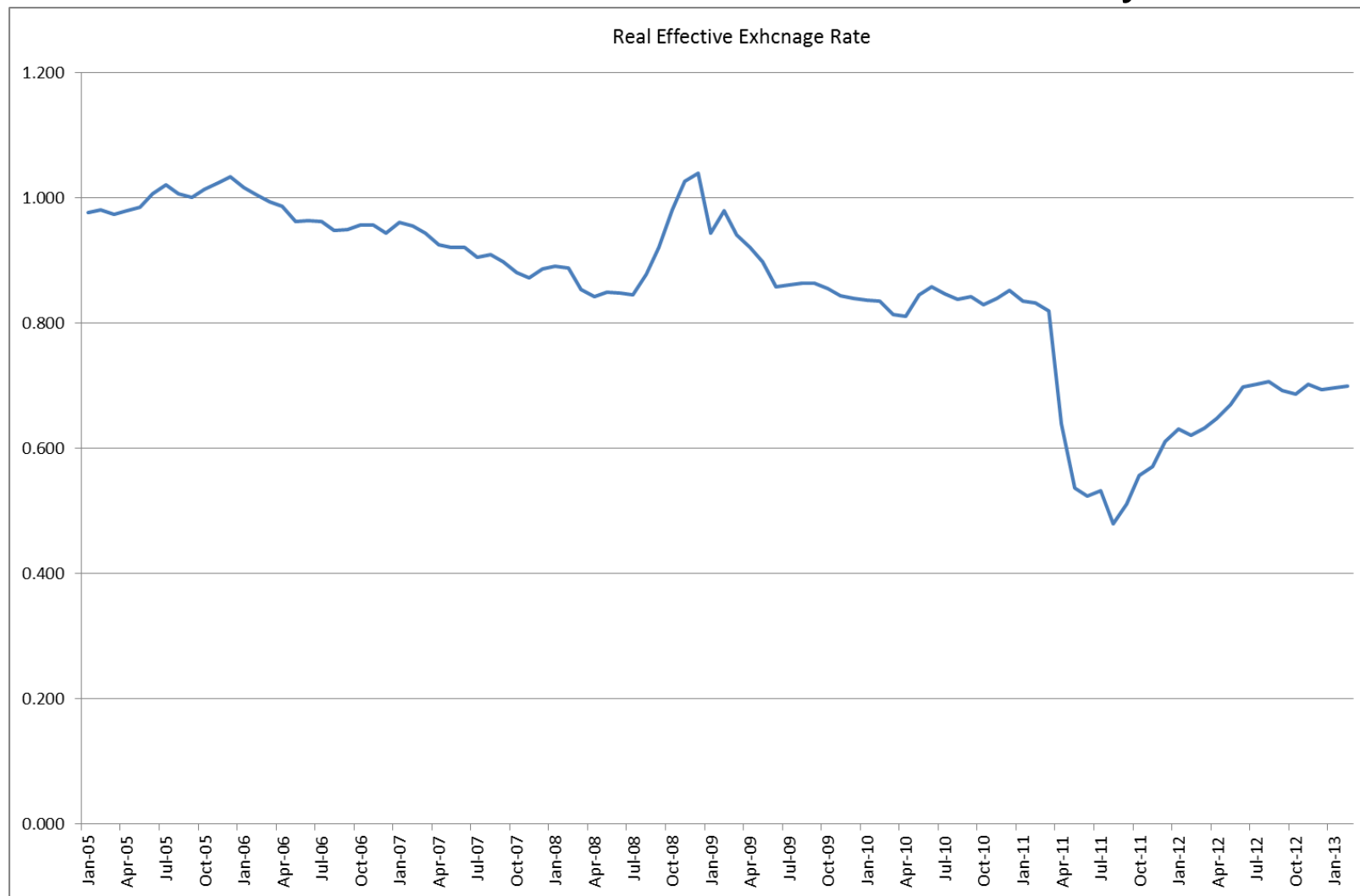
Real Wages



Real Unit Labour Cost



Forecast 2013-2014: Real Economy



Forecast 2013: Real Economy

Thus, we expect a steady deterioration in net exports in 2013 and 2014. Alongside, real wages will just modestly grow in 2013 (about 6%), but are going to stagnate afterwards, which will result in stagnation of household consumption. At this background, capital investments are going to become the engine of growth. However, this policy is to result in accepting lower growth environment along with progressing external imbalance. In 2013, we expect GDP to grow by 2.5%, and by 2.6% in 2014.

At the same time, this forecast is optimistic, in a sense that it assumes no severe external shocks for the national economy.

SOLUTIONS FOR LONG- AND MEDIUM-TERM PROBLEMS

For solving long-term problems structural reforms aimed at productivity growth and elimination of the sources of inefficiency are of prior concern. It should be stressed that the impact of long-term constraints becomes more and more evident for short-term dynamics.

From the view of current economic policy, a low resistance to adverse shocks seem to be a prior problem. Monetary policy is in a need of a new anchor, while fiscal policy has got a lack of room for maneuver.

Furthermore, expansionary economic policy is of concern, as it may generate shocks at the currency and money market. Finally, external borrowings may become a new problem, as it has become a key requirement for enhancing nominal stability.