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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/3-1

12:30 p.m., January 16, 2019

1. Republic of Belarus—2018 Article IV Consultation

Documents: SM/18/295 and Correction 1; and Supplement 1; and Supplement 2, 01/11/2019; SM/18/296; and Correction 1

Staff: Miniane, EUR; Murgasova, SPR

Length: 29 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	B. Jappah (AE), Temporary
	F. Sylla (AF)
	D. Vogel (AG), Temporary
	G. Preston (AP), Temporary
	P. Fachada (BR)
	X. Cai (CC), Temporary
	J. Rojas (CE), Temporary
	C. Williams (CO), Temporary
R. Kaya (EC)	
	A. Sode (FF), Temporary
	K. Merk (GR)
	P. Dhillon (IN), Temporary
	P. Di Lorenzo (IT), Temporary
	Y. Saito (JA)
	K. Badsi (MD), Temporary
	F. Al-Kohlany (MI), Temporary
	V. Rashkovan (NE)
	M. Bernatavicius (NO), Temporary
A. Mozhin (RU)	
	F. Rawah (SA), Temporary
	L. Rauqeuqe (ST), Temporary
	P. Trabinski (SZ)
	T. Hemingway (UK), Temporary
	D. Crane (US), Temporary

H. Al-Atrash, Acting Secretary
H. Malothra, Summing Up Officer
D. Alcantara, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Communications Department: O. Stankova, G. Vilkas. European Department: B. Jajko, J. Miniane, S. Romero Martinez. Fiscal Affairs Department: D. Benedek. MESSAGE: M. Roy OEDIN at the table. Strategy, Policy, and Review Department: G. Minasyan, Z. Murgasova. Statistics Department: J. Hur. Alternate Executive Director: S. Benk (EC), A. Castets (FF). Senior Advisors to Executive Directors: Y. Danenov (SZ). Advisors to

Executive Directors: O. Bayar (EC), K. Carvalho da Silveira (AF), S. David (AP), M. Josic (NE), M. Mehmedi (EC), H. Mori (JA), A. Zaborovskiy (EC).

1. REPUBLIC OF BELARUS—2018 ARTICLE IV CONSULTATION

Mr. Kaya and Mr. Zaborovskiy submitted the following statement:

The Belarusian authorities thank staff for the constructive discussions and policy dialogue during the 2018 Article IV consultation. There is broad concurrence between the authorities and staff about the directions of economic policies, and the new Belarusian Government, which has been appointed in August 2018, intends to move steadfastly in advancing the macroeconomic and structural policies in line with staff's recommendations.

Recent Macroeconomic Developments and Outlook

Favorable economic developments continued in 2018, characterized by accelerated broad-based GDP growth and subdued inflation. Real GDP growth is expected to exceed 3 percent in 2018, mostly driven by strong export and robust domestic demand, including investments and consumption. All main sectors except for agriculture are to record positive growth rates. The inflation, current account deficit, income inequality and unemployment remain at low levels underpinned by sound budget and monetary policies as well as structural reforms aimed at boosting the private sector and foreign direct investments (FDIs).

To entrench the achieved macroeconomic stability and support the current growth momentum, the new Government outlined an ambitious economic policy package. A wide range of policies, that have been approved by the Parliament in the Government's Action Program up to 2020, includes measures to (i) strengthen oversight and financial discipline of state-owned enterprises (SOEs), improve corporate governance and reduce fiscal risks; (ii) streamline the regulatory framework to enhance the business climate and attract FDIs; (iii) facilitate structural transformation of the economy towards the service sectors and IT-industries, and promote trade diversification. The authorities expect these policies to further boost the growth potential and accelerate Belarus' income convergence with regional peers.

Against the challenging external outlook, the authorities remain committed to sound policies and exchange rate flexibility. On the backdrop of elevated external risks, including geopolitical tensions in the region and trade-related frictions in the Eurasian Economic Union, the authorities strongly believe that the exchange rate flexibility and prudent macroeconomic policies remain the first line of defense against adverse shocks and unfavorable developments. Growth-enhancing structural policies are also high on the authorities' agenda and continue to be implemented with due regard to preserving the economic and social stability in the country.

Fiscal Policy and Debt Sustainability

Starting from 2015, the authorities have embarked on a sizable fiscal consolidation, comparable in its scale to some Fund-supported programs. Using the staff's broad definition of fiscal balance (page 41), the fiscal adjustment of 2.7 percent of GDP has been achieved in two years (since 2015). The fiscal adjustment package consisted of the pension reform, hike in utility tariffs, revenue mobilization measures (increases in personal income tax, corporate profit tax, VAT rates), significant cuts in current spending and off-balance sheet operations. The balanced budget net of cyclical revenues has been targeted to facilitate structural fiscal rebalancing and budget sustainability.

In 2018, fiscal policy continued to be disciplined. The actual fiscal outturn for 2018 is characterized by a solid primary surplus, higher revenue collection, better quality of expenditure, and restrained non-priority spending. The authorities have used the accumulated fiscal space for early redemption of public debt papers in the amount of up to US$ 0.5 billion as well as some priority capital and social expenditures.

The recently approved 2019 budget is based on conservative and risk-based assumptions. The budget: (i) rests on a lower GDP growth forecast than projected by staff; (ii) fully incorporates possible revenue losses caused by negative spillovers from the new taxation scheme in the Russian oil industry; (iii) targets the budget surplus of 1.3 percent of GDP (BYN 1.7 billion). On the expenditure side, it envisages a 10 percent spending cut of subsidies and transfers to SOEs, which is consistent with the authorities' gradual approach to restructuring and commercialization of the state-owned sector, as well as a 5 percent cut of subsidies on utilities for households which is in line with the steady increase in utilities tariffs' cost-recovery.

The 2019 budget is compliant with the medium-term budget framework aimed at putting public debt on a downward trajectory. The authorities intend to reduce the central government debt to 25 percent of GDP by 2025 by allocating budget surpluses to debt repayment. According to the fiscal rule approved by the authorities, the annual budget surpluses should be consistent with the debt reduction strategy and include revenues from export customs duties. A cap on net new domestic guarantees and stricter review procedures for both domestic and external guarantees are also in place to firmly keep publicly-guaranteed debt under control. Regarding the public DSA presented in the Staff Report, the relatively sizable contribution of the residual to changes in the public debt dynamics (page 45) points to the need for a more nuanced analysis of factors driving debt in Belarus. It is also worth noting the strong debt-reducing contribution of the primary surplus that stays at around 3 percent of GDP over the projection period.

The authorities press ahead with modernizing the tax administration and the revenue-neutral revision of the Tax Code. On January 1, a new version of the Tax Code entered into force which simplifies the tax administration and interaction between taxpayers and the tax authorities, liberalizes penalties (penalties will not exceed additional tax sums, which are charged after an audit), and ensures the predictability and integrity of the tax legislation. In 2019, the authorities intend to approve the methodology for assessing the effectiveness of tax expenditures and embark on the comprehensive evaluation of the existing preferential tax regimes to optimize the current system.

Efforts to further strengthen public financial management (PFM) and a fiscal risk assessment (FRA) framework are high on the authorities' agenda. The PFM Modernization Project is being implemented with the World Bank's support and a Public Expenditure Review has been launched by the Ministry of Finance recently. The implementation of the medium-term budget framework for 2019–2021 should reinforce fiscal discipline, facilitate informed policymaking, and provide predictability in planning and executing budgets. Result-oriented budgeting is also being employed to contain inefficient spending and promote growth-friendly public investment. The authorities welcome staff's positive assessment of the progress made in designing the FRA framework and intend to move forward with strengthening and advancing its architecture in line with staff's recommendations.

Monetary Policy and Financial Stability

The National Bank of the Republic of Belarus' (NBRB) monetary aggregates targeting framework proves to be instrumental in curbing inflation and reinvigorating healthy credit growth. In 2018 inflation has been brought down to 5.5 percent against the NBRB's target of not higher than 6 percent. Against falling real interest rates, credit to the economy recovered both for households and corporations. With the monetary policy rate (the NBRB's refinancing rate) currently at 10 percent, the authorities broadly agree with staff that the current monetary policy stance is appropriate and should be maintained. The inflation target for 2019 is set at 5 percent which is consistent with the broad money supply growth (an intermediate monetary policy target) at the level of 9-12 percent (December 2019 to December 2018). The interest rate on intraday interbank credits in the national currency continues to be the monetary policy operational target.

The planned transition to a full-fledged inflation targeting framework is firmly on track. This work is supported by the EU twinning project with a consortium of European Banks, which includes the central banks of Germany, Poland, and Lithuania, as well as the ongoing Fund TA on monetary policy modelling. In December 2018, the new communication policy to strengthen the NBRB's credibility and the transparency of policy decisions has been approved and the schedule of meetings of the Board of the National Bank and briefings on monetary policy issues for 2019 has been published. Increasing openness and transparency as well as multi-channel communications help better anchor inflation expectations which is critically important for smoothly switching to inflation targeting.

The FX market has been further liberalized while preserving exchange rate flexibility. The FX surrender requirements for exporters have been fully abolished in August 2018 as well as the requirement to explain the reasons for FX purchases. Starting on March 1, 2019, the requirement to obtain NBRB's permission to open current accounts in foreign banks by households will be eliminated and legal entities' FX transactions related to capital mobility will be liberalized. Notwithstanding the ongoing FX market liberalization, the FX reserves amounted to US$ 7.2 billion at the beginning of January 2019, covering approximately 2.2 months of imports. The NBRB remains committed to a flexible exchange rate determined by market forces and intends to proceed with further FX reserves accumulation when conditions permit.

The results of the EBA-light exercise warrant cautious interpretations as the large persistent residual attests the model's poor explanation power in the case of Belarus. Belarus' current account deficit shrank from 3.3 percent of GDP in 2016 to 1.6 percent of GDP in 2017, and to 1.1 percent of GDP in January – September 2018 supported by exchange rate flexibility, strong export receipts and increased money transfers from abroad. At the same time, the cyclically adjusted CA-Norm produced by the EBA-light for Belarus has jumped from -1.1 percent of GDP to +2.1 percent of GDP, and the residual has swelled significantly, explaining entirely the whole CA-Gap. Considering that during this period the NBRB accumulated more than US$ 3 billion in FX reserves, staff's conclusion of a slight exchange rate overvaluation is not shared by the authorities. Using several alternative methods, the NBRB estimates that REER is close to the equilibrium determined by economic fundamentals.

The authorities welcome staff's acknowledgement of the significant progress in implementing the FSAP recommendations and remain committed to steadfastly move forward in this area. Since January 2018, Belarusian banks are required to maintain capital ratios compliant with Basel III framework. The NBRB also published a list of systemically important banks which are required to maintain additional capital buffers. By October 1, 2018, the reported capital adequacy ratio of the operating banks stood at 18.2 percent for the sector as a whole and remains comfortably above the regulatory norms. Macroprudential measures (limits on loan-to-value (LTV) ratios and caps on debt service-to-income (DSTI) ratios) for addressing household sector credit risks have been employed starting on May 1, 2018. Despite the economic turbulence in 2015-2016, the deterioration in credit quality has been contained and by October 1, 2018 NPLs accounted for 4.1 percent of total assets with high coverage ratios. The authorities are determined to further develop a market for distressed assets and strengthen the operational framework of the Asset Management Company created to address the problem of NPLs transferred from the banks' balance sheets after the 2016 Asset Quality Review.

De-dollarization retains pace underpinned by the recent policy decisions. The authorities agree with staff's recommendations outlined in the report and Selected Issue Paper (SIP). They intend to employ a broad range of available instruments, including prudential policies, supervisory measures, and improved communications to bring down the dollarization to its optimal level. To develop the capital market in local currency, along with the measures presented in the SIP, as of March 1, 2019, the authorities will further limit the use of foreign currency for interbank and FX-bonds transactions, and at the domestic insurance market. The Ministry of Finance plans to extend BYN-denominated government bonds issuance for 2019. Overall, the authorities very much agree that sustainable macro policies increasing confidence in the domestic currency are the critical ingredient of the success in their de-dollarization efforts.

Structural Policies

The new Government considers restructuring and commercialization of the state-owned sector as one of the key priorities. The authorities have been focusing on improving governance and the quality of management in state-owned enterprises (SOEs) based on the appropriate OECD guidelines, in parallel with tightening the budget constraints, leveling the playing field and attracting investors to the state-owned sector. Work is under way to enhance the capacity of the State Property Committee in order to strengthen the oversight of state assets. In cooperation with the EBRD and the World Bank, a number of pre-privatization projects have been launched to undertake benchmark-setting corporatization and privatization in the real and banking sectors. A successful entry of credible international investors in SOEs and state-owned banks (SOBs) would set a precedent that could be replicated further. Transferring some SOEs from the national to the regional level also facilitates small-scale privatization. This process is being conducted in close cooperation with the regional authorities considering their capacities and incentives. Staff's concerns regarding possible risks related to the devolution of some SOEs to sub-national governments are well-noted and the authorities intend to move forward carefully to mitigate these risks. Overall, the state-owned sector restructuring is being conducted with due regard to social consequences for the labor market and in close connection with expanding targeted social safety nets and creating a more favorable environment for the entrepreneurship and self-employment.

In 2019, the household utility tariffs are expected to achieve the full cost recovery level except for heating. The cost recovery level has been steadily growing since 2014 reflecting the authorities' gradual strategy. On January 1, 2019 household tariffs for electricity and gas have been increased by 21.8 percent and 25.6 percent respectively to achieve the full cost recovery. All other utility tariffs except heating, that have already been set at the level covering the full costs, have been increased up to 3.5 percent to maintain the achieved level of cost recovery. Tariffs for heating are announced to be increased on June 1, 2019. Overall, the cost recovery level of all household utility tariffs has been increased by up to 80 percent, from less than 30 percent in 2014. The increase of heating tariffs is considered in conjunction with the ongoing modernization and restructuring of the existing centralized heating system. This work is also financially supported by the World Bank and EBRD. The authorities' gradual strategy accompanied by expanding the targeted social safety nets proves to be instrumental in reducing energy subsidies and boosting cost recovery without jeopardizing social stability.

The authorities' liberalization efforts are reflected by the improved Doing Business ranking. Belarus is ranked 37th out of 190 economies in the World Bank's 2019 Doing Business report. The broad-based measures to support the private businesses, including the Presidential Decree on Entrepreneurship Development signed on November 23, 2017, made starting a business easier, and simplified the issuance of construction permits by streamlining the process to a one-stop shop. Belarus' best rankings are for registering property (5th), getting electricity (20th) and trading across borders (25th). The authorities expect that the newly adopted Tax Code and entrenched macroeconomic stability will help simplify paying taxes and getting credit, thereby further improving the business climate, encouraging investment and boosting actual and potential growth over a longer period.

The ICT sector and services became the important drivers of economic development. Export of services increased by 18.2 percent and the positive trade balance in services improved by 35.7 percent between 2015 and 2017, contributing to Belarus' overall positive trade balance in goods and services. To further promote the development of the ICT sector, a Presidential Decree on digital economy development was adopted in December 2017. The decree prolongs the special taxation and regulation regime of the High-Technology Park (HTP), introduced a liberal legal framework for Blockchain technologies and legalized "smart contracts" in Belarus. Financial and legal tools have been introduced to stimulate venture capital transactions. In 2018, production and sales revenues of HTP resident-companies are expected to have increased by 40 percent and amount to US$ 1.5 billion, with an export share of approximately 90 percent. The ICT sector accounted for approximately 5.0 percent of GDP in 2017. The Government identified the ICT sector and service industries as the priority of structural transformation of the economy.

Liberalization and growth-friendly structural policies will keep up the momentum. The Government's Action Program up to 2020 stipulates the following priority areas: development of the business environment by creating favorable business conditions, ensuring fair competition, and protecting property rights. The polices to promote de-monopolization are being determined with the support of the IFC. On December 19, 2018, the Parliament approved amendments to the Criminal Code to decriminalize economic offences along with the efforts to create more favorable conditions for economic activities. The thresholds of damage when criminal liability applies have been increased substantially. In addition, economic crimes not representing a great danger to the society, committed for the first time, will not entail heavy penalties. This has been done primarily to ensure that insignificant errors made by small and medium-sized businesses do not become devastating for entrepreneurs. The new Government also announced its intention to successfully complete the ongoing negotiations on Belarus' accession to the World Trade Organization in 2020.

Belarus is shielded against the negative spillovers from the Russian tax maneuver by prudent macroeconomic policy mix in 2019 and continues to calibrate policies appropriately going forward. The 2019 budget absorbed revenue losses caused by the negative spillovers from the significant tax policy changes in Russia, the largest economy in the Eurasian Economic Union and Belarus' main trading partner. The Governments of Belarus and Russia work closely together to resolve the matter, considering the provisions of the Eurasian Economic Union Treaty and bilateral agreements. Going forward, the economic policy mix in Belarus will be calibrated appropriately following the outcome of this work.

Final Remarks

The Belarusian authorities are aware that ensuring sustained, broad-based medium-term growth requires continued policy efforts with emphasis on structural reforms. Staff's recommendations are being carefully studied and accommodated to the extent possible. The productive and constructive dialog with the Fund's staff and management remains an important factor for anchoring the economic policy agenda in Belarus and is highly appreciated by the authorities.

Mr. Merk and Ms. Fritsch submitted the following statement:

We thank staff for a comprehensive and informative report and Mr. Kaya and Mr. Zaborovskiy for their insightful buff statement while mostly concurring with staff's recommendations. Supported by more prudent macroeconomic policy frameworks, economic conditions in the Republic of Belarus have improved. At the same time, risks to the outlook are elevated. Against this backdrop, staff rightly calls for making best use of the cyclical recovery and press ahead with comprehensive economic reforms to reduce existing vulnerabilities and lift growth potential.

We note that public debt sustainability risks are substantial and necessitate reversing the upward trajectory of public debt. While the public debt ratio is not extraordinarily high, 90 percent of public debt is denominated in foreign currency making debt very vulnerable to exchange rate devaluations. Moreover, external financing requirements are considerably above the 15 percent of GDP threshold considered safe for emerging markets. We thus fully support staff that the authorities should seize the opportunity provided by the recovery to put public debt on a firm downward path. As noted by staff, this would require additional structural fiscal adjustment that could be spread over the next three years and should inter alia involve durably reducing quasi-fiscal transfers to SOEs.

We are encouraged to learn that the early 2015 adoption of a revised monetary framework is bearing fruits and has helped stabilize inflation at relatively low levels. An important complement to improvements in policy frameworks has been the enhanced operational independence of the NBRB which has helped improve policy credibility in delivering price stability. We note the NBRB's expressed goal of gradually transitioning to a modern (full) inflation targeting regime. In this context, staff rightly accentuates that such a transition continues to face several challenges such as high dollarization as well as a legacy of fiscal dominance. Against this background, the authorities are well-advised to cautiously transition to an inflation-targeting regime and avoid an implementation before the necessary prerequisites are firmly in place.

As regards structural policies, a well-sequenced and comprehensive SOE reform strategy remains key to reduce macro-financial vulnerabilities and raise growth potential. A key first step would be a systematic, risk-based assessment of SOEs' viability to subsequently inform an actionable and monitorable plan to guide restructuring efforts. Further reforms should aim at introducing more market-based elements in order to improve resource allocation, increase efficiency and lower costs. Furthermore, measures to improve the business environment are of the essence to stimulate the private sector and foster diversification of the economy. In this context, we concur with staff that other market-based measures such as a liberalization of prices and an abandonment of cross-subsidization in the utility market could complement these efforts.

Finally, we welcome the continued follow-up on the FSAP's risk and vulnerability assessments including on the implementation status of recommendations.

Mr. Tan and Ms. Rauqeuqe submitted the following statement:

We thank staff for the informative reports and Messrs. Kaya and Zaborovskiy for their insightful buff statement. The authorities' stronger macro-policy frameworks and policies have supported the cyclical recovery and bolstered reform efforts, while delivering increased exchange rate stability and much-reduced inflation. This improved institutional environment and current cyclical upturn provide further impetus to address structural vulnerabilities, such as low growth potential, rising public debt and extensive dollarization. As we share the thrust of staff's assessment, the following comments are made for emphasis.

Deep SOE reforms are key for lifting growth potential, strengthening resource allocation and supporting fiscal sustainability. We take positive note of the authorities' efforts towards gradual price liberalization and improving SOE governance and management. Nevertheless, unviable SOEs have weighed on trend growth and the budget. Therefore, implementing a broad-based and well sequenced structural reform agenda is crucial to boost medium term growth and income convergence. In this light, fast-tracking the commercialization/privatization of SOEs and better targeting social safety nets are important for improving resource allocation, generating efficiency and productivity gains, while safeguarding all-important social cohesion. Successful SOE reforms would also bolster fiscal consolidation efforts through reduced government transfers, subsidies and guarantees.

Fiscal consolidation is necessary for addressing substantial debt vulnerabilities. The authorities have already undertaken several fiscal adjustment measures. However, foreign exchange risks from the large share of foreign-currency debt and SOE contingent liabilities constitute significant risks to debt sustainability. Adopting staff's advice on steadily reducing transfers to weak SOEs and addressing widespread tax expenditures would help with lowering public debt to a sustainable level. In order to durably anchor the fiscal consolidation path, broad-based SOE reforms including a systematic risk-based assessment, strengthening corporate governance and developing a distressed assets market must accompany the needed reduction in transfers to these entities.

The authorities' reforms to monetary and financial policies are commendable and should continue. The monetary-targeting framework has effectively anchored inflation expectations, and the NBRB's recently-approved communications policy should strengthen central bank credibility further and support the transition to an inflation-targeting framework. In terms of de-dollarization, adopting a national and well-communicated strategy for educating the public about risks of FX borrowing is central to successful de-dollarization. While we take good note of the authorities' solid progress in implementing FSAP recommendations, we wonder about the motivation and preliminary impact of the authorities' new NPL regulation. Staff comments are welcome.

Mr. Virolainen and Mr. Bernatavicius submitted the following statement:

We thank staff for their informative reports and Mr. Kaya and Mr. Zaborovskiy for their useful buff statement. The cyclical economic recovery, low inflation and stable exchange rate provide a good opportunity to proceed with much needed structural reforms as Belarus remains one of the most state-controlled economies in Europe dependent on large energy discounts and transfers. We urge the Belarusian authorities to continue with a gradual transition to inflation targeting and price liberalization, strive for economic diversification and prepare comprehensive contingency plans in the event of less than full compensation on losses due to internal tax changes in Russia. We broadly concur with the thrust of the staff appraisal and offer the following comments for emphasis.

We concur with staff that reversing the upward trajectory of public debt would be useful to increase credibility and reduce financing needs in an uncertain environment. The ongoing recovery provides an opportune time to initiate the needed adjustment.

The operational independence of the central bank should be further strengthened as recommended by the 2016 FSAP. We welcome recent reforms in the right direction, which has helped to stabilize inflation at low levels of around 5 percent. We urge the authorities to step up policy efforts, which would enable a gradual transition to full inflation targeting regime. De-dollarizing of the economy and developing the rubel capital market should be the main guiding principles. The large negative equity position of the central bank should be recapitalized and its remaining shares in the two banks should be sold.

Belarus remains one of the most state-controlled economies in Europe with mostly inefficient SOEs. The new government’s priorities to further develop the private sector as specified in Mr. Kaya’s and Mr. Zaborovskiy’s buff statement are a welcome step in the right direction. It is critical to address inefficiencies in the SOE sector and raise growth potential as income convergence vis-à-vis regional peers has stopped or even gone into reverse.

The steadfast diversification of the economy should be a priority as Belarus is highly dependent on import subsidies. Belarus’s export structure is one of the most concentrated in the region as potash and refined oil accounts for one third of exports and Russia alone accounts for 45 percent of Belarus’s total exports. Existing financing is also relatively undiversified and primarily includes direct and indirect financing from Russia (including substantial financing needs for the construction of the new nuclear power plant). Therefore, efforts should be made to diversify financing, including issuing more rubel-denominated debt.

We welcome staff's analysis on the impact of Russia's tax maneuver on Belarus and possible oil subsidy losses starting in 2020 (Annex VII and Box 1). According to the extreme scenario of zero compensation for the gradual oil subsidy loss in 2020 and beyond, the impact would be significant. In the absence of any compensation, growth could fall to zero or become negative and there would be a need of USD 6.5 billion in additional financing. We therefore urge the authorities to prepare comprehensive contingency plans in the event of less than full compensation on tax maneuver losses.

Ms. Levonian and Mr. Williams submitted the following statement:

We thank staff for their comprehensive report and Messrs. Kaya and Zaborovskiy for their informative buff statement. The Belarusian economy is undergoing a nascent recovery; however, it faces a potentially worrisome challenge of adjusting to a new norm that may arise from changes to Russia's hydrocarbon tax regime. Even if negotiations with Russia were to end favorably, it is incumbent on the Belarusian authorities to steadfastly adopt a more robust set of macroeconomic and structural reforms to alleviate lingering vulnerabilities, foster greater investor confidence, and uplift potential growth. We broadly concur with staff's assessments and recommendations and offer the following remarks for emphasis.

Efforts to improve the fiscal position should continue unabatedly and be accelerated where feasible. This is key to stemming the rising public debt trajectory and supporting the economic recovery. In this regard, we welcome the information in the buff that the 2019 budget entailed a reduction in subsidies and transfers to SOEs and households. Plans to strengthen tax administration and upgrade the public financial management framework are well placed and should be pursued without delay. Furthermore, while the authorities are confident that a new energy agreement with Russia will leave them no worse off, we commend their prudent approach of excluding such revenues from the budget. Nevertheless, we note that the authorities are more positive than staff on the 2018 outturn, and relatedly they disagree with staff's recommendations for further fiscal adjustments. Can staff elaborate on this divergence in positions on fiscal policy?

We welcome the authorities' plans to modernize the monetary framework and bolster the stability of the financial sector. That said, a gradual transition toward full-fledged inflation targeting (IT) is sensible. This will allow the authorities sufficient time to put the requisite infrastructure in place to support IT. In this regard, we support the authorities' ongoing efforts to disincentivize dollarization and promote greater exchange rate flexibility.

Further, to minimize the exchange rate risk to the large share of dollar-denominated debt, we encourage the authorities to fast-track plans to issue ruble-denominated debt and develop the ruble capital market. Appetite for such instruments will however hinge largely on confidence, thus underscoring the need for Belarus to implement sufficiently robust structural and macrofinancial policies. We also urge the authorities to build on progress achieved with financial system stability by prioritizing the completion of key remaining FSAP recommendations. We invite staff's update on their assessment of the new NPL Regulation.

Deeper structural reforms are essential for Belarus to transition toward private sector-driven growth. Critical in this thrust to reduce the state's footprint in the economy and raise potential growth will be a strategic transformation of the large SOE sector - which remains a major fiscal burden - into a leaner and more efficient outfit. The authorities recognize the importance of this reform to induce private sector activity and stimulate inclusive growth; however, to secure broad stakeholder support they favor a more gradual approach than suggested by staff. A strengthening of social safety net will also be important to lessen the effect of the reforms on vulnerable households. While we agree with staff that the authorities' reform plans should be more ambitious, we are concerned about sequencing vis-a-vis the envisaged expansion of social protection. Staff comments are welcome.

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the informative papers and Messrs. Kaya and Zaborovskiy for the insightful buff statement. Belarus is enjoying a period of solid growth and low inflation. This is, thus, an opportune time to pursue more decisive structural reforms to address low productivity, reduce transfers to weak SOEs, and boost longer-term growth prospects. Belarus also needs to stand ready with contingency measures if negotiations on a new energy agreement with Russia do not turn out as planned. We broadly concur with the thrust of the staff appraisal and offer a few comments for emphasis.

Fiscal

While the fiscal deficit appears modest, contingent liabilities and risks are significant and warrant consideration of additional gradual fiscal adjustment, as suggested by staff. We welcome the authorities' focus on reducing quasi-fiscal transfers to SOEs and their intention to expand data reporting on nationally-owned SOEs to improve monitoring of contingent liabilities. As staff points out, monitoring transfers to sub-national SOEs is equally important, as are efforts to improve the quality of data, perhaps via audits.

Monetary and Financial Sector

We welcome the progress Belarus has made in strengthening its monetary framework and financial sector, following up on recommendations in the 2016 FSAP. We were glad to note the concurrence between staff and the authorities on future steps on financial sector supervision, including on asset classification and published data, and tackling systemic risks. We encourage the authorities to take up staff's suggestion on a de-dollarization strategy and are glad to note their cooperation with the EBRD on development of local bond markets and their plans to relay more on local currency-denominated debt.

SOEs

We agree with staff that more ambitious SOE reforms, carefully coordinated with strengthening of social safety nets, would serve Belarus well. We encourage the authorities to consider staff's suggestion to undertake a triage exercise. Staff notes that further efforts are needed to strengthen property rights and create a more business friendly environment, including by ensuring a level playing field between private and state sectors. Can staff elaborate on priority steps necessary to make the playing field more even?

Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for the well written set of reports and Mr. Kaya and Mr. Zaborovskiy for their candid statement. We broadly concur with staff's analysis and recommendations. We welcome the continued engagement with the Fund as this can help to lay the basis for economic resilience. Diversifying production base, trading partners and the external funding sources represent the main challenges going forward. We would like to provide the following points for emphasis.

Both the outlooks on growth and public finance crucially depend on the outcome of the negotiations with Russia on the new energy agreement. Given the uncertainties on the outcome, continuing with fiscal consolidation is appropriated. The DSA points at the real exchange rate depreciation as the main driver of the debt dynamic. The authorities' plans to extend the share of medium to long-term domestically denominated bonds issuance should help to reduce this vulnerability. Regarding external financing, while excessive relying to Eurobonds can expose Belarus to a large exchange rate shock and counteract the de-dollarization strategy, on the other side it can enhance the diversification of funding sources by relying more on western financial markets. Staff's opinion on how to better strike this delicate balance is welcome. Secondly, a durable reduction in the transfers to SOEs should be adopted, as they will produce a substantial improvement in the debt-to-GDP ratio trajectory comparing to the baseline, with a lower negative effect (it might also be positive) on output than the alternatives (cuts in tax expenditures or raising VAT rates).

A business-friendly environment is essential to spur and sustain growth. Efforts to expand the role of the private sector, including by attracting international investors constitute a turning point and should be pursued with determination. On the SOEs reforms, the gradual and incremental pace favored by the authorities could benefit from the communication of clear commitments on the ultimate goals of the reform and by setting exact deadlines. This would allow the authorities to strike the balance between an improved allocation of resources and the possible associated social costs. We see the identification of the unviable firms, and the consequent cuts in transfers, as an important initial step that should advance in parallel with the creation of a modern social safety net. What are, in staff's view, the possible funding sources for expanding unemployment benefits, as the cuts in the transfers are expected to be saved for debt reduction?

We support the gradual transition to inflation targeting. The recent reforms in the monetary framework have allowed to successfully contain inflation. A successful full transition to an inflation targeting framework requires also the ability to overcome the structural challenges hampering the transmission mechanism, starting with the widespread dollarization. We welcome the central bank's commitment to a flexible exchange rate and to further boosting reserve accumulation, which are below the ARA level.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for the detailed reports and Mr. Kaya and Mr. Zaborovskiy for their informative buff statement.

The macroeconomic performance of Belarus has improved in the recent past. Growth is in a cyclical recovery after the 2014-16 recession, inflation is subdued, and the budget deficit has declined. However, the current account deficit has increased, mainly due to higher imports. We commend the authorities for their efforts to restore macroeconomic stability. However, significant constraints remain and the continuation of growth enhancing structural policies in several areas, including in SOEs, are important to avoid mis-allocation of resources under the state-led growth model, enhance competitiveness, improve productivity, reduce vulnerabilities and unlock the country's growth potential. The tax maneuver remains a key near term concern as it could have bearing on the Belarusian economy if the ongoing negotiations are not concluded successfully. We broadly agree with the thrust of the staff reports and recommendations, and wish to offer a few remarks for emphasis.

The authorities' commitment to a strong fiscal stance to limit the budget deficit, reduce debt and address macroeconomic vulnerabilities is commendable. However, we note that expenditures are rising faster than the solid revenues mainly due to the increasing spending on salaries and wages. The resultant deterioration of the budget in the context of strong economic recovery therefore warrants careful consideration. It is reassuring to see the authorities' confidence on the successful conclusion of the negotiations on the tax maneuver. Measures to address the rising public debt are also important in the context of the very high share of foreign exchange debt and the high refinancing needs, as well as the risks emanating from the exchange rate and contingent liabilities. We see merit in using broadest possible definition of the budget deficit and linking it with debt sustainability, given the specific features of the Belarusian economy.

The high priority placed by the authorities on continued reforms in SOEs is important to create a level playing field for the private sector and reduce the drain on public finances. The raising of utility prices on households to a full cost recovery level will enable the reduction of fiscal burden on the budget. In this regard, authorities' commitment to address consequences of SOE reforms to safeguard the impact on employment, households and vulnerable is commendable. We would welcome staff comments on the extent of possible social implications due to SOE reforms.

The progress in overhauling the monetary framework towards a more predictable and rules-based approach is encouraging. However, the challenges to this process, including the still weak monetary transmission channels due to government price controls, need to be addressed effectively. The NBRN's efforts to transition to full inflation targeting should also be supported while preserving and deepening its operational independence through strengthening legal framework and reducing the legacy of fiscal dominance. Gradual elimination of outstanding interest rate caps will reduce the distortion in lending and savings decisions. Limiting intervention to dampen excessive volatility is important while using exchange rate flexibility as a first line of defence.

The financial sector needs further strengthening although it seems relatively sound with increased profitability and improved capital adequacy. The growth in credit to private enterprises reflects the potential increase in private sector activities going forward but high NPLs and low provisioning need close attention. The plans to strengthen supervision of systemic risks, including updating the macro-prudential toolkit, is important in identifying risks for appropriate responses. We positively note the progress in implementing the FSAP recommendations gradually and encourage the authorities to implement outstanding recommendations.

We positively note the ongoing efforts aimed at a durable de-dollarization in Belarus to mitigate financial sector risks and enhance effectiveness of monetary policy. It will obviously be a multi-year process and we agree on the measures proposed by staff, which have to be implemented following a publicly communicated national strategy. In this context, the success achieved in Peru, highlighted in Box I of the informative SI paper, is exemplary. Could staff comment on the measures proposed by Belarus in the SI paper in the context of successful countries like Peru?

We applaud the ongoing measures to stimulate private sector activity as reflected by the improved Doing Business Environment. Making property rights more secure and gradually dismantling the limits on competition are important to complement this process. Given the product and market concentration, export diversification will help to better address vulnerabilities to shocks. We would welcome staff's comment on the potential areas for economic diversification in Belarus. The plans to establish a world class IT sector in Belarus are commendable. Could staff highlight the significant features of the digital transformation in Belarus?

With these remarks, we wish the Belarusian authorities all the success in their future endeavours.

Mr. Mouminah and Mr. Alhomaly submitted the following statement:

We thank staff for a set of well-written reports and Mr. Kaya and Mr. Zaborovskiy for their informative buff statement. We welcome the broad agreement between the authorities and staff on the needed economic policies going forward. Against this background, we would confine our comments to the following few points for emphasis.

We take positive note of the continued economic recovery in Belarus, but vulnerabilities arising from public debt and high dollarization, coupled with the challenges associated with the State-Owned Enterprises (SOEs), remain. To this end, we welcome the new government's comprehensive set of economic policies and reforms to address the remaining vulnerabilities.

With regard to the SOE-related issues, we are encouraged to note that the new government is placing high priority towards enhancing the monitoring and financial discipline of SOEs, with the aim of improving their efficiency and reducing their burden on the budget. In this regard, we agree with staff on the need for a comprehensive reform strategy, coupled with robust social safety nets to dampen the impacts of SOEs' restructuring and utility hikes on employment and households. Given the importance of maintaining social stability and setting up the foundation for appropriate implementation, we consider a gradual pace of reforming SOEs to be appropriate. In addition, we welcome the authorities' plan to further improve the business environment, promote trade diversification, and ensure a level playing field between private and state-owned companies, as well as the emphasis placed on maintaining sound governance practices.

We welcome the progress made on the fiscal side and the plan to put the public debt ratio on a downward path. In this respect, we are encouraged by the progress made in simplifying the tax administration and strengthening public financial management and look forward to further progress in enhancing the fiscal framework. On the same note, we take positive note of the plan to issue debt denominated in local currency with a maturity of higher than one year, and consider that efforts should continue in this regard, with the aim of diversifying the financing sources and improving the domestic capital market.

Finally, we commend the authorities for the progress made in implementing FSAP recommendations and encourage them to press ahead with their efforts to further strengthen financial sector stability. In addition, we take positive note of the planned measures to reduce dollarization, including by developing the domestic capital market and enhancing the supervisory framework. Here, as rightly noted by staff, efforts should continue to strengthen confidence in the rubel and ensure effective public communication about the risks of FX borrowing.

With these comments, we wish the authorities all the success.

Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank staff for the reports and Mr. Kaya and Mr. Zaborovskiy for their helpful buff statement.

We are encouraged by the progress made by Belarus over the past years, and especially by the authorities' commitment to undertake the structural transformations that the country needs. Belarus showed a satisfactory growth rate in 2018, while inflation rates stabilized around five percent, half the rate observed in 2016. Still, challenges and risks are significant and especially related to growth and fiscal prospects, which in turn are deeply enrooted with the state of the large SOE sector. The profile of the public debt and more recently and eminently the impact of Russia's Tax Maneuver, are additional sources of risk.

Public debt sustainability risks should be assessed from different perspectives. As noted in the staff report, public debt ratios, somewhat above 50 percent of GDP, do not seem to be relatively high. Nonetheless, debt dynamics indicate that current debt levels present relevant increases compared to those, around 40 percent of GDP, observed between 2012 and 2015. Perhaps the most important risks emanate from Belarus' debt profile: 90 percent of the public debt is denominated in foreign currency making the country highly exposed to exchange rate movements.

We tend to agree with staff that under the circumstances and perspectives posed in the report as the baseline scenario, some additional fiscal adjustment would be needed to reinforce confidence in Belarus' economic policies. Again, a critical point is related to the impact of Russia's Tax Maneuver, and, in this regard, we note the important differences between the authorities and staff on the 2019 deficit. The authorities underline that the "deficit could be significantly lower than projected if a deal providing compensation is in place next year". We agree with staff that "contingency plans would be helpful in the event of less than full compensation". At this point, can staff provide further elaboration on the details of an eventual deal, and its political viability.

One key aspect affecting the fiscal position but also potential growth, is the needed reform of SOEs. The staff report poses an unambiguous analysis of the critical need to address SOEs. We note that the authorities have expressed a firm commitment to address this Achilles heel for the country.

How fast should these reforms be? On one hand, we fully understand the authorities' preference of taking a gradual approach in order to build the necessary consensus on the benefits of reform. Considering the progress made so far, the authorities would deserve the benefit of the doubt. On the other hand, the dynamics of the global economy and, more particularly, of the country itself, for example in terms of debt or regarding the need of boosting potential growth, would lead us to think that structural changes, especially in the SOE sector, require a rapid consideration and implementation.

We welcome the substantial progress made by Belarus in terms of combating inflation, taking into account that inflation reached three digits (109 percent) in 2011, displaying thereafter two digits until 2015. Clearly, low and stable inflation rates, as well as regulations, will contribute to reduce one critical vulnerability Belarus is showing, which is dollarization. Meanwhile, the Selected Issues paper presents an excellent chapter which includes an important number of recommendations.

With these comments, we wish Belarus and its people every success in their future endeavors.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

Staff's well-written paper and Mr. Kaya and Mr. Zaborovskiy's candid buff clearly identify the key challenges facing the Belarusian authorities in preserving macroeconomic stability, increasing economy's resilience, and building the foundations of a dynamic economy. We note with satisfaction the broad agreement between the authorities and staff on policy issues and direction and welcome the commitment of the new government to macroeconomic stability and structural reforms going forward. We also agree with the thrust of the staff appraisal while stressing a few key issues.

Important progress has been achieved since the 2015-16 crisis in reestablishing macroeconomic stability through prudent fiscal and monetary policy and exchange rate flexibility. However, still much remains to be done, and the corrective efforts need to be strengthened further as public debt is still elevated and the economy's vulnerabilities pose significant risks to the outlook. Notably, the timing and the extent of compensation for tax maneuver losses have important macroeconomic implications, as estimated by staff. While we share the authorities' expectations of a positive and speedy outcome to the ongoing negotiations, we urge them to have in place contingency plans in the event of less than full or delayed compensation.

While taking note of the significant tightening of fiscal policy since 2014, we agree with staff that the authorities should take advantage of the ongoing cyclical recovery and reinforce the fiscal space to guard against adverse external developments and ensure that the public debt/GDP ratio is firmly anchored at a lower level. To that end, and as indicated by Mr. Kaya and Mr. Zaborovskiy, we welcome the authorities' intention to use budgetary surpluses to pay down debt and reduce the central government debt to 25 percent of GDP by 2025. In staff view, is such a target consistent with a permanent deficit reduction of 1-2 percent of GDP over the next three years, allowing for the differences in coverage? Imperative to achieving the target is a sustained and significant reduction in quasi-fiscal transfers to SOEs and hard budget constraints as a part of a comprehensive and well-planned SOE reform strategy.

There is broad agreement that tight monetary policy has been instrumental in the rapid disinflation since 2014 and should be maintained, given price pressure that are still percolating in the economy, including the recent wage hike. The measurable improvement in the monetary policy framework since the crisis has also helped to strengthen the transmission mechanism and stabilize inflation, and should be reinforce—including by eliminating interest rate caps—as NBRB moves towards an inflation targeting framework to anchor monetary policy. Also important in this regard are the prudential measures to de-dollarize the economy, keeping in mind that the most important factor encouraging de-dollarization and garnering support in rubel is sustained macroeconomic stability. We found the SIP on de-dollarization quite useful and endorse its main recommendations. We commend the authorities for their flexible exchange rate management and stress that the exchange rate—supported by firm fiscal and monetary policy—should remain the economy's main shock absorber. We share the caution expressed by Mr. Kaya and Mr. Zaborovkiy in drawing firm policy conclusions based on the EBA-lite exercise. We urge the authorities to accelerate the implementation of the remaining recommendations of the 2016 FSAP.

As regards structural reforms, a set of inter-related issues stand out: SOE reform; establishing an enabling environment for private sector investment and growth; increasing productivity; and gradually reducing the state's footprint in the economy. A number of positive initiatives have been taken in these areas, but clearly more needs to be done. Besides hardening budget constraints for SOEs mentioned earlier, we support staff recommendation of adopting a holistic approach and a more ambitious strategy to address the entrenched SOE weaknesses, including measures to strengthen their governance and assess their viability to guide consolidation and restructuring of the sector, drawing on international experiences. We further encourage the authorities to push ahead with their plans to sell minority shares in non-strategic SOEs to private investors, including foreign investors. SOE reform and consolidation create space for the private sector to flourish. The recent government initiatives to decriminalize minor offenses, address property rights, and liberalize prices and remove energy subsidies have all been important steps in the right direction. Such major structural reforms would naturally have negative social and employment implications that need to be addressed through well-targeted income support, unemployment benefits and re-training.

With these remarks, we wish the authorities all the success in their endeavors.

Mr. Saito and Ms. Mori submitted the following statement:

We thank staff for the comprehensive papers and Mr. Kaya and Mr. Zaborovskiy for their informative statement. It is encouraging that macroeconomic policy frameworks have improved, and inflation is at historically low levels and the exchange rate has been broadly stable. However, the economy has many vulnerabilities stemming from rapidly increasing public debt, high dollarization, inefficiencies of state-owned enterprises (SOEs). Against this background, we agree with the staff's policy recommendations that the current cyclical recovery provides an opportunity for comprehensive policies to reduce vulnerabilities and raise potential growth. As we broadly agree with the thrust of the staff appraisal, we will limit our comments to the following points:

Growth Outlook

It is encouraging that growth rate of 2017 and first half of 2018 were stronger than expected, supported by higher oil prices and robust external demand. We also positively note that the new government remain committed to sound policies and outlined an ambitious economic policy package to boost the growth potential and accelerate income convergence with regional peers. Regarding losses of significant oil-related discounts and transfers due to internal tax changes in Russia, we note the significant impact of the negotiations on the outlook as shown in the adverse scenario in Annex VII. In this regard, could staff elaborate more on the rational of assuming full compensation in 2020 and thereafter in their baseline projections? How do staff assess the certainty of successful outcome of the ongoing negotiations on a new agreement?

Fiscal Policy

Rapidly rising public debt with the high share of FX and relatively large external financing needs are source of concern. We concur with staff that reversing the upward trajectory of public debt would increase credibility and reduce financing needs. In this light, fiscal policy should be disciplined. We encourage the authorities to continue their fiscal consolidation effort by reducing transfers to SOEs, gradually rising reduced VAT rate, increasing utility tariffs, and reforming pensions.

Monetary Policy

We welcome that current prudent monetary policy coupled with increasing central bank credibility helps keep inflation at historically low and exchange rate stable. We share the National Bank of the Republic of Belarus (NBRB) and staff's view that the current monetary policy stance is appropriate and should be maintained. On the transition to inflation targeting (IT), we acknowledge the work to strengthen its forecasting capacity, operational framework, and public communications supported by the ongoing Fund TA and the EU project. While the autonomy of NBRB should be respected and strengthened, transition to IT need to be proceeded in close coordination with the relevant ministries given the large share of regulated prices and administrative decision that can have impact on unregulated prices.

De-Dollarization

We appreciate the well written Selected Issues Paper that analyzes the current situation and challenges of Belarus as well as lessons from other countries cases. As staff point out, macroeconomic stability and the development of local currency capital market are key components. We acknowledge that de-dollarization has been gradually bearing fruits due to the authorities' macroeconomic and macroprudential policies. We encourage the authorities to take further measures including prudential policies, supervisory measures and improved communications as stated in their buff statement. In this relation, as we agree with staff that a public de-dollarization strategy to anchor expectations and signal commitment is a very important communication device, we would like to ask staff whether the Belarus authorities are planning to make such a de-dollarization national strategy.

Structural Reforms

Addressing inefficiencies in the SOE sector and developing private sector are needed to increase potential growth and diversify economy. Considering the high share of SOE in the economy which have led to macro-financial vulnerabilities, SOE reforms should be accelerated while bolstering targeted social safety nets to buffer the transitional impact on employment and household. We agree with the reform agenda described in the staff report including systematic risk-based assessment of SOEs' viability, strengthening the corporate governance of SOEs, social safety nets and developing distressed assets market. We also share the staff's concern that the devolution of non-systemic SOEs to sub-national governments risks transferring oversight of these SOEs to authorities who have skewed incentives to preserve employment at all costs. In this connection, we see the triage of SOEs is an important initial step to identify the main risks and develop an actionable plan, and therefore would like to know the progress of it. On the private sector reform, we welcome the authorities' recent effort to expand the private sector including less demanding certification requirements and plans to decriminalize minor offenses and encourage further effort to level playing field between private and state-owned companies.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for the well-written papers and Mr. Kaya and Mr. Zaborovskiy for their informative buff statement. While we broadly agree with staff's assessment and advice, we will add a few additional comments.

The recovery of the Belarusian economy is encouraging. In 2018 GDP growth is expected to have reached 3.7 percent, supported by robust external and domestic demand. Moreover, unlike in the previous episodes of economic expansion, this time the recovery is not accompanied by the accumulation of imbalances. Sound macroeconomic policies have been supportive for macroeconomic stability. Notwithstanding high growth and low unemployment, inflation has declined to historically low levels, the exchange rate remains relatively stable and, over two years, international reserves have increased by more than 30 percent. We also note continued progress in structural reforms, which are gradually improving the economy's efficiency and resilience.

Going forward, Belarus is facing considerable challenges and risks. Among the most prominent ones is a gradual decline in implicit energy subsidies from Russia with yet uncertain prospects for compensation for ensuing BOP and fiscal losses. Tightening of global financial conditions may also negatively affect external financing. These developments may have a substantial macroeconomic impact, including exchange rate depreciation, increase of debt burden, and lower growth rates. In order to increase the resilience of the economy, the authorities should strengthen policy buffers and accelerate structural reforms to increase efficiency of SOEs and further improve conditions for private sector development.

The authorities are well-advised to continue tight fiscal policy. Belarus was able to achieve a primary surplus of 3.6-4.9 percent of GDP in 2016-18 (excluding the Nuclear Power Plant (NPP) and off-balance sheet transfers to SOEs). The risk of a partial reduction in the energy subsidies and relatively high public debt require continued fiscal prudence. The authorities should advance SOEs reforms to reduce the need for off-budget support. Measures to broaden the tax base and to reduce tax exemptions could also be considered, as well as a further reduction of utility subsidies. We also note staff recommendations to develop domestic currency debt market to diversify sources of financing. However, in view of mostly positive fiscal balances (excluding NPP), there may not be enough supply of new debt to develop a liquid debt market. Could staff comment on this issue?

The tax reform in the Russian energy sector – "the tax maneuver" – may reduce profitability of Belarusian refining and export operations, as well as budget revenues. Taking into account the macro-critical size of the implicit energy subsidies, both countries are looking for ways to find a mutually acceptable solution. Several governmental working groups have been established and negotiations are ongoing. The tax maneuver is being implemented gradually, starting in 2015 and scheduled for completion by 2024, providing time for adjustment.

Acceleration of structural reforms is critical for preparedness to new challenges. We welcome the recent efforts to create a better condition for private sector expansion, including the Decree on Entrepreneurship and the announced plans to ease administrative pressure on businesses. The comprehensive reforms of SOEs should not only increase their efficiency, but also create a more level-playing field with private enterprises. The authorities' preference for a gradual and incremental approach to reforming inefficient SOEs may not be commensurate to the changing environment, and a more resolute approach may be required. At the same time, the SOEs restructuring process should be carefully managed and social safety nets should be strengthened. Well-designed active labor market policies are also essential in mitigating the adverse effects of SOEs reforms.

We welcome the measures to strengthen the resilience of the financial system. The Belarusian banking sector is adequately capitalized and profitable, and credit growth has been picking up. Over the last years, there has been significant progress in improving the regulatory framework, including implementation of the 2016 FSAP recommendations. We take note of the establishment of the Financial Stability Council, which should improve coordination of financial sector policies between the government and the central bank. It is also encouraging that the authorities envisage further steps to strengthen supervision of systemic risks, including a program to upgrade the macro-prudential toolkit.

We agree with staff that high dollarization remains a key vulnerability for the Belarusian economy and the efforts to reduce it should be stepped up. De-dollarization is a multi-year process, underpinned by sound macroeconomic policies, financial and price stability, which create confidence in the national currency. Building on the progress achieved in macro-stabilization, the authorities should advance the de-dollarization process on the basis of a comprehensive strategy, which may include prudential measures, the development of domestic currency capital market, and an educational campaign on the risks of high dollarization.

We have some doubts that staff's approach to the risks of high export concentration is fully even-handed. Staff have repeatedly alerted that low export diversification in Belarus represents a key vulnerability and needs to be addressed. Indeed, about 46 percent of its exports is directed to the EEU members, primarily to Russia and Kazakhstan[1]. At the same time, for most CEE countries, such export concentration is a norm, as about 45-55 percent of their exports depend on the euro area market. Even higher export concentration is observed in Mexico and Canada, with more than 75 percent of their exports going to the U.S. We, however, do not recall any advice to reduce these countries' dependence on the U.S. or euro area markets. Could staff comment on why Belarus is singled out and what factors justify special attention to export concentration vulnerability in the case of Belarus?

Mr. Sun and Ms. Cai submitted the following statement:

We thank staff for the well-written report and Messrs. Kaya and Zaborovskiy for their helpful buff statement. We commend the authorities'

[1] World Bank data – WITS database.

efforts to push forward reforms, including advancing growth-enhancing structural policies. We broadly agree with the thrust of the staff's appraisal and would limit our comments to the following.

Continued fiscal consolidation is critical to preserving debt sustainability. Public debt has risen fast over the last 10 years and the high share of FX debt in total public debt is a concern. We take positive note that fiscal policy continued to be prudent in 2018 and the authorities have used the accumulated fiscal space for early redemption of the public debt. We encourage the authorities to seize the window of opportunity of the ongoing recovery to make additional fiscal adjustments while maintaining growth-enhancing capital spending. We share the authorities' concern on the DSA and would welcome staff's comments on the sizable contribution of the residual to the changes in the public debt dynamics. More could be done to increase the efficiency of tax administration and strengthen the fiscal framework for better revenue mobilization. We welcome the implementation of the public financial management (PFM) Modernization Project supported by the World Bank, and look forward to the Public Expenditure Review by the Ministry of Finance.

Prudent monetary policy stance is appropriate for reining in inflation pressures. We encourage the authorities to closely monitor the development of inflation and stand ready to calibrate the policy stance when inflation pressure arises. While that the monetary policy framework has been strengthened and the transition to a full-fledged inflation targeting framework is on track, more efforts are warranted to enhance monetary policy communication to better anchor inflation expectation. The progress in implementing the FSAP recommendations is encouraging, but the high level of dollarization remains a concern. We therefore encourage the authorities to step up efforts to develop local capital market to promote the local currency.

Advancing structural reforms is necessary to unleash growth potential. More efforts are needed to address inefficiencies in the SOE sector, including strengthening the governance of SOEs. The entry of strategic investors would help accelerate the SOE reform. We take note of staff's concerns regarding possible risks related to the devolution of some SOEs to sub-national governments as well as the authorities' intention to facilitates small-scale privatization. More caution is warranted should this policy be advanced.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Trabinski and Mr. Danenov submitted the following statement:

We thank staff for a valuable set of papers, and Messrs. Kaya and Zaborovskiy for their insightful buff statement. We welcome the completion of the 2018 Article IV Consultation with Belarus. The cyclical economic recovery was supported by the authorities' stronger macro-economic framework, reflected by low inflation and increased exchange rate stability. The current environment is opportune for addressing existing vulnerabilities, such as rapidly rising public debt, high dollarization, as well as limited trade and financial diversification. We concur with the staff that reforms of the large state-owned enterprise sector are critical to tackle inefficiencies and increase potential growth. In our view, a particularly concerning source of risks is related to internal tax changes in Russia and their adverse impact on Belarus export margins on refined oil products.

We encourage the authorities to further improve the fiscal position. We commend the Belarussian authorities for a considerable fiscal consolidation over last years, as indicated by Mr. Kaya and Mr. Zaborovskiy in their buff. Nevertheless, the 2019 budget deficit is projected to widen significantly, and public debt is continuing its upward trajectory. Bearing this in mind, additional fiscal adjustment appears to be desirable to reduce public debt to more sustainable levels. Additionally, the large FX share makes debt very susceptible to any depreciation and creates a dependence on external financing. Against this backdrop, expanding rubel financing, e.g. through issuance of rubel-denominated bonds, would reduce the adverse impact of exchange rate developments.

We welcome the authorities' adoption of a revised monetary framework in early 2015. The inflation rate has been stabilized at low levels of around 5 percent and the exchange rate has shown greater stability as well. We concur with the staff that the gradual transition towards inflation targeting should continue, including removing remaining market distortions such as interest rate caps, and strengthening central bank independence, e.g. through legal changes in line with FSAP recommendations. Widespread government price controls significantly weaken monetary transmission channels. Therefore, in order to improve the effectiveness of monetary policy, prices should be liberalized more broadly. We also concur with the staff that the central bank should preserve the flexibility of the exchange rate as a shock absorber, within the limits imposed by the high dollarization of the economy.

Further improvements in the financial sector regulatory framework should continue. We welcome the authorities' commitment in implementing

FSAP recommendations and improving financial sector regulatory framework. At the same time, we underscore that the high level of dollarization remains a major systemic vulnerability. Although decreasing, dollarization remains higher than a decade ago and is above the estimated optimal level for the country. Moreover, it is also one of the highest among countries in the region. We thus welcome the authorities' initiatives to reduce dollarization, particularly through prudent fiscal policy and the introduction of a more rules-based monetary policy framework. We also welcome the introduction of differentiated reserve requirements. We share staff's opinion that the authorities should continue to pursue sound macro-policies to further strengthen confidence in the rubel. In addition, developing a domestic capital market is important to promote the local currency. However, in our view, the lack of an official strategy to pursue de-dollarization could significantly curtail this process.

Deeper reforms are needed in the SOE sector. Increasing inefficiencies in the state-owned sector pose a significant barrier to growth and remain the source of major risks to the economy. In order to address this challenge, we encourage the authorities to design and implement well-thought through privatization strategy. We take note of the authorities' initiative to provide the possibility of devolution of non-strategic SOEs to regional and municipal levels. In this regard, we would be very keen to learn about the first outcomes of that initiative. Staff's comments would be welcome.

Mr. Villar and Mr. Rojas Ramirez submitted the following statement:

We welcome the discussion on Republic of Belarus 2018 Art. IV Consultation and thank staff for its report and Mr. Kaya and Mr. Zaborovskiy for their comprehensive buff statement.

It is encouraging to see that the authorities remain committed to improving the fiscal framework for better planning, management and execution of fiscal policy. We see advances in transparency resulting from the reclassification of injections into statutory capital of SOE as budget expenditures and we welcome TA for strengthening instruments for revenue analysis and forecasting. We also note that Belarus is negotiating new energy agreements with its economic partners. However, despite a sound budgetary administration, primary surplus and robust revenues, the report establishes that rapidly increasing expenditures may broaden the budget deficit in 2019. Could staff elaborate on the causes for this rapid increase?

The upward trajectory of public debt and SOEs financing dynamics may jeopardize fiscal sustainability and economic stability. With this backdrop, we concur with staff on the need for actions to mitigate vulnerabilities thru fiscal adjustment and further measures for reversing debt trend. Regarding SOEs, the authorities are working on reducing quasi fiscal transfers and better monitoring risks by stablishing data reporting and financial situation tracking mechanisms. We also notice that the authorities are committed to achieving reforms aiming at efficiency of SOEs in the medium term.

The financial system indicators are in good standing. Bank profitability has improved over the last two years. Authorities are committed to improving the regulatory framework. We welcome the implementation of Basel II liquidity rules and net funding ratios as well as significant progress in FSAP recommendations. The NPL indicators are performing well. Could staff elaborate on the NPL new regulation guide for asset classification?

We welcome actions oriented at de-dollarization of the economy. Exchange rate stability, low inflation and implementation of prudential measures have contributed to dollarization reduction. We encourage authorities and EBRD on developing and deepening local capital markets and working on the construction of a benchmark yield curve for longer maturities.

Belarusian most needed structural reforms concern with promoting a more efficient and market-oriented economy. Authorities agree with staff on this view but within a gradual implementation. Structural reform policies aim at promoting SOEs efficiency, strengthening corporate governance, and encouraging social safety nets and assets market. Authorities are also aware of the importance of structural reforms oriented at macroeconomic stability such as developing a market-oriented price system through gradual liberalization of the energy sector and utility prices, preserving the flexibility of exchange rate and an adequate fiscal discipline framework.

We commend the authorities for their efforts and wish them the best in their future endeavors.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their document and Messrs. Kaya and Zaborovskiy for their insightful buff statement. We welcome the current recovery Belarus is experiencing and commend the authorities for recent reforms. However, we agree with staff that given the current uncertainties related to the external environment, tackling long-standing vulnerabilities would help create buffers in case potential shocks would materialize. Structural reforms appear also warranted to ensure stronger and more inclusive growth and so create the conditions for income convergence with European peers going forward.

On the fiscal front, progress has been made since last year to improve the policy framework. We are pleased to see that the Fund-provided technical assistance was instrumental in reducing divergence regarding the assessment of the situations of public finances. Could staff elaborate on the persisting gap between the authorities' approach and international standards such as the Government Finance Statistical Manual? Going forward, we fully support staff's recommendation to adopt a prudent strategy, notably by reducing SOE subsidies and eliminating tax expenditures, as well as to prepare a contingency plan should the Russian financial support be downsized more than expected in coming years.

Regarding the reforms of SOEs and the business climate, we welcome the willingness of the authorities to modernize Belarus economic model. However, we remain concerned by the slow pace of implemented reforms so far. Given Belarus high economic potential, notably the quality of its human capital, the absence of convergence of the income per capita level towards Belarus' European peers raises question. Stepping up reforms to make SOE more efficient and increasing the level playing field for private actors could trigger a much higher growth rate. While we understand the argument made by the authorities about the social function of SOEs, we think that their effort should now focus on developing a social safety net which would provide insurance to workers impacted by future restructuration processes. Could staff elaborate on the discussions hold so far with the authorities regarding the creation of social safety nets?

On monetary and financial policies, the inflation rate remains stable. While the monetary framework has improved, price liberalization will also help to set the condition for the transition to an inflation targeting regime. The strengthening of the financial regulation and supervision framework is commendable. However, further efforts should be undertaken to implement the recommendations of the latest FSAP, notably concerning the de-dollarization of the economy. In this regard, we encourage the authorities to undertake the reforms highlighted in the Selected Issue Paper, especially increasing public debt issuance in domestic currency.

Mr. Rashkovan and Mr. Josic submitted the following statement:

We thank staff for their informative set of papers and Messrs. Kaya and Zaborovskiy for their helpful buff statement. The Belarussian economy has strongly recovered from the recession of 2015 and 2016 during the last two years, on the back of a supportive global environment and a decisive domestic macroeconomic policy mix. Many of the vulnerabilities remain, but the authority's strong commitment to the reform program is reassuring that staff's policy recommendations will be implemented. We broadly share the staff's appraisal and would like to offer the following comments for emphasis.

A good cyclical position should be used to further stabilize the public finance. The level of public debt is still below 60 percent and the authorities have made significant fiscal consolidation efforts, as emphasized by Messrs. Kaya and Zaborovskiy's in their buff statement. However, off-balance sheet operations are still high and are projected to increase in 2019 and bring the overall balance to close to -4.0 percent of GDP. Considering that the public debt is highly sensitive to the real exchange rate and GDP growth shock, we find it important to adhere to the fiscal rule and further curb the current expenditures and salaries, as well quasi-fiscal loses. We note that the data for the general government primary balance as well as overall balance including off-balance sheet operations are significantly different when compared to last year's report. Could staff explain where this difference comes from?

The large and relatively inefficient system of SOEs is not only putting pressures on public finance but is also significantly constraining economic growth. While we note the social implications of large SOEs, poor SOE performance at the same time raises three main risks: large and risky contingent liabilities could stretch public finances; sizeable state ownership of banks coupled with poor governance could threaten financial stability; and negative productivity spillovers could affect the economy at large (IMF, 2017). With this in mind, we find it extremely important that the new Government has recognized the importance of the problem and has put the restructuring and commercialization of the SOE sector high on their priority list. However, we continue to share staff's concern about the moral hazard related to SOE FX borrowing, as well as the optimality of dealing with non-strategic SOEs by transferring them to local governments.

On the external sector assessment, we note a disagreement between staff and the authorities' assessment. We would be cautious about focusing on the point estimate in cases like this, and would suggest using the range of estimates, which would then correctly and transparently emphasize the uncertainty around the estimate, in particular in cases where one is not certain where the large residuals come from.

The authorities should step up their efforts to reduce the high level of NPLs. We note from the report and Messrs. Kaya and Zaborovskiy's buff statement that the credit growth, including to the private sector has revived. However, the ratio of NPLs to total loans has remained unchanged at the level of close to 14 percent since 2016, which is high by international standards. In case of a new economic slowdown, such high levels of NPLs could potentially materialize in larger crises and deepen the eventual recession. Therefore, the authorities should step up their effort and adhere to the 2016 FSAP recommendations and delegate NPL resolution to a single entity with powers for restructuring.

Despite their high ranking in the Doing Business Report, Belarus' economy remains relatively undiversified. While we note a slight divergence between the staff and the authorities' projections for the potential output, we fully support staff that deeper structural adjustments are required to boost the potential growth. This should primarily focus on continued market and price liberalization, export diversification, as well as decrease of the overall influence of the state of the economy. In addition, salary adjustment, which is at double digits by some estimates and significantly above productivity, should be linked to productivity growth so it does not compromise the external competitiveness of the domestic sector.

With these remarks, we wish the authorities the best in their future endeavors.

The Acting Chair (Mr. Furusawa) noted that the Belarusian economy had continued its favorable economic development, characterized by broad-based growth and subdued inflation. Directors had noted that the authorities should use the favorable cyclical recovery to entrench macroeconomic stability and to address the longstanding vulnerabilities by implementing comprehensive macroeconomic policies and structural reforms.

Mr. Trabinski made the following statement:

We thank the staff for a comprehensive set of reports and Mr. Kaya and Mr. Zaborovskiy for their candid buff statement. We take positive note of the Belarusian economic recovery. We commend the authorities for improving their macroeconomic policy framework, and we encourage them to address remaining shortcomings. We issued a gray statement and would like to offer three points for emphasis and further elaboration.

First, we believe that fiscal consolidation is necessary for addressing existing debt vulnerabilities, and therefore we encourage the authorities to further improve their fiscal position. In this regard, we share the staff's advice to gradually reduce transfers to state-owned enterprises (SOEs) and raise reduced value-added tax (VAT) rate.

Second, we support efforts aimed at privatizing the SOEs, as this would strengthen the environment for private sector investment, increase productivity, and reduce the state's footprint in the economy. We would like to reiterate that any such privatization should be guided by a well thought-through and timely strategy and should be supported by a well-established and implemented corporate governance framework.

In this regard, could the staff provide more details on whether the authorities' efforts to transfer non-systemic SOEs to subnational governments are embedded in a greater privatization strategy and on what the authorities' plans for the expanding private sector are?

Finally, we broadly agree with the staff that the tax reform in the Russian energy sector may reduce the profitability of Belarusian refining and export operations as well, as budget revenues. We are encouraged by the authorities' optimism regarding the outcomes of the negotiations, yet we noted a more reserved stance among Directors, including Mr. Mozhin's and Mr. Tolstikov's gray statement. Could the staff provide us with an update on the current state of negotiations and elaborate on the details of this deal?

With this, we wish the Belarusian authorities all the best in their future endeavors.

Mr. Merk made the following statement:

We take positive note of the ongoing cyclical recovery and enhanced macroeconomic policy frameworks in the Republic of Belarus. Amidst these favorable circumstances, we encourage the authorities to press ahead with comprehensive economic reforms to address longstanding vulnerabilities to the economy, including rising public debt, high dollarization, and limited economic diversification.

Regarding fiscal policy, risk to public debt sustainability remain elevated, not least due to the high share of foreign-currency denominated debt. The authorities should put public debt on a firm downward path while staying vigilant regarding a deterioration in the fiscal position due to risks such as higher quasi-fiscal transfers to weak SOEs and decreasing oil-related discounts and transfers.

On structural policies, a more ambitious and comprehensive SOE reform strategy remains key to reduce macrofinancial vulnerabilities and raise potential growth.

Mr. Rashkovan made the following statement:

As we emphasized in our gray statement, it is important to start by commending the authorities for the initial fiscal consolidation measures in the last year as well as for their efforts in achieving cost recovery in most of their utilities, and we are looking for further actions. Therefore, the strong commitment to their reform program reassures us that the staff's policy recommendations will be implemented.

I will focus on three more specific points: the issue of de-dollarization, the role of SOEs in transforming the economy, and fintech developments in Belarus.

First, on the issue of de-dollarization, the staff rightly points to the risk of high dollarization, particularly on financial stability and debt sustainability. However, we find the selected issues paper related to this issue too simplistic, maybe even weak. Dollarization is a joint characteristic of many eastern European countries, and the roots can be found usually in previous periods of high inflation or even hyperinflation when the fear of inflation is deeply entrenched in people's minds. Thus, changing such a system is a complex task, and we agree with the staff that elements of the solution are sound macroeconomic policies and development of a local capital market. However, analyzing supply and demand factors that could influence such process would be an important element as well. In addition, the selected issues paper could also have benefited from a stocktaking exercise from some of the central and eastern European countries, in addition to the case of Peru, because these countries had a similar economic model and behavior as in Belarus. We are speaking especially about the CAS countries. Such experience is important because some of them remained largely dollarized, even almost 30 years after periods of high inflation and despite sound macroeconomic policies and developed local capital markets .

Second, on the role of SOEs, and like Mr. Merk, Mr. Virolainen, Mr. Gokarn, Mr. Saito, and many others, we remain concerned about the speed of the transformation of state-dominated economy. Economic theory and empirical research have well documented the contribution of SOEs to the inefficiencies and productivity losses in the economy. Both the staff and the authorities recognize the problem, although the authorities would prefer a more gradual solution.

I think everyone in this room agrees that the solution to the problem should take into account the social component. However, the short-term focus on social elements only intensifies the productivity losses in the long-term and even prolongs the length of the eventual recession period, as we witnessed in some eastern European countries. In the case of Belarus, this largely contributes to a slowdown of potential growth to 2 percent, which ultimately constrains the income convergence process with the rest of Europe.

With this in mind, let me stress two important caveats. One, we are not advocating for quick privatization; and two, un-reformed or partially reformed SOEs could bring higher social costs in the long term.

Finally, on fintech, at the end of the 2017, the Belarusian authorities adopted a new law, so-called Decree No. 8, “On the Development of the Digital Economy,” with the aim to bring foreign high-tech businesses to the country. This document also legalized activities related to digital assets, such initial coin offerings (ICOs) and crypto mining, but we have not read anything about these developments in the last two Article IV reports. Considering that the Board has recently adopted the Bali Fintech Agenda, which among other issues mentions more frequent coverage of fintech issues in surveillance, does the staff see fintech developments in Belarus as a potential source of risks?

The staff representative from the European Department (Mr. Miniane), in response to questions and comments from Executive Directors, made the following statement:[2]

> There were many questions, including on the outcome of the negotiations on tax maneuver losses, and let me say that the staff have not been privy to these negotiations, and as a result, we cannot offer an assessment of the odds of one outcome or another and what is feasible or likely. Because of this, we have always relied on the authorities' assessment of the relative likelihood of various outcomes, and in the report we have been clear that this assessment is the authorities' and not ours, including in the Risk Assessment Matrix. What we could do and have done is assess the impact of various outcomes, such as full compensation versus no compensation. But on the likelihood of each scenario, we have had to rely on the authorities and have been transparent about that.
>
> There were questions on whether the assumption of full compensation in the baseline was the right assumption. Because we do not have an independent view of the relative likelihood of the various scenarios, we have used as the baseline what the authorities view as the most likely scenario, while performing our own independent assessment of possible developments under each scenario. But because the authorities do have in their baseline full compensation starting in 2020, we have taken the same assumption. But it is key that we all understand that the staff cannot provide an independent assessment of the likelihood of various possible outcomes. The outcomes themselves vary by the day. This is a dynamic, moving negotiation.
>
> There were several questions on whether the staff has an update on the assessment on the new NPL regulation. This is very preliminary because the expert assessment was concluded yesterday. It has not yet been reviewed by the Monetary and Capital Markets Department (MCM). It has not yet been transmitted to the authorities. The authorities have not had a chance to comment; but with all these caveats, the assessment is that the new regulation, on the positive side, is an improvement over the old regulation in various aspects in regards to alignment with best international practice. Nevertheless, there are two areas where there is a significant gap between the new regulation and best international practice. To be concrete, we believe that if NPLs were assessed under best practice regulation, they would fall somewhere between where they are now under the new regulation and where they were before under the old regulation. Maybe the true ratio is not

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

4 percent as it is now; it is not 12 percent as it was before with the old regulation; it is somewhere in between.

There were some questions on fiscal adjustment and the differences between the staff and the authorities. Without wanting to put words in the authorities' mouths, the authorities' position is that fiscal policy is already sufficiently tight because when one looks at the medium-term primary balance, in the baseline, it is already above the debt-stabilizing level, assuming no change in the exchange rate. That is true, but the reality is that the gap between the primary balance and the debt-stabilizing level is not enough to compensate for even the modest depreciation assumed in the staff's baseline. We have sympathy for the authorities' views that fiscal policy should not be guided or anchored by a somewhat exogenous variable like the exchange rate, but the reality remains that as long as the currency composition of debt remains what it is, if further efforts are not made, the debt trajectory will continue to increase, if only because of modest exchange rate depreciations, let alone larger depreciations.

There were some questions on SOE reform and the social safety net, which is related to that. As far as we know, there are no concrete plans to triage SOEs into those that are viable, those that are viable with restructuring, and those that are unviable. That is a key step. We do not believe that is in the cards. It is the same regarding the social safety net. As far as we can tell, there has not been much progress, and it is fair to say that this is an area where the difference of views between the staff and the authorities remains.

In the social contract of Belarus, which is a legitimate social contract, full employment figures prominently, and the economy has by and large delivered on full employment, and so in such a social contract, something like unemployment insurance does not mesh well.

There was a question on the devolution of SOEs to sub-national authorities. Thankfully this has stopped, whether because of advice from Fund staff and the Board or not, but the reality is that a significant number of SOEs have been devolved which are non-systemic. There has been some minor privatization resulting from that, but whether the moral hazard of the devolution has made things worse, the truth is that it is too early to tell. We do not have the data to assess whether this devolution is the problem that we believe it could be.

There were some questions on the priorities for private-sector development and leveling the playing field. To be concrete, there has to be a better playing field between state- and private-owned enterprises in the area of private procurement. There has to be less bias in the courts when it comes to SOEs versus privately owned enterprises; but the good news is that Prime Minister Rumas and his government are committed to addressing these things, and there has been explicit statements that they plan to tackle the abusive inspections that are used to deter private activity. They plan to tackle the criminalization of minor offenses which are used to dissuade private activity, so all of this is very good.

There was a question on economic diversification and what the new growth sectors could be. The staff do not pretend to know what the comparative advantage is or should be, but what we advocate is a system transparent enough and flexible enough where market and entrepreneurial ingenuity can flourish and where the factors of production such as capital and labor can go into these new opportunities.

There was a question on fintech, and that is a point well taken. I do not believe I could answer this question because these are complex questions that require specialized expertise, and the reality is we have not looked into any possible risks from fintech; so this is something that we could tackle in the next consultation.

The staff representative from the Strategy, Policy, and Review Department (Ms. Murgasova) noted that the staff's recommendation that Belarus diversify its regional concentration of exports was in line with recommendations in other countries, including the 2018 Canada staff report, the 2017 Mexico staff report, and 2015 Spain selected issues paper.

Mr. Kaya made the following concluding statement:

We thank the staff for the informative papers and Directors for their constructive statements and comments, which we will duly convey to the Belarusian authorities. While the authorities are new to engagement with the Fund and its role as a trusted advisor, there is broad agreement between staff and the authorities.

I would like to make a few points to highlight the recent policy decisions, which will increase the resilience of the Belarusian economy and continue its transformation in a socially responsible manner.

First, the 2019 budget, based on prudent and conservative assumptions, has been approved by the parliament in December 2018. It targets a solid primary surplus. In addition, on general terms this year, the special presidential decree to further reduce budget subsidies and off-balance sheet operations has been signed. It significantly tightens the budget constraints for state-SOEs and cements the new government strategy of gradual growth-friendly fiscal consolidation complemented by the restructuring of the state-owned sector.

The authorities are committed to stay the course of prudent fiscal policy. They agree with the staff and Directors on the need to reverse the upward debt trajectory and announced a medium-term debt anchor which is consistent with the staff's recommendations.

Directors have noted some divergence between the authorities' and the staff's assessment of the fiscal policy stance. Like last year, the authorities are convinced that the actual fiscal outturn will be the most compelling evidence of their consolidation efforts.

Second, on the monetary front, the central bank recently decided to maintain the tight monetary policy stance, which is in line with the staff's advice. The exchange rate flexibility remains the main shock absorber, and the liberalization of the foreign exchange market is further advancing.

In December 2018, the new central bank's communication strategy has been approved to support the transition to a full-fledged inflation-targeting regime. Many Directors noted that all preconditions should be in place to complete this transition, and the authorities agree with this point. They intend to proceed with their de-dollarization efforts, strengthen the macroprudential toolkit, and move steadfastly in implementing the remaining Financial Sector Assessment Program (FSAP) recommendations. They agree with the staff's advice outlined in the selected issues paper. The new package of decisions supporting their de-dollarization strategy has been announced in December and enters into force in the second quarter of 2019. This approach will be supported by enhanced communications.

Third, regarding structural reforms, the new government prioritizes structuring and commercialization of the state-owned sector. The three-pronged approach of reducing subsidies, expanding social safety nets, and promoting private business is at the core of the authorities' strategy.

To advance their policies, two days ago the prime minister signed an order to create a high-level working group for developing the roadmap of structural reforms in cooperation with the World Bank. This work is supported by EU-funded project and reinforces the reform momentum.

In conclusion, I have a few words about the authorities' response to the so-called tax maneuver. It can be described by an old Belarusian proverb which approximately translates into, "Hope for the best, but prepare for the worst." The authorities believe that the ongoing dialogue with the Russian government on this issue will be fruitful.

Like in 2018, they also intend to maintain a balanced budget net of cyclical revenues. The economic policy mix in Belarus continues to be calibrated appropriately and remains the first line of defense against adverse shocks and unfavorable external developments.

I also would like to stress that the Belarusian authorities are keen on continuing the intensive policy dialogue with Fund management and staff. They thank the excellent team and especially the mission chief, Mr. Miniane, for their efforts.

The Acting Chair (Mr. Furusawa) noted that the Republic of Belarus is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Belarus's continued economic recovery, supported by improved policy frameworks. However, Directors noted that rapidly rising public debt, high dollarization, and the uncertainty about negative spillovers from Russia's new energy taxation system pose risks. They encouraged the authorities to use the current cyclical recovery to implement comprehensive macroeconomic policies and ambitious reforms, including the reform of state-owned enterprises, to strengthen economic resilience and increase potential growth.

Directors noted that, while the authorities have undertaken several fiscal adjustment measures, more needs to be done to stem the rapidly rising public debt. They encouraged the authorities to undertake additional consolidation, spread over the next three years, to achieve a credible medium-term debt target, which strikes an appropriate balance between development needs and fiscal sustainability. Directors also encouraged the authorities to monitor fiscal risks from state-owned enterprises and to gradually switch funding toward rubel-denominated debt, in order to make debt less susceptible to exchange rate movements.

Directors agreed on the importance of continued central bank independence. They supported the authorities' current monetary policy stance, which is consistent with the inflation target goal. Looking ahead, Directors welcomed continued progress towards inflation targeting. In this context, they commended the authorities for the liberalization of the FX market and for reductions in directed lending. It will be equally important to eliminate interest rate caps.

Directors encouraged the authorities to continue to strengthen financial sector stability. They welcomed the progress made in implementing the FSAP recommendations and encouraged implementation of the remaining ones. Directors emphasized the need to further reduce the high dollarization to continue building confidence in the rubel. They also stressed that developing local capital markets will be a key component of successful de-dollarization.

Directors emphasized that advancing structural reforms is key to reducing macroeconomic vulnerabilities and raising growth potential. They called for a comprehensive reform of state-owned enterprises via a systematic, risk-based assessment of SOEs' viability, followed by an actionable plan to guide restructuring. In addition, Directors underscored the need for enhanced social safety nets, to cushion the impact of restructuring on vulnerable groups. Separately, facilitating private sector activity by improving the business climate and leveling the playing field will also be important.

It is expected that the next Article IV consultation with the Republic of Belarus will be held on the standard 12-month cycle.

APPROVAL: April 14, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Fiscal Policy

1. What are, in staff's view, the possible funding sources for expanding unemployment benefits, as the cuts in the transfers are expected to be saved for debt reduction?

- The fiscal consolidation recommended by staff can generate resources for the expansion of social safety nets, including unemployment benefits. Specifically, cutting tax expenditures (estimated at some 4 percent of GDP) can provide necessary sources of financing.

- An expansion of social safety nets should also go hand in hand with SOEs restructuring. Overtime, less fiscal support to SOEs can free up resources which then can be directed towards well-targeted social safety nets.

2. We welcome the authorities' intention to use budgetary surpluses to pay down debt and reduce the central government debt to 25 percent of GDP by 2025. In staff view, is such a target consistent with a permanent deficit reduction of 1-2 percent of GDP over the next three years, allowing for the differences in coverage?

- In staff view, the authorities' target of 25 percent of GDP of central government debt by 2025 could be achievable with a permanent consolidation of about 2 percent of GDP (not 1–2 percent). There are however two caveats: (i) this narrowly defined debt does not include local government debt, government guarantees or debt resulting in what staff defines as off-balance sheet items; (ii) the exchange rate remains broadly stable, otherwise any material depreciation would put the target beyond reach.

3. Regarding external financing, while excessive relying to Eurobonds can expose Belarus to a large exchange rate shock and counteract the de-dollarization strategy, on the other side it can enhance the diversification of funding sources by relying more on western financial markets. Staff's opinion on how to better strike this delicate balance is welcome.

- Traditionally, Belarus has not relied substantially on Eurobonds as a source of external financing. As of 2017, Eurobonds accounted for some 10 percent of total central government debt. Therefore, switching towards Eurobonds issuance in global markets and away from bilateral loans may help diversify the *geographic* sources of financing.

- However, the large exposure to exchange rate depreciation in the case of Belarus stems primarily from the *currency* concentration, namely the very high share of foreign currency denominated domestic debt. Therefore, as a de-dollarization measure staff has been advising a gradual switch of domestic financing from foreign currency to domestic currency denominated instruments.

4. In view of mostly positive fiscal balances (excluding NPP), there may not be enough supply of new debt to develop a liquid debt market. Could staff comment on this issue?

- Staff acknowledge that, excluding the NPP which is already financed, the projected primary surpluses would limit the flow of new debt. It is also true that much of the rollover of FX debt is likely to take place in FX as well. However, it is not excluded that some debt in FX could be refinanced with local currency debt, depending on costs and the authorities' objectives. As stated in the Staff Report, staff encourages the authorities to seize *any opportunity* to expand medium and long-term rubel financing to reduce the impact of exchange rate developments on debt.

5. We share the authorities' concern on the DSA and would welcome staff's comments on the sizable contribution of the residual to the changes in the public debt dynamics.

- It is true that the residual is significant in the DSA projection. However, this residual includes any exchange rate depreciation. The fact that the residual is large shows that even the modest depreciation assumed by staff has a significant effect on increasing debt. And this is consistent with historical experience: exchange rate depreciations *have been* large contributors to rising debt. Put differently, the fact that the residual is large is not reason enough to downplay the DSA, on the contrary it should be seen as evidence of the large sensitivity of public debt in Belarus to the exchange rate.

6. Despite a sound budgetary administration, primary surplus and robust revenues, the report establishes that rapidly increasing expenditures may broaden the budget deficit in 2019. Could staff elaborate on the causes for this rapid increase?

- Both in 2018 and 2019, significant increases in the public sector wage bill in response to ambitious nominal wage targets have a bearing on the deficit, as does the ramp up in spending on the nuclear power plan (1.1 percent of GDP in 2017, 2.7 projected in 2018, 3.2 projected in 2019). In 2019, the deficit is further increased because of lower revenues, not least driven by the assumption of no compensation for tax maneuver losses in 2019.

7. Could staff elaborate on the persisting gap between the authorities' approach and international standards such as the Government Finance Statistical Manual?

- The authorities have been taking steps to bridge the gap between the GFSM and their national fiscal accounts. Specifically, starting in 2018 they have classified capital injections to SOEs/SOBs under expenditures, which was not the case in the past. They excluded budget loans from expenditures, reclassifying them correctly as a financing item. Despite these efforts, some differences still exist, including the classification of the NPP for example.

8. We note that the data for the general government primary balance as well as overall balance including off-balance sheet operations are significantly different when compared to last year's report. Could staff explain where this difference comes from?

- Changes to fiscal numbers relative to the 2017 Staff Report are related to (i) new, more detailed data not available before which increased the accuracy of staff's calculations of some items, specifically off-balance sheet items, (ii) revisions to historical numbers, and (iii) correcting errors in staff's fiscal numbers. Any revisions have been done in close cooperation with the authorities.

De-Dollarization

9. Could staff comment on the measures proposed by Belarus in the SI paper in the context of successful countries like Peru?

- As discussed in the SIP successful de-dollarization country cases, e.g. Peru, share the following set of key components:

- **A public de-dollarization strategy** to anchor expectations and signal commitment;

- **Sustainably better macro policies**, that increase confidence in domestic currency;

- **Prudential policies and supervisory measures that reduce financial stability risks due to dollarization**; and

- **Developing local capital markets to promote the local currency**.

- Belarus has made progress in some of these areas in recent years, for example macro stability has been restored and several macroprudential measures have been introduced to reduce financial stability risks; however, several other components are outstanding. Most importantly the local currency capital market is shallow and the local currency yield curve needs to be extended. Moreover, Belarus would benefit from an overarching de-dollarization strategy, including on public communications.

Structural Policies

10. We would welcome staff comments on the extent of possible social implications due to SOE reforms.

- The possible social consequences of comprehensive SOE reforms were elaborated in the 2017 SIP 'State-Owned Enterprises Restructuring in Belarus: Potential Labor Aspects'. The SIP estimates that total layoffs over a three-year period would be between 250-300 thousand workers, or 5.5-7 percent of the total labor force.

- While large, this impact would be significantly lower than that experienced by Central and Eastern European countries during transition. The reason is that many of the urgent macroeconomic reforms during the initial period of transition to the market economy have already taken place in Belarus. Moreover, some of the overstaffing has probably already been reduced: the share of employment in organizations of state and mixed ownership has declined from 64 percent in 2009 to around 58 percent in 2015. Furthermore, the already existing private sector has the potential to absorb a significant part of the laid off if the authorities all the more if the authorities continue to promote its development.

- Staff also estimated that the fiscal costs of social protection measures during state-owned enterprise restructuring would be manageable even if the restructuring happens in a rather short period. For this, staff relies on the World Bank assessment on the cost implications of these compensatory measures, but staff broadly assessed that sufficient space could be provided in the budget to finance these compensatory measures.

- Furthermore, while the no-reform scenario may preserve full employment, the not-so-hidden costs of this scenario are also substantial through lower economic growth and stalled income levels.

11. Could staff highlight the significant features of the digital transformation in Belarus?

- Indeed, the performance of the IT sector in Belarus over recent years has been impressive, with sustained double-digit growth even at this later stage of development. Two factors appear to have played an important role: first, strong human capital, reflecting a history of high quality of training especially in computer programming. Second, a highly preferential regime for the sector, including tax exemptions, reduce registration burdens, easier hiring practices, etc. While this preferential treatment may have been justified in the early stages of development of the IT industry in Belarus, the rationale for some of the tax preferences in particular may need be revisited now that the sector is gaining maturity.