ECONOMICS – REGIONAL STUDIES

Republic of **Belarus**

Financial Sector Review and Private Sector Financing

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European Investment Bank
The EU bank
60 years

Republic of Belarus: Financial Sector Review and Private Sector Financing

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The mission of the EIB's Economics Department is to provide economic analyses and studies to support the Bank in its operations and in its positioning, strategy and policy. The Department, a team of 40 staff, is headed by Debora Revoltella, Director of Economics.

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1. Summary

1.1 Economic background

- Belarus is an upper-middle income economy with a GDP per capita of USD 4 986.4 (USD 18 090.7 in PPP terms) and a population of around 9.5 million as of 2016. Belarus's Human Development Index (HDI) grew to 0.795 in 2015, promoting the country to the high human development category. Between 1996 and 2014 Belarus experienced a period of relatively strong GDP expansion, followed by a recessionary period in 2015 and 2016. An economic recovery started in 2017.
- The official unemployment rate remains low, with a significant share of the workforce concentrated in the public sector. The annual inflation rate is estimated to have decelerated to 4.7% in 2017, in line with the National Bank of the Republic of Belarus (NBRB)'s target.
- The Belarusian economy is mainly driven by manufacturing, followed by wholesale and retail trade, and by the agricultural sector. Belarus's exports are somewhat concentrated on few commodities, with petroleum products amounting to about 30% and chemical products accounting for 15% of the total.
- Weak growth and falling revenues have paved the way for a persistent fiscal deficit, expected to reach 3% of GDP in 2017. Public debt is expected to exceed 59% in 2017.
- Belarus has avoided large scale privatisations whilst a strong presence and dominance of state-owned enterprises (SOEs) and focus on full employment in the public sector has constrained the allocation of capital and labour to more productive sectors of the economy.
- The role of small and medium-sized enterprises (SMEs) in the economy is growing, albeit starting from rather low levels. According to 2016 statistics, SMEs generate less than 28% of the total value added in the economy and account for slightly more than 23% of GDP. At the same time, the share of SMEs' exports in the country's overall export performance reached 45.7% in 2016.
- Lately the government has strongly re-focused its economic strategic orientations towards SME support: reform packages focused on strengthening the business environment; creating a positive image of SME sectors; promoting infrastructure projects for SMEs. As a result, the government expects the share of SMEs in total value added to reach 40% in 2020 and 50% in 2030.
- The government's commitment to improving the business environment was also reflected in a significant jump in Belarus's ranking in the Doing Business Indicator. Specifically, Belarus was ranked 57th in the overall index (69th position in 2012) and 60th in the paying taxes indicators in 2015 (156th position in 2012), respectively.

1.2 Financial sector

- Banks dominate the financial sector. Commercial banks in Belarus represent around 85% of total financial assets and are estimated at 73% of GDP (2016). Leasing, microcredit and insurance companies account for roughly 5%. The Belarus Development Bank represents 7% of total assets. Within the financial sector, state dominance is rather high. State-owned banks comprise around 65% of the banking sector's assets.
- The Belarus banking system comprises 24 operating banks, including 19 banks with foreign capital participation. The banking system is concentrated, with the five largest banks accounting for 79.1% of assets and 73.2% of the banking sector's capital.
- In the period 2002-2011 Belarus experienced rapid credit expansion from 16% to 66% of GDP. However, the economy went through an exchange rate crisis in 2011. At the same time the

banking system experienced a spike in deposit growth rates in 2011. This large increase was explained by state measures to increase liquidity in the banking system. Specifically, deposits of SOEs were channelled to the banking system, thus increasing abruptly the deposit base of banks. The loan-to-deposit ratio decreased after 2011 (starting from a very high level – 200% roughly). Its decline should also be attributed to a significant slowdown of credit growth. As of Q3 2017 the loan-to-deposit ratio reached 138% although it still remains at elevated levels.

- Levels of financial intermediation remain relatively low with a 40% total domestic credit-to-GDP ratio in 2016. Moreover, domestic credit to the private sector as a % of GDP accounted for 25.8% in 2016. This difference is very important given the significant presence of SOEs in the economy.
- In early 2017 credit growth resumed, primarily driven by credit extensions to the private sector, and banking sector profitability also increased. However, it still remains below pre-recession levels.
- In 2016 risk-weighted assets grew by 12% yoy. Overall, capital adequacy increased to 19.6% (3rd quarter of 2017) from 18% in 2016. According to NBRB, the dynamics of regulatory capital adequacy ratio varied between banks, with foreign-owned banks increasing regulatory capital and state-owned banks decreasing it.
- The level of non-performing loans (NPLs) increased to 13.7% as of the third quarter of 2017[1]. A significant spike in NPLs is attributed to the underperformance of inefficient SOEs. In particular, the corporate sector accounted for 68.9% of assets exposed to credit risks in 2016. A further increase in NPLs was prevented by transferring non-performing loans to the newly established Asset Management Company operating outside the banking system. Households remained the category with the least risky borrowers.
- The Belarus banking system is highly dollarized. Despite the fact that NBRB imposed the net open currency limit, the banking system remains exposed to the risks implied in exchange rate depreciation. Foreign-currency denominated loans as a share of total loans accounted for around 55% in 2017 (mostly corporates) and the share of foreign currency deposits rose to 70%. Episodes of sharp exchange rate depreciation in 2015 (around 40%) showed that corporates (mainly SOEs) were largely unhedged against currency fluctuations. This was reflected in the spike of NPLs in the corporate sector. The high dollarization may also determine liquidity constraints in foreign currency. The ratio of high liquid assets to total assets decreased from 32% at the beginning of 2016 to 20.8% in the same period of 2017.
- Segments other than traditional banking are relatively underpenetrated. The Belarus capital market is represented exclusively by the state-owned stock exchange JSC “Belarusian Currency and Stock Exchange”. Its role in the economy is rather small and trading is largely illiquid. Leasing started increasing over the last few years in Belarus and in 2016 its assets accounted for 3.2% of total financial assets. Like leasing activities, microfinance activities are regulated by NBRB. As of January 2017, total assets in the microfinance sector accounted for a very small portion of total financial assets.

1.3 Gaps in SMEs’ finance

- Over the past five years Belarus has progressed in leaps and bounds in improving its business environment, reaching 38th place in the WB Doing Business Report 2018. This reflects the authorities’ efforts to remove administrative barriers and improve the regulatory environment.

[1] NPLs are likely to be underestimated in view of forbearance, evergreening, and diminished real sector repayment capacity, particularly among SOEs

- Belarus's authorities started recognising the role of the private sector in economic development with the Presidential Directive on the Development of Entrepreneurship and Stimulation of Business Activity (late 2010). It aimed at reducing a number of bureaucratic requirements governing company registration procedure and licensing, and introduced quotas for SMEs in public procurement, thus allowing for enhanced SME growth potential in a country that is largely state-dominated.
- Alongside tax rates, the informal sector and mismatches in the labour force, access to finance has been detected as one of the most limiting factors in SMEs development.
- A large share of SMEs and young firms are credit-constrained, with high interest rates being described as the main limiting element.
- While bank-based financing makes up the biggest share of private-sector and SME financing, large gaps still persist. Access to long-term finance, local currency financing and high interest rates are identified among the main financing barriers to private sector development.
- Access to finance represents a constraint for companies, particularly SMEs. The share of credit-constrained SMEs is high. Many of them are discouraged even from applying due to high interest rates, complex procedures, the lack of requested collateral and low financial literacy.
- Local currency instruments to support SMEs are limited, especially for longer-term maturities.
- Moreover, high interest rates and a general lack of long-term finance both in local and foreign currency represent major constraints to SMEs' development, especially for young firms.
- Non-bank finance and capital markets are underdeveloped. Therefore, support for the development of alternative sources of finance and services is also needed.
- Banks' activity is also partially limited by the considerable state dominance on both the funding and lending side, with SOEs being a large contributor of revenues and also a direct and indirect source of funding. Therefore, enhanced differentiation in funding sources is needed.
- Funding for SMEs and the private sector at large should be seen as complementary to domestic public sector sources, also taking into account the relatively limited availability of local funding and support programmes.
- Technical assistance and advisory services for SMEs could increase their bankability through enhanced financial literacy, improved business planning capacity and best management practices.

2. Macroeconomic environment

Belarus is an upper-middle income economy with a GDP per capita of USD 4 986.4 (USD 18 090.7 in PPP terms) and a population of around 9.5 million as of 2016. Between 1996 and 2014 Belarus experienced a period of relatively strong GDP expansion. Its average annual growth was around 6%. This strong performance was halted by a recessionary period in 2015 and 2016. Belarus's Human Development Index (HDI) grew to 0.795 in 2015, promoting the country to the high human development category. The gross national income (GNI) per capita has increased sharply, reaching USD 6 067.2 in 2015.[2] Belarus has also succeeded in substantially cutting the poverty rate, with a share of population below the national poverty line decreasing to 5.7% in 2016.

The Belarusian economy is mainly driven by manufacturing, which accounted for 20% of total GDP in 2016, followed by wholesale and retail trade (11% of GDP each), and by the agricultural sector – around 7% of GDP. Belarus's exports are somewhat concentrated on few commodities, with petroleum products accounting for about 30% of the total, and chemical products (mainly potash) for 15% of the total. Belarus also has a high degree of concentration in its export geographical orientation, with the Russian market accounting for 46% of total exports (and 55% of imports). On top of that, Russia is also its largest creditor (48% of public external debt) and largest investor (50% of FDI in 2011-2015). Against this backdrop, Belarus has avoided large-scale privatisations. This has constrained private sector development. For example, a strong presence and dominance of state-owned enterprises (SOEs) and a focus on full employment in the public sector have limited the allocation of capital and labour to more productive sectors of the economy. As a result, the private sector's contribution to total economic output was estimated to be around 30% of GDP in 2012. This is a low share when compared to around 60-75% in other post-Soviet economies. State dominance was also supported by directed lending operations to SOEs.

In recent years the political and economic landscape of Belarus has been shaped by geopolitical developments in its neighbouring countries. The country's focus has shifted and Belarus has started strengthening its sovereignty and increasing its international openness. The authorities have developed a Roadmap for Structural Reforms, aimed at promoting market reforms and macroeconomic stability. Notably, among the main objectives of the Roadmap are: the abolishment of output targets for SOEs, the elimination of price controls on vital social goods and services, and a gradual phasing out of directed lending activities in support of SOEs, which have already been on a declining trend since 2016.

Recent developments

The Belarusian economy experienced a recession between 2014 and 2016 and only started to grow again in 2017. Low oil prices and deteriorating economic conditions in partner economies, mainly Russia, dragged the economy down. The economy contracted by 3.8% in 2015 and 2.6% in 2016 (Annex A). Moreover, the negative performance was exacerbated by structural bottlenecks. A 36% decline in potash prices led to a loss of around 8% of GDP in export earnings in 2016. A favourable environment, including Russia's slow recovery, set positive conditions for 2017. The economic recovery has surprised

[2] In 2010 constant prices

on the upside and it is estimated at 2% of GDP growth yoy[3]. The official unemployment rate remains low, around 1% as of 2017, with a significant share of the workforce concentrated in the public sector (half of the workforce is employed with SOEs)[4]. The annual inflation rate decreased from 13.5% in 2015 to 11.8% in 2016, and it is estimated to have decelerated to 4.7% in 2017, in line with NBRB's target. Furthermore, a 6.6% yoy increase in real wages stimulated household consumption in 2017.

The near-term economic outlook has improved recently due to: (i) the resolution of the gas price dispute with Russia; (ii) an agreement to restore crude oil supplies to Belarus to ordinary annual volumes; (iii) resumption of disbursements by the Eurasian Fund for Stabilization and Development (EFSD) and bilateral lending from Russia; and (iv) the successful issuance of dual-tranche sovereign Eurobonds for the aggregate principal amount of USD 1.4bn in June 2017.

Table 1. Selected statistics for the Belarus economy

Indicators	2011	2012	2013	2014	2015	2016	2017F
Nominal GDP (USD bn)	61.8	65.7	75.5	78.8	56.5	47.4	51.8
GDP per capita (PPP basis, USD)	17 153	17 801	18 276	18 916	18 364	18 073	-
Real GDP (% change)	5.4	1.9	1.3	1.2	-3.7	-2.6	1.5
Inflation (CPI, % change Dec./Dec.)	108.7	21.8	16.5	16.2	12	10.6	4.7
Nominal Exchange Rate (local currency per USD, Dec.)	0.84	0.86	0.95	1.18	1.86	1.96	2
Gen. Gov. Financial Balance/GDP	-2.8	0.4	-1	0.1	-2.2	-3.4	-5.6
Gen. Gov. Debt/GDP	53.9	37	36.9	39.5	53.3	53.9	58.8
Gen. Gov. Debt/Gen. Gov. Revenue	143.7	94.3	92.5	101.5	129.2	126.1	141.6
Gen. Gov. Int. Payments/Gen. Gov. Revenue	2.2	2.8	2	2.3	3.6	4.3	4.3
Current Account Balance/GDP	-8.2	-2.8	-10	-6.6	-3.2	-3.5	-2.5
Short-term External Debt/Total External Debt	39.5	34.4	35.5	32	30	28.3	27
External debt stocks, total (DOD, current USD bn)	33 932	33 755	39 573	40 013	37 934	37 515	38 975
External Debt/GDP	55.1	51.4	52.5	50.8	67.8	79.1	78.7
Total reserves minus gold (current USD bn)	6.01	5.8	4.93	3.42	2.74	3.2	6.1
Interest Paid on External Debt (USD bn)	0.91	1.15	1.08	1.12	1.24	1.26	1.2
Amortization Paid on External Debt (USD bn)	3.25	5.03	4.67	5.35	5.35	5.94	5.55
Net Foreign Direct Investment/GDP	6.3	2	2.6	2.3	2.7	2.4	2.9

Source: own calculations on Moody's country statistics, National Statistical Committee of the Republic of Belarus and NBRB

Those factors have also enabled the net international position to be stabilised at -82% of GDP towards mid-2017. The current account deficit stood at 2.5% of GDP in 2017 compared to a near 8.2% deficit in 2011. This was largely driven by decreasing imports (reflecting the recessionary period in Belarus), increasing exports of services, and REER adjustments at around 17%.

Monetary policy and exchange rate adjustments

In 2015 a crawling peg was replaced with a de jure managed floating exchange rate regime. NBRB set broad money as a nominal target and Belarusian ruble (BYR) base money as the operational target. As a result of the exchange-rate regime change, Belarus has experienced episodes of currency depreciation. Its BYR lost 36% of its value against the USD in 2015, and another 7.5% in 2016. The authorities' medium-term objectives are to reduce inflation to 5% by 2020, increase international reserves to USD 10bn, and a gradual transition to inflation targeting. In July 2016, the authorities redenominated the currency to help boost confidence, issuing new bills (BYN) dropping four zeros. The authorities instituted reserve requirements to tackle structural liquidity deficiencies in the banking

[3] Largely owing to the significant growth in industrial output, with the highest growth achieved by machinery building (23%); pulp, paper and printing (14%); pharmaceuticals (11.8%) and chemical production (11.6%) on a yoy basis.

[4] Self-employed and full-time students are counted as employed in the country's statistics.

system and to better steer money supply dynamics. In 2017 NBRB managed to achieve its broad money targets and to lower inflation. Consequently, exchange rate volatility decreased in 2017. Moreover, NBRB lowered the refinancing rate from 25% to 11% towards the end of 2017.

Fiscal policy and debt

Starting in 2013, quasi-fiscal operations resulted in large distortions of the fiscal balance. For example, increases in real wages (at 19% on a year-to-year basis) were not aligned with productivity growth. On the other hand, substantial liabilities started accumulating as lending was often state-directed to ineffective enterprises. These developments combined with weak growth and falling revenues have paved the way for a persistent fiscal deficit. Despite tighter fiscal policies since 2015, the overall fiscal deficit has been increasing. It is expected to reach 3% of GDP in 2017, according to IMF projections, whilst the fiscal budget was nearly balanced in 2014. Against this backdrop, public debt started increasing rapidly from 37.3% of GDP in 2014 to almost 55% in 2016, and is expected to exceed 59% in 2017. In 2017 general government debt as a share of government revenues exceeded 147%. Moreover, government debt is highly dollarized with a share of FX-denominated debt accounting for 88% in 2017.

The most recent IMF debt sustainability analysis (DSA) shows improvements in the medium-term prospects (Table 2), largely driven by a convergence of GDP growth to its potential. Lower off-balance sheet operations and changes in the pace of nuclear power plant spending resulted in a relatively contained fiscal deficit. The primary balance is expected to reach 2.1% in 2022. However, high interest payments (2.5 to 3.2% of GDP) and off-balance sheet operations will result in a negative overall balance. Downside risk to public debt still persists, mainly reflecting potential further depreciation and contingent liabilities risks related to banks' and SOEs' recapitalisation efforts. A good share of public debt is in foreign currency, making it vulnerable to exchange rate depreciation. Gross public financing needs are forecasted to reach 8% in the medium term (down from a previously projected 15% of GDP in 2016). Under the IMF baseline scenario, public debt is projected to stabilise at around 57% of GDP.

Table 2. IMF Debt Sustainability Analysis (DSA) - Baseline scenario

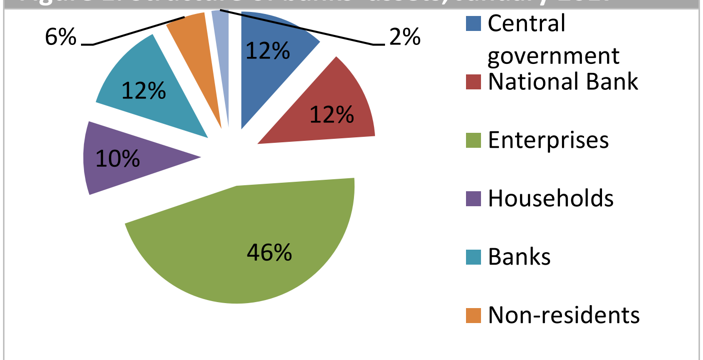
Indicators	2018	2019	2020	2021
Nominal gross public debt and guaranteed debt (as % of GDP)	58.1	58.9	59.3	57.3
External debt (as % of GDP)	71.2	70.5	67.9	65.2
Public gross financing needs (as % of GDP)	10.1	10.2	8.3	7.9
Gross external financing needs (USD bn)	16.2	15.7	15.5	16.1
as % of GDP	29.4	27.4	25.8	25.6
Current account deficit, excluding interest payments (% of GDP)	-0.4	-0.2	0.5	0.9
Real GDP growth (in %)	1.8	1.8	2.0	2.0

Source: IMF, Article IV Consultation 2017

Broadening the scope and looking at the external outstanding exposure, the nominal gross external USD-denominated debt stock decreased slightly between 2014 and 2017 from around USD 40bn to USD 38bn. However, the debt burden increased significantly due to a large drop in USD-denominated nominal GDP from USD 78.8bn in 2014 to USD 51.5bn in 2017. As a result, gross external debt as a percentage of GDP ballooned from 50.8% in 2014 to an estimated 73.1% in 2017. On the other hand, this debt metric is assumed to be stabilising in the outer horizon. Share of the FX-denominated debt is around 89% of the total debt, which leaves Belarus vulnerable to the risks implied in currency volatility. Further, the vulnerabilities are augmented by the interest-rate risk stemming from 50% of debt being priced at floating rates. Despite a decline in the ratio of external financing requirements as a percentage of international reserves from 223% in 2014 to 144% in 2017, the external financing vulnerability is high. Total reserves covered only 1.8 months of imports in 2016 and amounted to roughly USD 3.2 bn. The drastic shortage of capital buffers was partially covered by foreign exchange borrowing from Russia (USD 0.8bn) and the EFSD (USD 2bn committed). Overall international reserves had been increased to around USD 6.6bn as of June 2017, corresponding to *2*.4 months of current external payments. Gross external financing needs amounted to 32% of GDP in 2017 and are expected to decrease to 25.6% of GDP by 2021. Spreads on Belarusian 2018 Eurobonds halved from 1 000 bps in mid-2015 to around 450 bps in July 2017, roughly in line with similarly rated peers –reflecting a strong repayment track record as well as credibility gains from stronger policies. External debt is projected to decline to 65.2% of GDP by 2021. However, the overall debt performance is sensitive to oil price developments due to lower direct revenues from sales of refined commodities, Russia's slowdown induced by low oil prices and disruptions in energy price arrangements with Russia.

3. Financial Sector Overview

Figure 1. Structure of banks' assets, January 2017



Source: National Statistical Committee of the Republic of Belarus

Banks dominate the financial sector. Commercial banks in Belarus represent around 85% of the total financial assets and are estimated at 73% of GDP (2016)[5] (Figure 1). Leasing, microcredit and insurance companies account for roughly 5%. The Belarus Development Bank represents 7% of total assets (see Box 1). Within the financial sector state dominance is rather pronounced. State-owned banks comprise around 65% of the banking sector's assets. In the insurance sector around 90% of life insurance, 60% of non-life insurance and 100% of reinsurance lines are linked to state-owned companies.

3.1 Banking sector

3.1.1 Structure and funding

The Belarus banking system comprises 24 operating banks[6], including 19 banks with foreign capital participation. The biggest stake in Belarus's external liabilities is held by Russia, followed by Germany and Austria, with 90% of liabilities being interbank loans. The banking system is concentrated, with the five largest banks accounting for 79.1% of assets and 73.2% of banking sector capital[7]. The Gini index for assets and capital was estimated at 0.748 and 0.694 (January 2017).

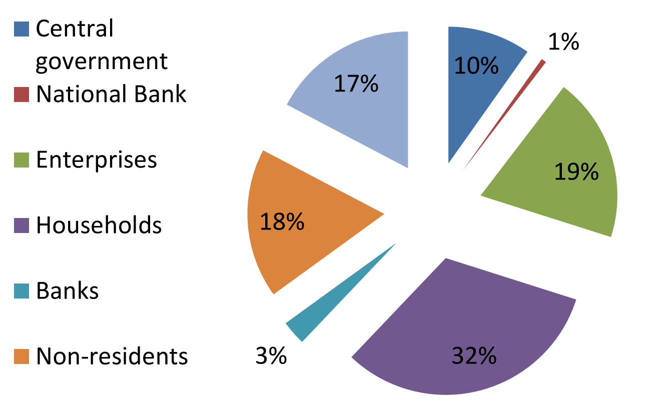
[5] Nominal GDP: USD 47.4bn in 2016

[6] At the beginning of 2017, five banks went through bankruptcy and liquidation procedures.

[7] In 2016 total banking system assets amounted to USD 32.6bn and total banking system capital amounted to USD 4.9bn

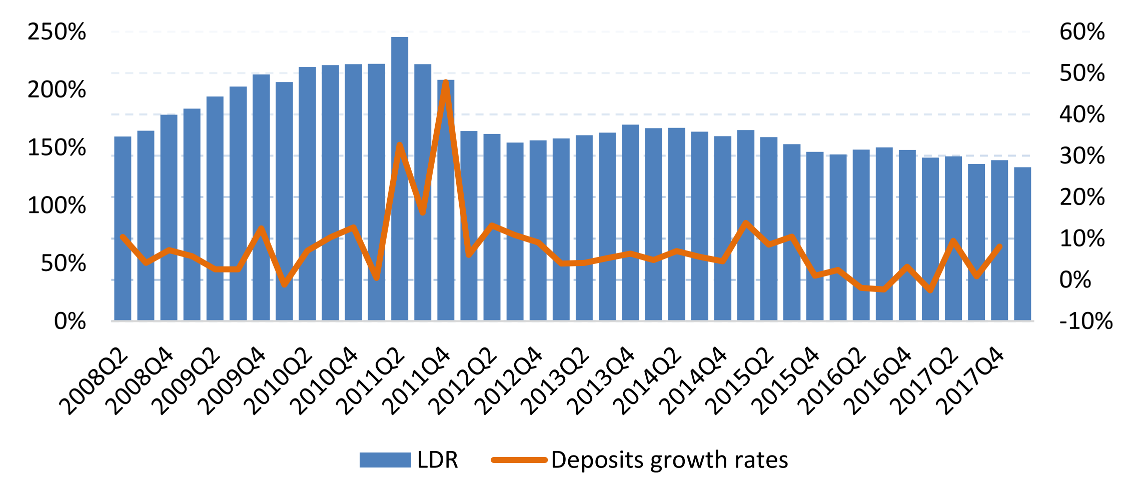
A breakdown of the banking sector's liability structure (Figure 2) shows that the domestic interbank market remains small, with banks accounting for around 3% of total sector liabilities. Households constitute the biggest share of banks' funding (32% in 2017). The share of the National Bank in the structure of the banking sector's liabilities is rather negligible with a reported 0.6%, down from 2.5% in 2016. On the other hand, central government's share increased from 8.3% in 2016 to 9.8% at the beginning of 2017. While household deposits remain the main source of funding, the vast majority of deposits in national currency have a very short maturity. Only 4% are between 1 and 2 years' tenor, with the share of deposits with over 3 years' maturity close to zero; deposits with less than 1 month of maturity account for around 62% of total deposits. Deposits denominated in foreign currency are more diversified in terms of maturity. Up to 19% are between 2-3 years' maturity, 7% between 1-2 years, and 2% above 3 years' tenor.

Figure 2. Structure of banks' liabilities, January 2017



Source: National Statistical Committee of the Republic of Belarus

Figure 3. Loan-to-deposit ratios and deposit growth rates



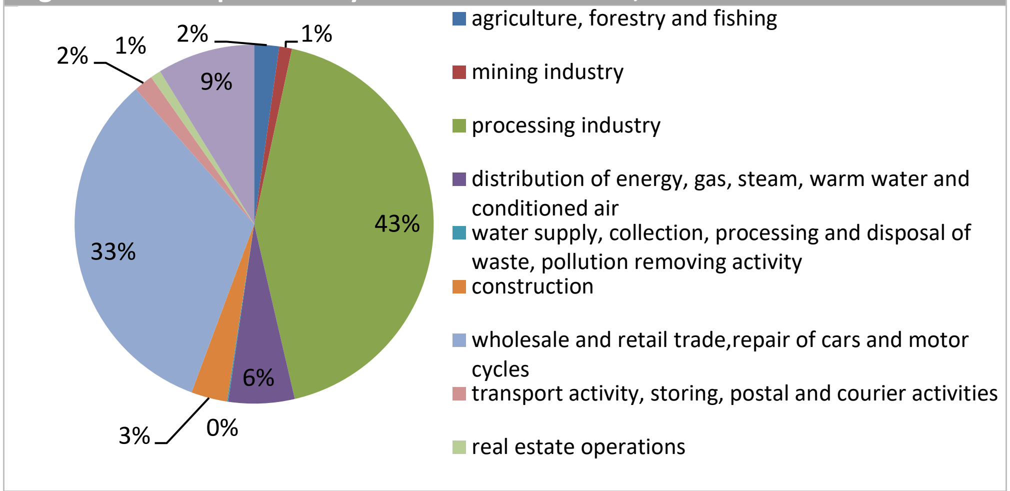
Source: IFS

Deposits are the banking sector's main source of funding. However, their share in GDP terms is rather low and has been below 30% over the last decade. In 2011 the banking system experienced a spike in deposit growth rates (Figure 3). This large increase was explained by state measures to increase liquidity in the banking system. Figure 3 shows that the loan-to-deposit ratio has been historically high, exceeding 200% between 2010 and 2011. To provide liquidity to the banking system, particularly to the banks involved in state financing programmes, deposits of SOEs were channelled to the banking system, thus abruptly increasing the deposit base of banks. These measures also contributed to a distortion of competition in the banking sector. The loan-to-deposit ratio began to fall after 2011, but its decline should be somewhat attributed to the significant slowdown of credit growth. As of Q3 2017, the loan-to-deposit ratio stood at 138%, which is still high.

The share of external funding in the banking system's liability structure decreased to 17.7% in 2017 from 18.9% in 2016. Russia and Germany are the main creditors of the Belarus banking system, to the tune of a reported USD 3.5bn and USD 0.7bn respectively. Overall, the ratio of the banking sector's external debt to international reserves stood at 121.4% (early 2017).

3.1.2 Credit developments

Figure 4. Credit provided by Belarus banks in 2016, sectoral breakdown



Source: National Statistical Committee of the Republic of Belarus

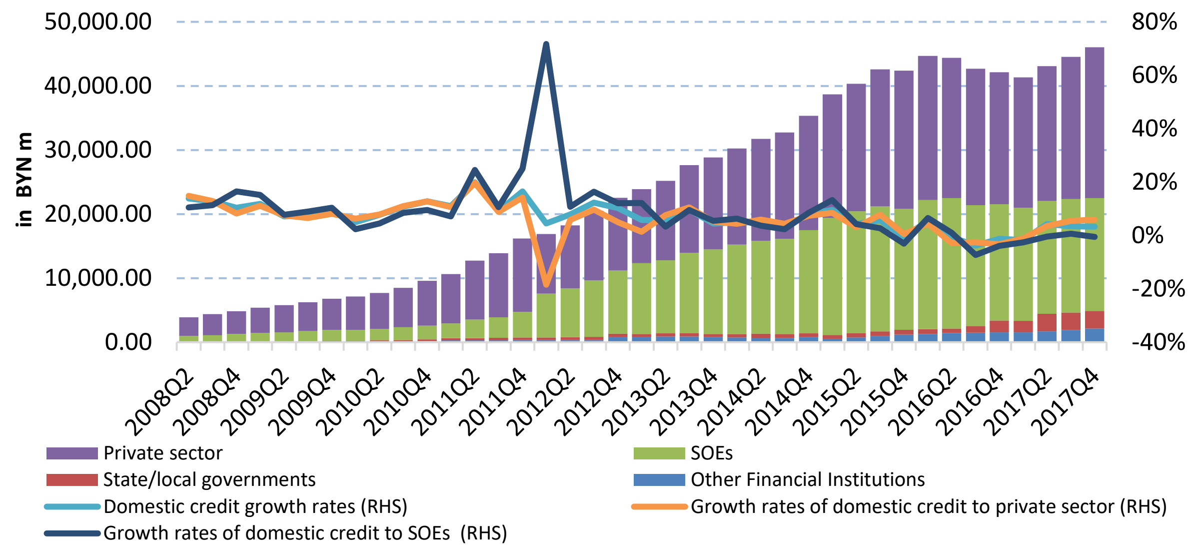
Levels of financial intermediation remain relatively low with a 40% total domestic credit to GDP ratio in 2016. Moreover, domestic credit to the private sector as a percentage of GDP accounted for 25.8% in 2016. This difference is very significant given the sizeable presence of SOEs in the economy. The breakdown of credit by economic activity shows that 42% of total loans were channelled to the processing industry and 38.2% to the wholesale and trade industry in 2017. Construction, real estate and agricultural industries accounted for around 6% of total loans (Figure 4).

Box 1. Belarus Development Bank

State intervention in the financial system, through the ownership structure, directed lending and subsidised programmes, has shaped the banking system and determined the way financing is offered. A good part of the financing provided by banks is channelled to state-owned enterprises (SOEs), with 55% of all banks' claims on the corporate sector being represented by SOEs. The Development Bank (DB) was established in 2011 aimed at gradually phasing out inefficient direct lending programmes and providing solidity to the banking system. In 2011 directed lending accounted for over 9% of GDP and according to IMF projections under the DB it is expected to have fallen to 1% of GDP in 2017. As of January 2017, DB's assets amounted to USD 14.6bn. The accountability and governance of DB, the scope of DB, banks' participation in the future lending under government (LGP) programme, and DB's treatment under the limits set on new LGP were not overseen in the bank's regulatory framework. These have resulted in DB transforming from a vehicle of phasing out directed lending into an additional source of subsidised lending. By further financing state enterprises it has fuelled contingent liabilities for the government; moreover, it has supported exuberant growth in domestic demand.

In the period 2002-2011 Belarus experienced rapid credit expansion from 16% to 66% of GDP. In 2011 the economy went through an exchange rate crisis, mainly driven by an overvalued real exchange rate, expansionary wage policies and excessive credit growth. As a result, NBRB had to increase the refinancing rate from 18% to 45%, and the overnight rate from 22% to 70% in the second half of the very same year. These measures helped to stabilise the economy and after a short period of slump, credit growth started to recover. Figure 5 shows credit developments since 2008. It indicates that up until Q1 2012 the private sector accounted for the largest share of the domestic credit portfolio. After the eruption of the currency crisis, credit to the private sector went into sharp decline (-18% from Q4 2011 to Q1 2012), and overall credit growth was fuelled by lending to SOEs. While already in Q2 2012 credit growth had started to recover, the share of SOEs persisted above 40% of the total credit portfolio, which is almost double compared to the pre-crisis period. As of Q4 2017, 38% of total loans remained tied to governmental direct lending programmes[8].

Figure 5. Dynamics of domestic credit and breakdown by economic sector



Source: own calculations based on IMF International Financial Statistics

A second recession in 2015 paired with episodes of currency devaluation negatively affected credit developments. On the demand side, the deteriorating financial performance of corporates became the main impediment to credit growth. Against this backdrop, regulatory requirements tightened up, including a phasing out of direct lending programmes, and banks' profitability levels shrank. This resulted in tighter lending conditions and standards. The combined effect of lower demand and tightened supply determined a period of negative credit growth that extended into 2016 (Figure 5). In early 2017 credit growth resumed, although at a slower pace than earlier. The primary driver was credit extended to the private sector.

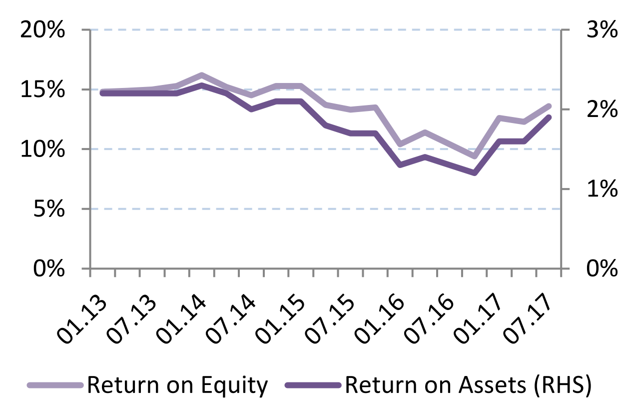
3.1.3 Soundness and performance

After a year of declining profitability (Figure 6), in 2017 the banking system started showing signs of recovery. In January 2017 the banking sector's profit was reported at BYN 884.9m (after tax). Return on assets grew from 1.3% (January 2016) to around 1.6% (January 2017), while return on equity increased from 10.4% to 12.6%. Return on equity was affected by push and pull factors. Increasing

[8] Direct lending decreased to around 1.8% of GDP in 2017, which is still above the IMF's recommended level.

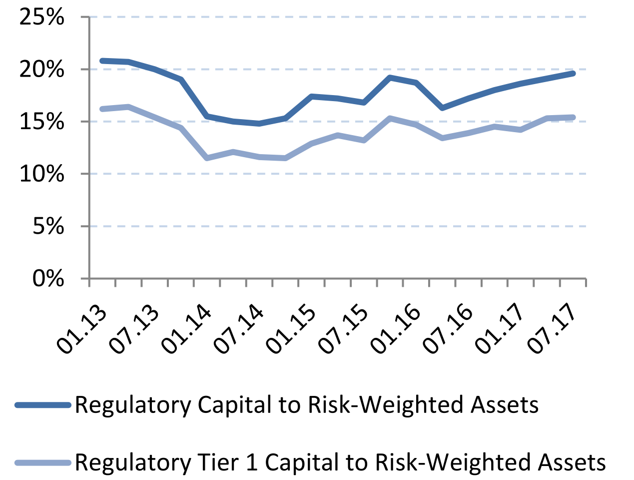
profit margins and risk levels created an upward pressure on returns, while declining return on risk-weighted assets pulled down the ratio. Overall, profitability levels in the banking sector improved. However, they still remain below pre-recession levels. This may generate some limitations on the banking sector's capacity to set aside additional capital buffers.

Figure 6. Profitability of the banking sector



Source: own calculations based on NBRB

Figure 7. Banking sector capital adequacy ratios

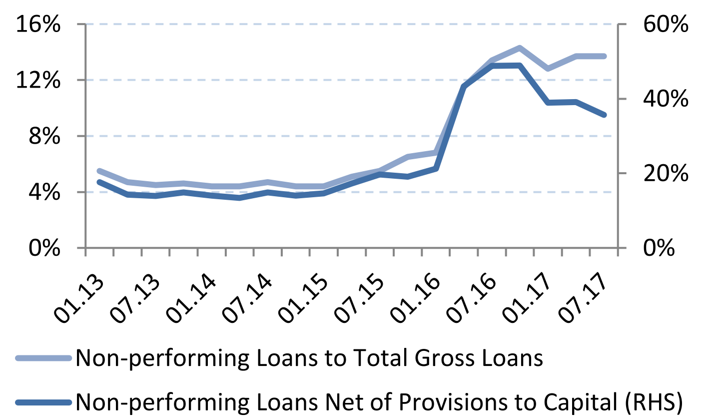


Source: own calculations based on NBRB

In 2016 risk-weighted assets grew by 12% yoy or by BYN 5bn in nominal terms. According to NBRB, the dynamics of the regulatory capital adequacy ratio varied between banks. Within state-owned banks the capital adequacy ratio decreased from 19.7% (beginning of 2016) to 17.7% (beginning of 2017). Foreign banks operating in Belarus displayed a strong increase in their regulatory capital position from 16.6% to 19.8% over the same period. Overall, capital adequacy increased to 19.6% (3rd quarter of 2017) from 18% in 2016 (Figure 7). Over the observed period, the revaluation of fixed assets and growth in the banks' registered authorised capital became the main drivers behind increasing the regulatory capital of the banking sector.

The recent deterioration of the macroeconomic environment has revealed the risks enshrined in the Belarusian financial system. In early 2016 the level of NPLs continued to increase, reaching 13.7% as of the third quarter of 2017[9] (Figure 8). A significant spike in NPLs is attributed to the underperformance of inefficient SOEs. In particular, the corporate sector accounted for 68.9% of assets exposed to credit risks in 2016. According to NBRB, the agricultural (including forestry and fishing), real estate and construction industries pose the highest risk. A further increase in NPLs was prevented by transferring non-performing loans to the newly established Asset

Figure 8. Banking sector NPLs



Source: own calculations based on NBRB

[9] NPLs are likely to be underestimated in view of forbearance, evergreening, and diminished real sector repayment capacity, particularly among SOEs

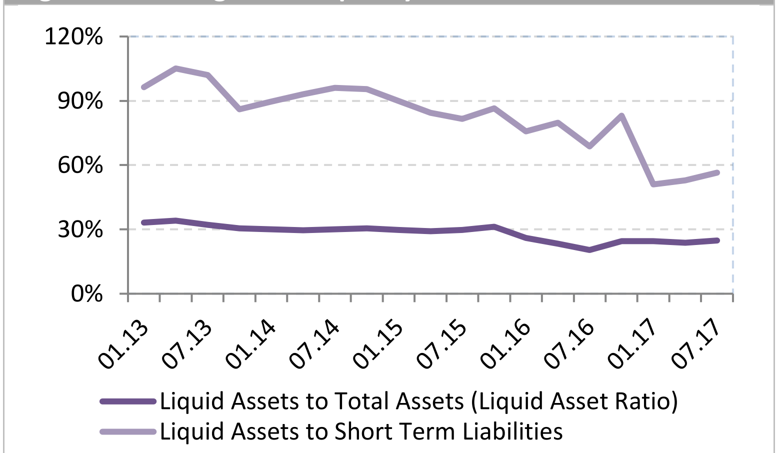
Management Company (AMC)[10] operating outside the banking system. Households remained the category with the least risky borrowers, with a share of bad assets reaching 0.79% towards the end of 2016.

Against this background, the credit risk profile of the banking system significantly deteriorated. Throughout 2016 the banking sector's bad assets increased by almost 86% to BYN 5.1bn. This led to an increase in bad assets as a percentage of total banking sector assets from 6.8% in January 2016 to 12.8% in January 2017. Over this period, the share of long-term debt grew by 88.1% and uncollectable debt written off the balance sheet increased by 60%. To reduce the credit risk pressure on the banking system, NBRB took several measures aimed at restructuring the banks' credit portfolio. This has helped loosen the pressure on the banking sector and improve its liquidity.

In 2016 the banking system increased its exposure to interest rate risk. The risk is related to changes in interest rates on assets and liabilities denominated in foreign currency. NBRB reported that the cumulative interest rate gap between FX-denominated claims and liabilities increased by BYN 4.1bn in 2016 and totalled BYN 5.8bn as of January 2017. The economic costs of the banking system's capital doubled from 0.78% to 1.58% (January 2018). This may also serve as an indicator of the underlying risk in changes of yield on FX-denominated assets and liabilities.

The Belarus banking system is highly dollarized. Despite the fact that NBRB imposed a net open currency limit (not more than 10% of the banking sector's regulatory capital), the banking system remains exposed to the underlying risks in exchange rate depreciation. In 2017 foreign currency-denominated loans accounted for around 55% of total loans (mostly corporates) and 70% of foreign currency deposits. Episodes of sharp exchange rate depreciation in 2015 (around 40%) showed that corporates (mainly SOEs) were largely unhedged against currency fluctuations. This was reflected in the spike of NPLs in the corporate sector. The open foreign exchange position as a share of the banking sector's regulatory capital stabilised at 6.4% (January 2017), which is within the limits required for individual banks (the ratio should not exceed 10%).

Figure 9. Banking sector liquidity indicators



Source: own calculations based on NBRB

The high level of dollarization may also determine liquidity constraints in foreign currency. In 2016, the banking sector kept liquidity levels in excess of the minimum requirement although a downward trend could be observed (Figure 9). The liquid asset ratio has been declining and was reported at 24.8% in the 3rd quarter of 2017, down from 30% as of 2014. Liquid assets covering short-term liabilities were reported at 56.6% at the end of 2017 compared to almost 86.5% in 2015. The ratio of high liquid assets to total assets decreased from 32% at the beginning of 2016 to 20.8% in the same period of 2017.

[10] IMF reports AMC to be a collection agency for problem loans, with SOE loans representing over 90% of the loans and around half of them classified as NPLs. Nevertheless, these transfers remained costly to the budget and illustrated the inefficiency of the SOE and NPL resolution framework.

Significant mismatches are observed in the capacity to cover short-term liabilities denominated in euro and Russian rubles.

3.1.4 Regulations in the banking system

Established in mid-2016, the Financial Stability Council (FSC)'s primary role consisted in strengthening macroprudential supervision. This was an important step towards ensuring financial stability. Macroprudential measures provided for under its supervision included net open foreign currency position limits; monitoring of the liquidity coverage ratios; identification and classification of systemic banks[11] and countercyclical capital buffers (Basel II). In February 2017 the Belarus authorities adopted an Action Plan aligned with the IMF's 2016 FSAP recommendations. The Action Plan addresses the key shortfalls in the current banking supervisory framework: (i) tightening of provisioning requirements governing foreign currency-denominated loans to unhedged corporate borrowers; (ii) strengthening of the AQR framework (to date, large banks' remedial actions are complete[12], small banks with potential capital shortfalls were identified); (iii) detailed requirements in respect of provisioning and risk classification on restructured loans (to address the widespread evergreening issue). A comprehensive list of prudential ratios and key banking regulations can be found in Annexes B and C.

Furthermore, as from January 2018 NBRB will apply Basel III capital requirements and net stable funding ratios. In addition, the World Bank is assisting in reviewing the Development Bank's mandate (to more effectively address market failures) and is providing assistance in strengthening the resolution framework. Still, a number of important steps have not been undertaken, including the operational independence and accountability of NBRB. For example, the Chairman of NBRB (including the appointment procedure) and its statutes are accountable to the President of the Republic of Belarus.

3.2 Capital market

Belarus's capital market is represented exclusively by the state-owned stock exchange JSC "Belarusian Currency and Stock Exchange". Its role in the economy is rather small and trading is largely illiquid. In 2015 the market experienced a dramatic decline of 75% (compared to 2014) in trade volumes and reached USD 12.7m. According to NBRB the share of the stock exchange in total financial assets (BYN 101.4bn) was below 0.05% in 2016. A decree signed by the President in 2016 aimed at providing the stock exchange with the right to create guarantee funds, which may mitigate the risks of transaction defaults. It also provides the stock exchange with a possibility to provide a number of banking transactions to support clearing and settlement. The government bond market represents higher trade volumes accounting for 66% (around USD 6bn per year) of total trading volumes; 145 corporate bonds and 126 government bonds were listed in 2016. The last IPO in Belarus took place in 2013 and was run by Minsky Zavod Igristikh Vin[13].

3.3 Leasing

Leasing started to grow over the last few years in Belarus and in 2016 its assets accounted for 3.2% of total financial assets (0.2% growth on a yoy basis). At the beginning of 2017, 95 leasing companies were registered, of which 27 were established with foreign capital participation. In 2016 the value of

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[11]JSC "JSSB Belarusbank", JSC "Belagroprombank", BPS-Sberbank, "Priorbank" JSC, Bank BelVEB OJSC, Belgazprombank, "Belinvestbank" JSC, Alfa-Bank, JSC "BNB", JSC "MTBank", JSC "Technobank", and CJSC VTB Bank

[12]NBRB recognises JSC "Belagroprombank", "Belinvestbank" JSC, and Alfa-Bank as those that would potentially need additional capitalisation

[13] Local wine producer

the new leasing agreements reached BYN 1 111.5m (5.5% growth yoy), amounting to 1.18% of GDP. An increase in the volume of new deals was largely driven by natural persons, whilst a number of new deals with legal persons showed a slight decline, reflecting the overall slowdown in business activity. Leasing items were purchased by leasing organisations employing own funds and bank credits in equal parts. Since 2014, all leasing activities have been regulated by NBRB and only those entities registered with the bank are eligible to perform leasing activities in the country. In 2016 new amendments were introduced to the regulations[14] governing leasing activities, requiring more detailed specifications of the transactions carried out by leasing entities. Furthermore, new legislation is being prepared to regulate leasing operations in the real estate sector for natural persons.

3.4 Microfinance

Microfinance activities are regulated by NBRB and since 2015 all microfinance institutions must be registered with the bank. To date, four consumer cooperatives and four funds have been registered. In Belarus microfinance services are mostly offered by pawnbrokers (107 registered to date). As of January 2017, the microfinance sector's assets totalled BYN 23.5m (around 0.03% of total financial assets), and over the course of 2016 it attracted BYN 8.8m of funds. In 2016 the total volume of microloans was BYN 100.9m. Over 90% (BYN 3.6m) of the credit was extended to natural persons. Pawnbrokers, which account for over 95% of all microfinance credits, mostly lend for personal purposes. At the beginning of 2017, NBRB set liquidity requirements for consumer cooperatives in respect of short-term, mid-term and long-term liquidity ratios of 70%, 80% and 90% respectively.

4. The SME Segment

4.1 SMEs' activities

In Belarus the definition of SMEs is based on the number of employees, without considering the revenue component or the ownership structure (Table 3). However, this way of defining SMEs creates inconsistencies across legislative acts. For example, tax advantages are based on turnover definitions.

Table 3. MSME definition in Belarus

Category	Number of employees
Individual	1-4 employees
Micro-enterprises	up to 15 employees
Small enterprises	16-100 employees
Medium-sized enterprises	101-250 employees

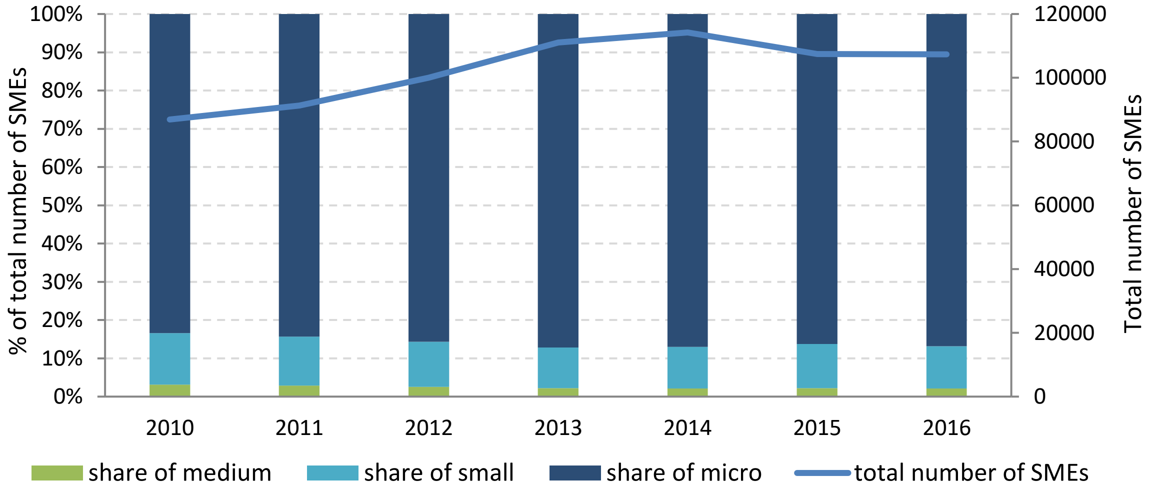
Source: National Statistical Committee of the Republic of Belarus

In 2016 the number of registered SMEs ran to 107 382 entities (Figure 10), with over 56% located in Minsk oblast[15] and the city of Minsk. All the others were relatively evenly distributed across the other five regions of the country. The breakdown by entity size shows that in 2016 micro-enterprises accounted for 87% of the total, small enterprises 11% and medium-sized enterprises only 2%. Between 2010 and 2016 the total number of enterprises increased by 20%. This development was predominately driven by micro-enterprises (a 30% increase over the observed period).

[14] On the volume and order of disclosure of information on the leasing activities and financial state of the leasing organisations included in the Register of Leasing Organisations
[15] Type of administrative division in Belarus

To the contrary, the number of medium-sized enterprises decreased by 15% to 2 394 units. The decrease in medium-sized enterprises may indicate that SMEs in Belarus face difficulties in terms of growth. The SME sector had 1.43 million employees, accounting for around 26% of the total workforce. Overall, employment in the SME sector experienced a slight decline (around 6%) in 2016 compared to 2010 levels. In terms of public versus private ownership, privately domestic-owned SMEs account for 93%, foreign-owned SMEs 5% and only 2% are state-owned enterprises. However, the breakdown by size (see Table 3 for definitions) shows that state-owned entities account for around 27% of all medium-sized firms while they are marginal in the small and micro segments (Table 4).

Figure 10. Individual share of micro, small and medium-sized enterprises in the total number of SMEs



Source: own calculations based on National Statistical Committee of Republic of Belarus

Table 4. Breakdown of SMEs by form of ownership

Enterprises	Domestic		Foreign
	Public/SOE	Private	
medium-sized	27%	68%	5%
small	5%	89%	6%
micro	1%	94%	5%

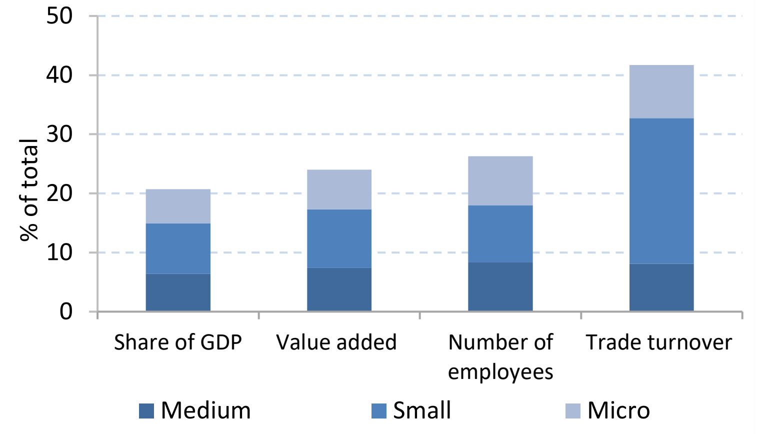
Source: own calculations based on National Statistical Committee of the Republic of Belarus

According to 2016 statistics (Figure 11), SMEs generate less than 28% of the total value added in the economy and account for slightly more than 23% of GDP. Since 2010, SMEs' share in GDP has increased by less than 5%, mainly driven by small and micro-enterprises. At the same time, the share of medium-sized enterprises in GDP decreased from 7.2% in 2010 to 6.4% in 2016. In 2016 the share of SMEs' exports in total country export performance was 45.7% (of which medium-sized enterprises accounted for 6.7%), with more than 20% of total SME revenue coming from export sales. SMEs' imports accounted for 40% of total imports in 2016, with small enterprises representing almost half of this share (17.1%). While value figures show positive net exports, the vast majority of SMEs are import-oriented (particularly in the trade and manufacturing sectors). In reality, exports are largely driven by state-owned SMEs, which serve as trading houses for big enterprises. The main export destination is the Russian market, where Belarus entrepreneurs benefit from prioritised access to the market.

However, the share of EU trade in total external trade is considerably lower than for peer countries (Figures 12, 13).

As shown in Figure 14, around 37% of all SMEs are in the retail sector, followed by manufacturing (14%), transport (10%) and construction (9%). According to the National Statistical Committee of the Republic of Belarus, in 2016[16] the share of innovative products in the total volume of produced goods and services remained critically low. Among medium-sized firms, the transport sector was the most innovative, with 70% of all products considered innovative, followed by pharmaceutical production (12%), and electronic machinery (11). In the manufacturing sector only 10% of all products produced by medium-sized enterprises are considered innovative, whilst among small enterprises this share is less than 1%. Among small-sized enterprises the pharmaceutical sector is the most innovative, with innovative products amounting to 9% of the total. In most of the other sectors the share of innovations introduced by small enterprises was negligible or roughly reached 1% of total produced goods and services.

Figure 11. Macroeconomic indicators of SME sector performance, 2016



Source: own calculations based on National Statistical Committee of the Republic of Belarus

Figure 12. Share of exports by destination of medium-sized enterprises, 2016

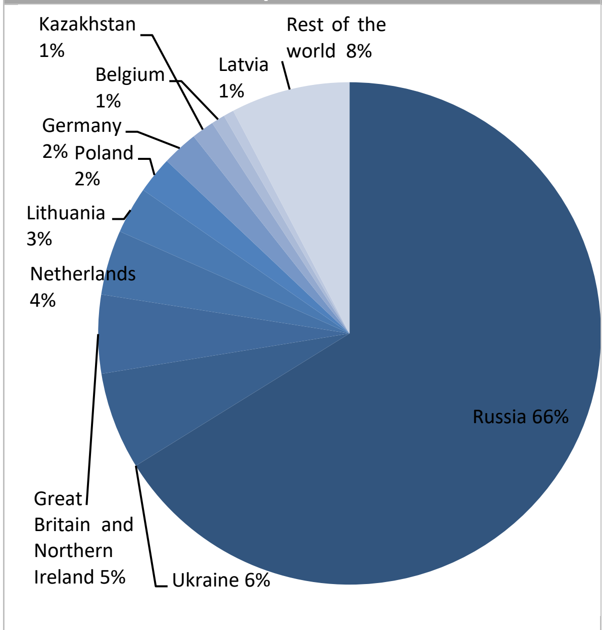
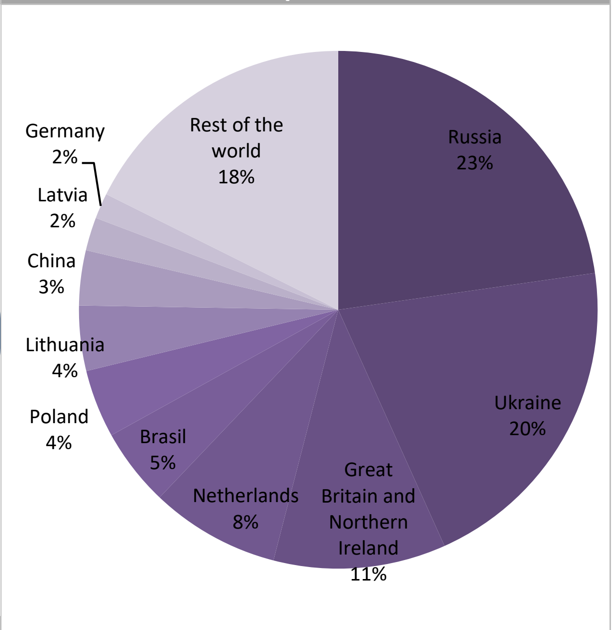


Figure 13. Share of exports by destination of small and micro-enterprises, 2016

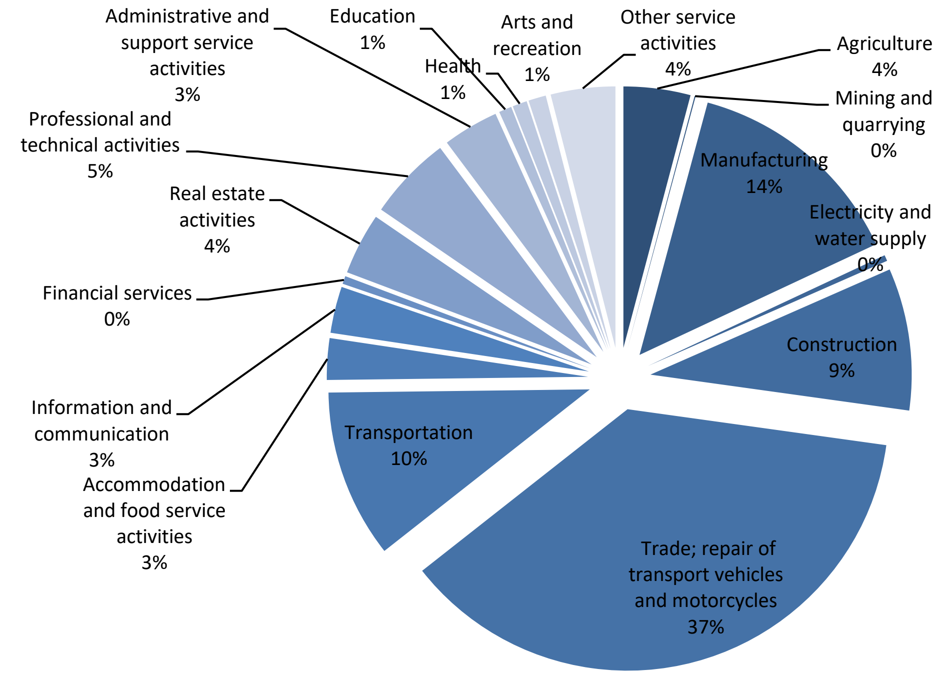


Source: own calculations based on National Statistical Committee of the Republic of Belarus

[16] Statistical Bulletin: "Small and medium-sized business in the Republic of Belarus", 2016

4.2 SMEs' access to finance

Figure 14. Sectoral distribution of SMEs, 2017



Source: own calculations based on National Statistical Committee of the Republic of Belarus

According to the 2013 Business Environment and Enterprise Performance Survey (BEEPS), access to finance scored as one of the most limiting factors in SMEs' development, reflecting the decrease in loan duration. Moreover, 49% of SMEs and 64.1% of young firms reported that they were credit-constrained (the majority reported high interest rates as the main reason). Access to finance needs have been prioritised through the Development Bank (interest rate subsidies) and the "Programme on State Support for Small and Medium Enterprises in the Republic of Belarus for 2013-2015" (programme envelope of USD 38.74m). However, a large gap still remains in tackling SMEs' access to finance according to a more recent survey of SMEs. For example, access to long-term finance and local currency financing are identified by the IPM 2017 survey[17] among the main financing barriers. Bank financing made up the biggest share of SMEs' financing sources. In terms of financial inclusion, 72% of the overall population has a bank account[18]. In rural areas this indicator scores much lower at 46%. However, according to a recent survey[19] the vast majority of customers have a very poor knowledge of financial products and broadly lack financial literacy. Therefore they make use of very basic financial services (such as utility bill payments, etc.). According to Global Findex, around 61% of respondents reported that they receive wages or government transfers into an account. Almost 70% of account holders reported that they use their bank account to pay utility bills. Alternative payment methods are not widespread in Belarus. Less than 5% of the population use mobile phones to pay bills, for secondary education and other similar payments, and only 18% made a transaction from an account at a financial institution using a mobile phone. In the SME sector there is significant account coverage. According to the BEEPS data, 91% of all SMEs have an account at a formal financial institution.

[17] IPM Research Center: Business in Belarus 2017. http://www.research.by/publications/surveys-of-business/1701/

[18] In 2014, Global Financial Inclusion, WB database

[19] Financial Literacy in Belarus: Facts and Conclusions, 2016 https://www.nbrb.by/engl/today/InternationalCooperation/AFI/FinancialLiteracyPopulationFeb2016.pdf

High real estate prices and a lack of available investment resources led SMEs to lease assets. At the same time there are no guarantee funds that could provide security for lending to SMEs. Borrowing procedures remain very time-consuming and require substantial collateral. Furthermore, relatively high interest rates in national currency made long-term financing largely inaccessible to SMEs although interest rates experienced a considerable decline both in national and foreign currency in 2017. These findings are consistent with the IPM 2017 survey. It shows that only 25% of respondents applied for credit, with almost 10% being turned down in 2016. Over 65.5% reported that they were not seeking new credit lines because they did not have the necessary collateral.

In addition, excessively high interest rates in national currency were described as constraints to demand for credit. When it comes to the sources of SMEs' capital investments, the share of own resources among medium-sized firms (47%) is almost double that of small and micro-enterprises (26%). This dynamic is mirrored in the share of credit, which among the latter group accounts for 20.3%, while among the former group the figure is only 9.8%. FDI accounts for around 11% among small and macro units, while among medium-sized firms it is less than 5% (Figures 15, 16).

The share of governmental support is more evenly distributed at 23.3% and 27.9% respectively. However, the picture on the sources of finance for capital investments has changed significantly over the past five years. Compared to 2010, the share of credit in total sources of finance for capital investments has halved among small and microenterprises and decreased threefold (31% in 2010) among medium-sized firms. To the contrary, the share of FDI has substantially increased in both cases by 3% and 1% respectively.

However, the positive dynamic in FDI is not sufficient, as the overall share of FDI in capital investments as well as in the overall economy remains critically low, which substantially reduces SMEs' international competitiveness. Moreover, the dynamics of foreign investment among SMEs show that after a peak in 2014, both FDI and portfolio investments started to decline (Figure 17). The main investors in the Belarus economy are the Russian Federation (51.5% of total investments), Great Britain and Northern Ireland (17.1%), followed by Cyprus (7.3%). Considering the origin of the

Figure 15. Source of capital investments for medium-sized enterprises in 2016

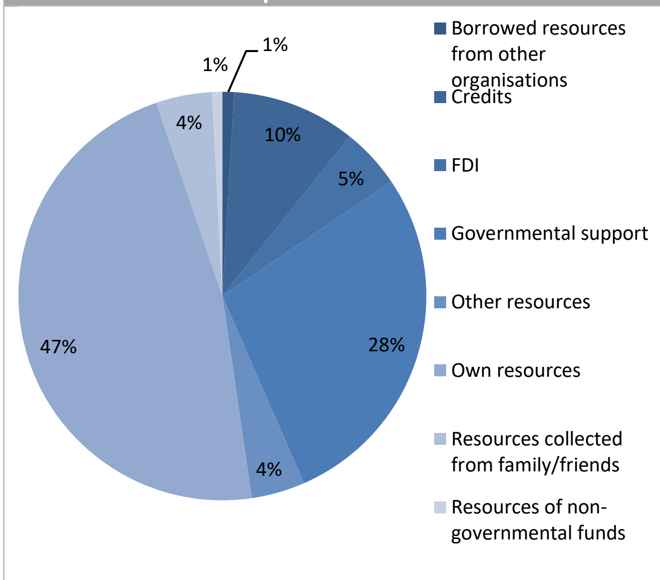
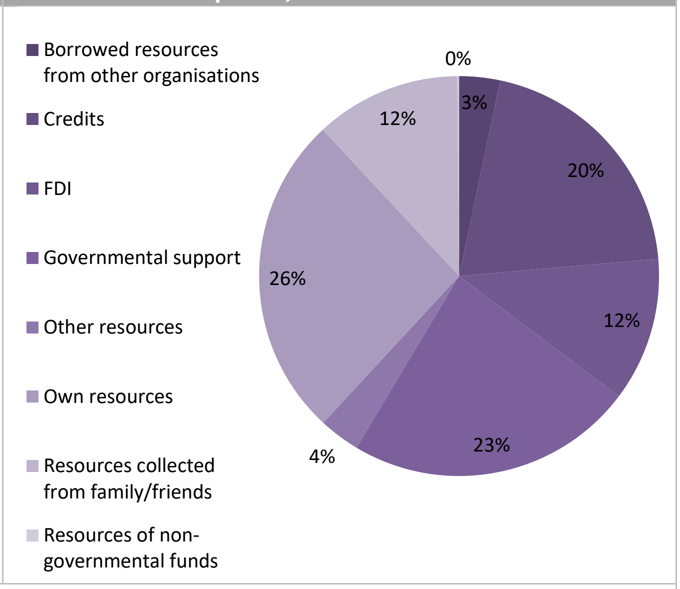


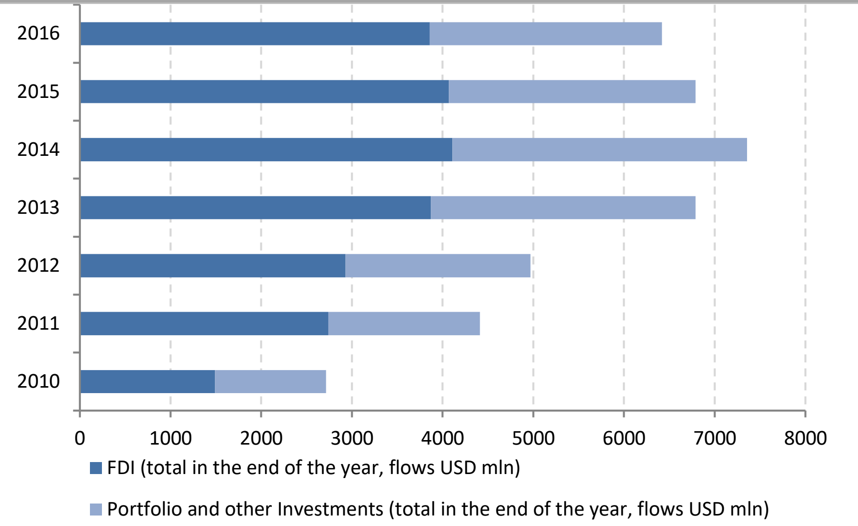
Figure 16. Sources of capital investments for small and micro-enterprises, 2016



Source: own calculations based on National Statistical Committee of the Republic of Belarus investments and significant role of Russia, it could be assumed that the weakened performance of foreign investments reflects the slowdown in Russia's economy.

Despite innovative potential[20] Belarus has underdeveloped venture capital infrastructure. According to the Presidential Decree[21]. The Belarusian Innovation Fund (BIF) is responsible for innovative projects on a repayment basis. However, it provides venture capital only for those SMEs that have SOEs as their customers. Another requirement is profitability of the project, which is set at 40% over the period of its implementation. Direct BIF support for scientific research and innovative projects is also limited exclusively to SOEs.

Figure 17. Dynamics of Foreign Investments in SME sector

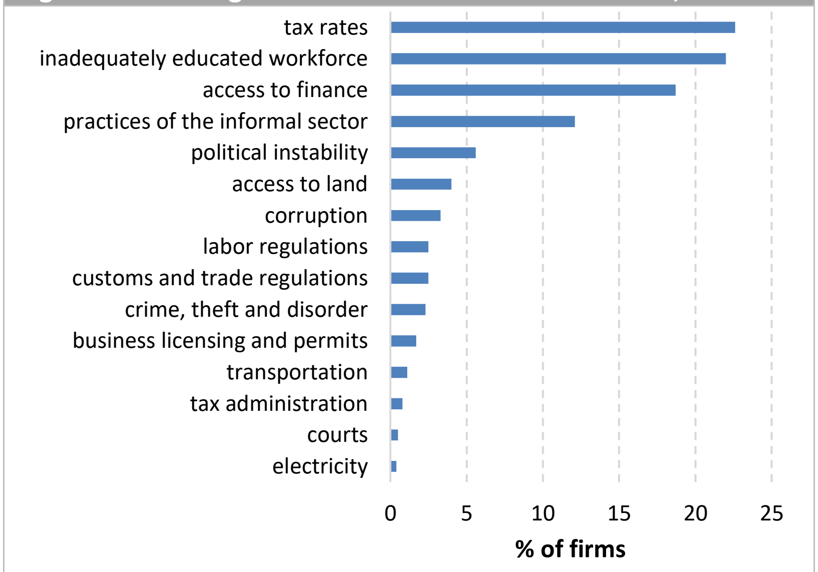


Source: own calculations based on NBRB

4.3 Institutional environment

The authorities started to recognise the private sector's role in economic development with the Presidential Directive on the Development of Entrepreneurship and Stimulation of Business Activity (late 2010). It aimed at reducing a number of bureaucratic requirements for company registration procedure and licensing requirements, and introduced quotas for SMEs in public procurement.

Figure 18. Ranking of Business Environment Obstacles, 2013



Source: own calculations based on 2013 BEEPS

According to the 2013 BEEPS (Figure 18), 26.5% of respondents recognised tax rates as a major obstacle to doing business, followed by an inadequate level of skills (22%). The latter was probably a result of the large outflow of the country's workforce to Russia, driven by significant wage differentials

[20] According to the 2013 BEEPS, new processes were introduced by 21.7% of firms and 18.1% of firms introduced new products, which were above BEEPS average shares of 8.9% and 10.8% respectively.
[21] Basically venture capital is regulated with one Presidential Decree (January 2007) "On approval of the Regulation on the creation of Innovative Infrastructure Entities".

(around 40% on average)[22]. This difference was even higher among the qualified workforce (close to 50% on average). Competition with the informal sector (12.1%) was ranked fourth among the major obstacles. In late 2012 the government addressed a number of the listed issues through the introduction of e-payment systems and simplifications of corporate tax and VAT declarations.

In 2012 Belarus was ranked 69th in the World Bank Doing Business Report and 156th in the tax rate section of the same report. The government's commitment to improve the business environment was reflected in a significant improvement of Belarus's score in the same World Bank Doing Business Report. In 2015 Belarus was ranked 57th in the overall index and 60th in the paying taxes indicators respectively. At the beginning of 2016 the reforms to support SMEs' development were framed under "The National Strategy for Sustainable Development of the Republic of Belarus until 2030" and the state development programme for 2016-2020 "SMEs in the Republic of Belarus". This programme focused on strengthening the business environment, creating a positive image of SME sectors and promoting infrastructure projects for SMEs. As a result of these reform packages, the share of SMEs in total value added is expected to reach 40% in 2020 and 50% in 2030 (from 27.5% in 2016). The programme also foresees an increase in the level of employment to around 42% of the total workforce by 2020 (in 2015 this share was 25.6%[23]). Financing for this USD 317m programme is mainly sourced through the Development Bank. Furthermore, to promote innovations among SMEs and to support start-ups, a guarantee fund is expected to be created in 2018.

According to the OECD Policy Index 2016[24], the main progress in promoting SMEs was achieved in the operational environment, including insolvency procedures, and human capital spheres. Modest progress was observed in establishing an institutional framework and in promoting exports and innovation. Access to finance remained the least reformed sphere, which substantially constrains SMEs' growth potential. These findings are aligned with the 2017 SME survey run by IPM Research Center[25]. It indicates that like in the 2013 BEEPS survey, the majority of the respondents (52%) ranked high tax rates as the main obstacle to doing business. Constantly changing legislation, in particular tax regulations, was ranked third with 39.7%. Almost the same percentage (39.2%) of respondents cited rental prices as a major barrier to doing business.

5. Challenges and Opportunities

Over the past five years Belarus has progressed in leaps and bounds in improving its business environment, reaching 38th place in the WB Doing Business Report 2018 (Russia was ranked 35th and Ukraine 76th). This reflects the authorities' efforts to remove administrative barriers and improve the regulatory environment. At the same time, according to the Heritage Foundation's 2017 Index of Economic Freedom (IEF) Belarus is ranked 104th out of 178 countries. This index assesses the rule of law, government size, economic openness and regulatory efficiency. Belarus's low ranking reflects the country's widespread problems with corruption, unprotected property rights and ineffective judiciary system. Overall, this suggests that some progress in promoting vibrant private entrepreneurship,

[22] Data on wage differentials: 2013 BEEPS on Belarus

[23] Does not include individual entrepreneurs

[24] OECD Policy Index: Eastern Partner countries 2016 http://www.oecd.org/development/sme-policy-index-eastern-partner-countries-2016-9789264246249-en.htm

[25] Respondents could choose up to five items out of 22 presented

including the SME sector, has been made. However, the overall economic environment remains challenging.

Belarus's authorities started to recognise the role of the private sector in economic development with the Presidential Directive on the Development of Entrepreneurship and Stimulation of Business Activity (late 2010). It aimed at reducing a number of bureaucratic requirements for company registration procedure and licensing requirements, and introduced quotas for SMEs in public procurement, thus facilitating the enhanced growth potential of SMEs in a largely state-dominated country. Recently Belarus has expressed interest and the political will to open its markets to external competition (including interest in joining WTO). This therefore calls for a strengthening of the capacity of the SME sector to compete in international markets. However, Belarus's education system offers a very limited number of post-graduate programmes focusing on entrepreneurship or business administration[26]. In recent years few initiatives have been launched to promote entrepreneurship, particularly among youth – see "Business Start 2014" initiative and "Export=Success", for instance. A similar landscape is detectable in the realm of women entrepreneurship. Gender equality has been declared a state priority, specifically in the SME segment. However, this has not yet been translated into concrete policy actions. Moreover, the absence of official statistics regarding gender distribution in business precludes the assessment of the state of equality/inequality in different sectors of the economy.

Alongside tax rates, the informal sector and mismatches in the labour force, access to finance has been detected as one of the most limiting factors in SMEs' development[27]. Moreover, a large share of SMEs and young firms are credit-constrained, with high interest rates being described as the main limiting element. Accordingly, access to finance needs have been prioritised through the Development Bank (interest rate subsidies) and the "Programme on State Support for Small and Medium-Sized Enterprises in the Republic of Belarus for 2013-2015". While bank-based financing makes up the biggest share of private-sector and SME financing, large gaps still persist. Access to long-term finance, local currency financing and high interest rates are identified[28] among the main financing barriers to private sector development. In addition, borrowing procedures remain time-consuming and require substantial collateral. For example, a large share of SMEs do not seem to be seeking new credit lines because they perceive that they do not have the necessary collateral. Last but not least, tentative evidence of discouraged SMEs has also been identified whereby only a quarter of SMEs from a surveyed sample applied for credit in 2016.

Against this backdrop, several opportunities emerge to tap the recurrent financing needs of the private sector at large, including the SME segment.

- Access to finance represents a constraint for companies, particularly SMEs. The share of credit-constrained SMEs is high. Many of them are discouraged even from applying due to high interest rates, complex procedures, the lack of requested collateral and low financial literacy.
- Local currency instruments to support SMEs are limited, especially for longer-term maturities.
- Moreover, high interest rates and a general lack of long-term finance both in local and foreign currency represent major constraints to SMEs' development, especially for young firms.

[26] Belarus formally joined the Bologna Process only in 2015

[27] 2013 Business Environment and Enterprise Performance Survey (BEEPS) and IPM 2017 survey – IPM Research Center: Business in Belarus 2017. http://www.research.by/publications/surveys-of-business/1701/

[28] IPM Research Center: Business in Belarus 2017. http://www.research.by/publications/surveys-of-business/1701/

- Banks are the main source of external funding to SMEs, mostly through loans. Non-bank finance and capital markets are underdeveloped. Therefore, support for the development of alternative sources of finance and services is also needed.
- Banks' activity is also partially limited by the considerable state dominance on both the funding and lending side, with SOEs being a large contributor of revenues and also a direct and indirect source of funding. Therefore, enhanced differentiation in funding sources is needed.
- Funding for SMEs and the private sector at large should be seen as complementary to domestic public sector sources, also taking into account the relatively limited availability of local funding and support programmes.
- Technical assistance and advisory services for SMEs could increase their bankability through enhanced financial literacy, improved business planning capacity and best management practices.

Annexes

A. Selected statistics for the Belarus economy

Indicators	2011	2012	2013	2014	2015	2016	2017F
Nominal GDP (USD bn)	61.8	65.7	75.5	78.8	56.5	47.4	51.8
GDP per capita (PPP basis, USD)	17 153	17 801	18 276	18 916	18 364	18 073	-
Real GDP (% change)	5.4	1.9	1.3	1.2	-3.7	-2.6	1.5
Inflation (CPI, % change Dec./Dec.)	108.7	21.8	16.5	16.2	12	10.6	4.7
Nominal Exchange Rate (local currency per USD, Dec.)	0.84	0.86	0.95	1.18	1.86	1.96	2
Gen. Gov. Financial Balance/GDP	-2.8	0.4	-1	0.1	-2.2	-3.4	-5.6
Gen. Gov. Debt/GDP	53.9	37	36.9	39.5	53.3	53.9	58.8
Gen. Gov. Debt/Gen. Gov. Revenue	143.7	94.3	92.5	101.5	129.2	126.1	141.6
Gen. Gov. Int. Payments/Gen. Gov. Revenue	2.2	2.8	2	2.3	3.6	4.3	4.3
Current Account Balance/GDP	-8.2	-2.8	-10	-6.6	-3.2	-3.5	-2.5
Short-term External Debt/Total External Debt	39.5	34.4	35.5	32	30	28.3	27
External debt stocks, total (DOD, current USD bn)	33 932	33 755	39 573	40 013	37 934	37 515	38 975
External Debt/GDP	55.1	51.4	52.5	50.8	67.8	79.1	78.7
Total reserves minus gold (current USD bn)	6.01	5.8	4.93	3.42	2.74	3.2	6.1
Interest Paid on External Debt (USD bn)	0.91	1.15	1.08	1.12	1.24	1.26	1.2
Amortization Paid on External Debt (USD bn)	3.25	5.03	4.67	5.35	5.35	5.94	5.55
Net Foreign Direct Investment/GDP	6.3	2	2.6	2.3	2.7	2.4	2.9
Source: Moody's country statistics							

B. Prudential ratios of the Republic of Belarus

Ratio	Criteria
Capital adequacy ratio (as a % of risk-weighted assets)	≥ 10%
Liquidity Liquid assets to total assets Instant liquidity (ratio of assets on demand to liabilities on demand) Current liquidity (current assets to current liabilities)	 ≥ 20% ≥ 20% ≥ 70%
Reserve requirements Reserve requirements (funds attracted in national currency) Reserve requirements (funds attracted in foreign currency)	 ≥ 9% ≥ 13%
Net open foreign currency position (as a % of regulatory capital)	≥ 20%

C. Key banking regulations

Category	Brief description
Financial reporting standards	Since 2017 Belarus has complied with IFSR for the consolidated financial statements of all public interest entities. In 2016 the Belarus Council of Ministers and the National Bank of the Republic of Belarus formally adopted Act 657/20 specifying IFSR.
Corporate governance standards	The corporate governance framework in Belarus is regulated by the Regulation on Organisation of Corporate Governance in Banks, Non-Banking Credit Organisations and the Regulation on the Activities' Disclosure of Banks, Non-Banking Credit and Financial Institutions, Banking Groups and Bank Holding Companies. Banks are required to have an internal control framework in place. Banks are required to have an audit committee (which must be chaired by an independent director). Furthermore, banks are required to have at least two independent directors on their board; however, there is no clear definition of independence.
Ownership restrictions	There are certain restrictions with regard to the presence of foreign capital in the banking system. The National Bank of Belarus has established a 50% quota (limit) for foreign participation in Belarusian banks. This quota is determined as a ratio of total foreign capital in charter funds of all banks registered in Belarus. Therefore it applies at aggregate level. The National Bank would deny registration of banks with foreign investment once the quota for foreign ownership in the banking system is reached.
Capital adequacy requirements	Since 1 January 2016, regulatory capital has been calculated in line with the international standards of Basel III (the first official data on calculation in line with the new approaches was obtained as at 1 February 2016). Credit and market risks are measured with standardised or basic indicator approaches. NBRB strengthened provisioning requirements for unhedged FX borrowers, and introduced higher risk weights for banks' exposures to systemically important borrowers (accounting for over 10% of the banking sector's aggregate capital).
Minimum capital requirements	The minimum capital requirement for a bank is BYN 52.06m (as of 01.01.2018).
Definition of NPL	Loans past due for over 90 days, high-risk loans, prolonged and overdue loans up to 90 days as well as term loans to borrowers with signs of financial instability.
Deposit insurance	Deposit insurance is executed by the Agency of Deposit Compensation of Belarus. The Deposit Insurance Agency Mandate concept is currently being reformed.
Provisioning requirements	Since 2014, the provisioning floor for loans in Risk Category II was set at 5% and in Category I at 0.50%; the risk weight of foreign currency government and national bank securities at 10% and for foreign currency loans at 100%; and the amortisation of intangibles from capital to aid banks in capitalising technological upgrades is suspended until 2019. NBRB prepared a draft version of the new Instruction on Provisioning, which defines restructured debts as those that had changes in the terms of the contract, and require that they be classified as Risk Category IV or below the level at which they were included before the restructuring, and provisioned for as required. Banks can reclassify the restructured loans to a lower risk category.
Reserve requirements	The minimum reserve requirement with NBRB is 4% for BYN resources and 17% for FX resources.
Related party transactions	On 22 August 2017, the Ministry of Finance of the Republic of Belarus introduced the draft law "On Introducing Additions and Amendments to Certain Laws on Tax and Accounting Issues". Accordingly, related party transactions will be recognised under its framework. The Law became effective as from 1 January 2018.

D. Selected references from national / international institutions

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ECONOMICS – REGIONAL STUDIES

Republic of **Belarus**

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