Eurasian Development Bank

Manager of the Eurasian Fund for Stabilisation and Development Resources

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Review of the Report by the Ministry of Finance of the Republic of Belarus on Compliance with Conditions of the First Tranche of the EFSD Stabilization Credit

In accordance with the decision of the EFSD Council of 8 December 2015 (Minutes No. 24), the Manager and the Republic of Belarus have finalised the Economic Policy Reform Matrix of the Government and the National Bank of the Republic of Belarus, adding to the package of measures in the framework of the first tranche 17 measures to demonstrate the launch of deep structural reforms. All in all, the first tranche envisages 26 conditions—against 9 conditions envisaged in the previous version of the Matrix—11 of which bear the status of control targets.

The conditions set in the framework of the first tranche focus on bringing down the inflation and sustained replenishment of gross international reserves through consistent implementation of tight monetary and fiscal policies. The Matrix envisages containment of the net domestic asset and base money growth to optimise money supply and maintain a positive refinancing rate. In their turn, fiscal policies focus on containment of the augmented budget deficit, *inter alia* by reducing subsidies as a result of raising the utility and transportation cost recovery through tariffs and reducing directed lending, and limiting the nominal wage bill growth. The key additional conditions under the first tranche include liberalisation of prices for socially important goods, lifting gross mandatory targets, more significant reduction of directed lending, and developing a framework for public private partnerships.

In general, the Manager notes the improved quality of the economic policies followed by the authorities in 2015 and so far in 2016. These measures, supported with flexible foreign exchange policies, have contributed to lowering the inflation in the RB to 12% as at end-2015 compared to 16.2% as at end-2014.

By 1 March 2016 (the control date for the first tranche review), all the conditions for the first tranche had been met, except for one indicative target, envisaging mobilisation of new loans in an amount not exceeding half of the annual public debt repayment needs. The actual public borrowing in January-February 2016 made 91,4% of repayments.

Based on the results of the review and taking into account the fact that all of the control targets have been met, the Manager recommends to disburse the first tranche of the EFSD stabilization credit to the Republic of Belarus in the amount of US $500 million.

Status of compliance with conditions for the first tranche of the EFSD financial credit

I. Macroeconomic stabilisation

This package of measures aims at bringing down the inflation and raising the national savings through implementation of balanced monetary, foreign exchange, and fiscal policies, as well as improving the efficiency of domestic demand.

Anti-inflation measures and price stability gain importance against the background of the two-digit inflation experienced by the RB over the last 5 years. High inflation—and, thus, high depreciation—expectations make the economy less efficient due to stronger overall uncertainty, extremely high real interest rates and a high rate of dollarization[1]. The high inflation rates are fuelled by the significant accumulated gap between real wages and labour productivity (245% to the level of 2000) and directed lending. The resulting unbalanced growth of the unit cost in gross output is a fundamental factor contributing to weaker competitiveness of the Belarusian economy and creating pressure on the exchange rate.

Target 1.1. The gross international reserves (GIR) should be at least US $4.1 billion (equivalent to 1.5 months of imports) – a control target.

Status: met.

According to the NBRB’s analytical review as at 1 March 2016, the GIR made US $4.1 billion or 1.5 months of imports (compared to 1.3 months of imports as at the beginning of March 2015).

Building up the GIR measured in months of imports is essential for improving the resilience of the RB to external shocks in the environment of a persistent CA deficit[2], decelerating capital inflow, high levels and burden of external debt service, and deep-rooted depreciation expectations.

In 2015, the external and domestic foreign exchange debt repayment and service reached US $3.5 billion or 69.5% of the GIR as at the start of 2015. That was nearly fully financed with new foreign exchange borrowing totalling US $3.3 billion. In 2016, the amount of foreign exchange required for these purposes will make US $3.3 billion or 72% of the GIR as at the start of 2016. Going forward, the practice of refinancing debt primarily with new borrowings is to be discontinued as the authorities approved their new Public Debt Management Strategy for 2015-2020 in mid-2015 (see the status for target 1.15).

In the context of the limited access to borrowing in external markets, the transition of the NBRB to the two-way continuous auction regime used for setting the exchange rate and the monetary targeting policy aimes at facilitating replenishment of GIR. That helps minimise interventions in the foreign exchange market, which are used only to avoid sharp exchange rate fluctuations.

Thanks to the measures taken by the NBRB, the GIR have been stabilised at the level of US $4.6 billion since March 2015 that resulted in lower depreciation expectations: the spread between the rate of return for household deposits in rubels and freely convertible currencies was 20.2% in January 2016 compared to 37.9% a year earlier. For the first two months of 2016, the

[1] The rate of dollarization of deposits is 74.5%.

[2] In 2010, 2011, 2013, and 2014, the CA deficit was correspondingly 15% of GDP, 8.5% of GDP, 10% of GDP, and 5.6% of GDP, exceeding US $5 billion.

GIR declined by US $65 million due to that fact that the NBRB repaid its liabilities to banks under forward contracts in the amount of US $186 million. This reduction of reserves was to a large extent off-set by rising gold prices, therefore the GIR decline since the beginning of the year has been not so significant. The improvement of this indicator from 1.3 months of imports in March 2015 to 1.5 months of imports as at end-February 2016 was achieved due to a significant reduction of imports against the background of worsening terms of trade, decelerating capital inflow, exceeded external debt ceilings, and significant domestic debt growth.

Target 1.3. The net domestic assets (NDA) (at the programme exchange rate) should be no more than BYR 74 trillion – a control target.

Status: met.

According to the NBRB's analytical reviewas at 1 March 2016, the NDA made BYR 68 trillion.

This measure focuses on maintaining tight and consistent fiscal and monetary policies with the aim to ensure balanced domestic demand.

Implementing tight and consistent economic policies gained importance in the environment of strong national currency depreciation in early 2015 in response to the Russian rouble depreciation[3]. Higher money supply in the economy in that environment could significantly strengthen the pressure on the foreign exchange market against the background of high depreciation expectations: the spread between the interest rates for household deposits in rubels and freely convertible currencies was 37.9% in January 2015; the interest rate for domestic currency household deposits was 43.4%.

Monetary policy tightening, *inter alia* through reduction of the NBRB's lending to commercial banks and its asset operations to withdraw excess liquidity from the economy, combined with the budget expenditure consolidation and reduction of the augmented budget deficit, contributed to meeting the target.

Target 1.4. The reserve money (at the programme exchange rate) should be no more than BYR 46 trillion – an indicative target.

Status: met.

According to the analytical review prepared by the NBRB, the reserve money was BYR 41.5 trillion as at 1 March 2016 compared to BYR 38.7 trillion as at the start of March 2015.

Meeting this target helps reinforce the effect of the anti-inflation measures. This condition was met through containment of the NDA growth. Tight monetary policies facilitated the reduction of inflation in 2015 to 12% compared to 16.2% in 2014. The inflation deceleration trend continued in January and February 2016: net of utility tariff hikes, prices grew by 1.1% in January 2016 compared to 2.0% in January 2015, and by 0.9% in February 2016 compared to 1.3% in February 2015.[4]

[3] In January 2015, the depreciation was 30%.

[4] The inflation including tariff hikes was 1.8% in January 2016 against 2.4% in January 2015, and 2.9% in February 2016 against 1.7% in February 2015.

The Manager welcomes the measures taken by the RB to limit the base money, noting, however, that the inflation deceleration in 2015 was also a result of lower international prices, and to reach the targeted inflation level in 2016, the NBRB may need to set a tighter limit on base money growth against the background of price liberalisation, continued high inflation expectations, and uncertainty in external markets. The Economic Policy Matrix envisages that over the period of the programme supported by the credit, the base money growth will be only a result of growth of required reserves for foreign exchange deposits due to Belarusian rubel depreciation.

Target 1.5. The broad money supply growth (at the programme exchange rate) should be no more than 0% – an indicative target.

Status: met.

The money supply has declined at the programme exchange rate by 2.7% since the start of 2016.

It is important to avoid excessive money supply growth as there is still a significant monetary overhang resulting from the accumulated gap between the rates of growth of real wages and labour productivity, high inflation and depreciation expectations, and declining demand for money against the background of recession. Over the last 5 years, the RB has had two-digit inflation that reflects persistent excess money supply. High and volatile rates of inflation distort price signals in the economy, strengthen the uncertainty risks, virtually fully setting off the effects of policy measures aimed at promoting economic growth, and bring down the country's investment attractiveness.

Target 1.6. No multiple exchange rate practices – an indicative target.

Status: met.

There are no multiple exchange rate practices. In 2015, some small differences between the exchange rates in the over-the-counter and cash foreign exchange markets and the official exchange rate were observed over the periods of high depreciation—in January, when the depreciation reached 30%, and in August, when the Belarusian rubel depreciated vis-à-vis the US dollar by 15%. Otherwise, the exchange rate differential did not exceed 2%.

This measure aims at creating a level playing field for all market participants and is an important prerequisite for reducing depreciation expectations and accumulating the GIR.

In the past, the RB regularly faced multiple exchange rates. For instance, over most of 2011, the NBRB maintained a fixed exchange rate and made no interventions to support it that resulted in a big difference between the official and the cash exchange rates. In 2013, the IMF also noted significant deviations of the over-the-counter exchange rate from the official one that was a result of restrictions on the amount of foreign exchange that could be sold in the over-the-counter market – no more than US $1,000. Multiple exchange rates were also observed at end-2014, when the legislation fixed a 30% fee on foreign exchange purchases.

This measure has been implemented by means of discontinuing various restrictions on foreign exchange conversion. The Manager stresses the importance of having no multiple exchange rate practices in future.

Target 1.7. Introduction of a two-way continuous auction mechanism for exchange trading – an indicative condition.

Status: met.

The NBRB introduced a two-way continuous auction mechanism for the formation of the official exchange rate on 1 June 2015. Under this mechanism, requests for foreign exchange purchase and sale are filed throughout the trading sessions organised by the Belarusian Currency and Stock Exchange OJSC, while deals are closed if there are offsetting requests in the trading system to satisfy the conditions.

This measure is aimed at transition to a floating exchange rate, which pattern should follow changes in the fundamental factors. Such policies would facilitate elimination of external imbalances by generating adequate price signals in the foreign exchange, money, and commodity markets.

The introduction of the two-way continuous auction mechanism has helped develop a platform for transition to a floating exchange rate regime and reduce—according to the NBRB—interventions made to support the exchange rate that has promoted some accumulation of the GIR in mid-2015.

The Manager welcomes transition to the flexible exchange rate policies, noting, however, that the capacity of this regime would be fully utilised on condition of mainly market-based pricing in all the other markets. At the moment, the exchange rate is still above its equilibrium level and is supported with high real interest rates that is largely explained by continued significant subsidised directed lending.

Target 1.8. Introduction of a framework of bank liquidity regulation instruments consistent with the monetary targeting regime – an indicative condition.

Status: met.

On 13 May 2015, the NBRB switched to the monetary targeting regime in implementing its monetary policies. In this framework, the key instrument of achieving the inflation target is control over money supply using an established money supply growth objective.

This measure will help improve the efficiency of fighting inflation, which is still one of the core challenges of the economy of the RB, while maintaining the necessary level of liquidity at commercial banks.

The NBRB regulates the money market by changing the volume of its operations of regulating liquidity in the banking system. The level of interest rates both in the money market and in auctions of the NBRB is determined by market factors taking into account the liquidity available to banks.

Introduction of this instrument has had a positive effect from the point of view of inflation deceleration in 2015.

Target 1.9. A decision should be taken on changing the refinancing rate taking into account the actual pattern of interest rates in auctions of the National Bank[5], interest rates in the

[5] The NBRB's operations to provide liquidity.

interbank market and with the objective of minimising interventions to support the exchange rate.

Status: met.

In the environment of still high depreciation expectations, the refinancing rate remains high at the level of 11-13% annual in real terms. Other interest rates (in the interbank market, for instruments of the NBRB, in the loan and deposit market) also remain at a high level. The lack of sustainable GIR growth does not allow yet to state that depreciation expectations are going down.

This measure aims at reducing the volume of directed lending and containing the pressure of the monetary overhang on inflation and exchange rate. The high share of directed lending results not only in pressure on the balance of payments, but also in a higher cost of credit resources for other market participants and lower efficiency of the interest rate channel of monetary policies.

On 9 January 2015, the refinancing rate was raised to 25% annual and has remained at this level since then. The average overnight interest rate in the interbank market for loans in domestic currency declined from 45.2% in January 2015 to 29.6% in January 2016. In 2015, the average weighted interest rates for auctions to mobilise liquidity were within the range of 20-28% annual, and those for auctions to provide liquidity were around 30% annual.

Tight interest rate policies in the RB have resulted in lending going down by 7.1% in 2015 at the programme exchange rate compared to growth by 7.3% in 2014. Maintaining the refinancing rate at a level close to the auction rate has helped avoid creation of preferential terms for enterprises getting loans under state programmes.

The Manager notes that on 16 March 2016, the NBRB Board adopted a decision to reduce the refinancing rate to 24% starting from 1 April 2016. As this decision is not associated with lower interest rates in the interbank market and for auction operations, and information on the volume of interventions has not been provided by the Belarusian counterparts, the Manager is concerned about that and stresses that failure to comply with this condition as of the control date for the second tranche can result in changing the status of this target from indicative to control. Taking into account the acceleration of the 12-month inflation from 11.4% in January 2016 to 12.8% in February 2016 compared to 17.1% and 16.7% correspondingly in January and February 2015 due to utility tariff hikes, and lack of prerequisites for sustainable GIR growth and reduction of foreign exchange interventions observed currently in the economy, the Manager is of the opinion that the refinancing rate reduction was premature.

Target 1.10. Liquidity support should be provided to banks by the NBRB performing its lender of last resort function at interest rates not lower than the refinancing rate of the NBRB – a control target.

Status: met.

According to the information posted on the website of the NBRB, the interest rates for operations of providing liquidity were maintained above the refinancing rate throughout 2015.

This measure controls the efficiency of the NBRB's managing the current liquidity. As the NBRB performs the function of the lender of last resort, its loans should be the most expensive for the economy, as the lending capacity of the NBRB is actually limited only by demand. It is essential to avoid situations when the NBRB is lending to the economy at a rate below the interbank market rate as that can point at the fact that the NBRB extends preferential loans to individual banks.

This measure has helped maintain an acceptable level of liquidity in the economy and create a level playing field for all banks.

Target 1.11. The republican budget should be formed with a surplus equivalent at least to the amount of export customs duties from crude oil and selected oil products exported from the territory of the RB outside the customs territory of the Customs Union – an indicative target.

Status: met.

Under Law of the Republic of Belarus No. 341-Z of 30 December 2015 *On Republican Budget for 2016*, the republican budget surplus is to reach BYR 17.2 trillion. According to article 14 of the Law, the export customs duties from crude oil and selected oil products exported from the territory of the RB outside the customs territory of the Customs Union should be used to make payments in foreign currency related to public debt repayment and service.

According to the RB MoF, the amount of export duties on crude oil and oil products was BYR 23 trillion in 2015, while the republican budget surplus was BYR 24.8 trillion or 2.9% of GDP.[6] In January-February 2016, the budget received BYR 2.1 trillion of export duties, while the consolidated budget surplus was BYR 5.3 trillion.

This measure primarily aims at maintaining the GIR and improving the country's debt sustainability. Export duties on oil products produced from Russian oil, which used to be transferred to the budget of the RF, have been retained in the budget of the RB since the start of 2015 and are used exclusively for the purposes of public debt service. The Manager sees that as a step in the right direction. This decision also facilitates budget consolidation, reduction of the augmented budget deficit, and optimisation of domestic demand to slow down inflation.

Target 1.12. The augmented general government budget balance, including net lending of the Development Bank, should be zero for January-February 2016 – control target.

Status: met.

Based on the Manager's calculations, the augmented general government budget surplus, including net lending of the Development Bank, was 4.6% of GDP in January-February 2016.

Setting the limit for the augmented budget deficit is aimed at consolidation and improved efficiency of budget expenditures and public debt reduction.

[6] The RB MoF data on the actual surplus adjusted upwards by the amount of BYR 8.9 trillion, which is reflected in budget expenditures as targeted budget loans to machine-building enterprises to repay their debts to banks under state programmes. The source of financing these expenditures were the resources of the RB MoF generated through sales of government long-term bonds to the banks holding the enterprises' bad debts and not reflected in the revenue part of the budget.

The high level of the augmented consolidated budget deficit observed in the RB in recent years—around 4.8% of GDP on average in 2010-2014—is primarily determined by the large volumes of off-balance sheet budget expenditures aimed at supporting state-owned enterprises (state programmes financed with government deposits, execution of government guarantees under government borrowings, replenishment of statutory funds of state-owned enterprises, and recapitalisation of commercial banks). The significant scope of these expenditures resulted in lower budget deposits (including those in foreign exchange) and higher government borrowing. In 2015, the augmented general government budget deficit, including net lending of the Development Bank, was 0.5% of GDP compared to 2% of GDP in 2014, but that was achieved exclusively owing to additional revenues, mostly in the form of export duties on oil and oil products paid to the budget, and not owing to cutting off-balance sheet expenditures.

The objective of improving the budget sustainability and replenishing the GIR and Government deposits calls for further reforms aimed at budget expenditure consolidation. The structural reforms supported with the EFSD stabilization credit cover commercialisation of state-owned enterprises, improvement of the utility and transportation cost recovery through tariffs for households, as well as reduction of lending under state programmes and containment of growth of wages of budget sector employees that would help reduce budget expenditures, including off-balance sheet ones. Nevertheless, the sharp increase of government guarantees for external borrowing extended in 2015—US $1.6 billion that is 3.8 times the amount of 2014—poses significant risks of growth of off-balance sheet expenditures of the budget in 2016 related to execution of these guarantees against the background of recession and worsening financial position of the borrowers.

Target 1.13. The 2016 budget expenditures on wages of budget sector employees should be limited by the targeted inflation level of up to 12% – control target.

Status: met.

The Council of Ministers of the RB adopted a regulation dated 21 January 2016 introducing provisions, which limit increases in grade wages and extra payments to wages for budgets of all levels (republican and local). The revised annual wage bill of the consolidated budget for 2016 envisages its increase by 11.9% in nominal terms against its actual level of 2015.

The measures to limit the wage bill growth aim at stabilisation of the economy. This condition becomes even more important in the context of price liberalisation efforts, when any increase of the payable demand can result in another surge of inflation.

The regulation adopted by the Council of Ministers focuses on ensuring implementation of measures agreed in the Matrix to comply with wage thresholds. The Belarusian legislation provides for certain independence of local governments both in budget formulation and in using saved budget resources, *inter alia* to finance a range of additional payments to wages and bonuses allowed by the legislation[7]. Due to that, the rate of growth of the wage bill of local budgets of 19.1% in 2015 was significantly higher than that of the republican budget of 14.5%, resulting in growth of consolidated budget expenditures on wages by 17.5%. The regulation

[7] These are mainly provisions of Ordinance of the President No. 29 of 26 July 1999 (as amended in 2012) *On Additional Measures to Improve Labour Relations, Strengthen Labour and Performance Discipline*.

limits growth of wages at all levels of the budget system that significantly improves the probability of meeting the targets planned for subsequent tranches and envisaging the wage bill growth for the whole consolidated budget within the limits of targeted inflation in 2016-2017.

Target 1.14. Amendments aimed at reducing tax preferences should be introduced to the tax legislation – an indicative target.

Status: met.

Amendments made to a range of legislative acts in December 2015 envisage reduction of preferences under a number of taxes, including elimination of VAT preferences for electricity and gas supply to households, raising property tax rates, as well as rates of a resort fee.

The measure aims at improving the budget sustainability in the context of a worsening external market environment and decelerating economic activity. Some estimates show that elimination of these tax preferences can improve budget revenues by BYR 1.5 trillion or 0.15% of GDP.

Target 1.15 (1). Unconditioned implementation of the Public Debt Management Strategy of the Republic of Belarus in 2015-2020, including:
- the annual mobilisation of non-project related government loans[8] a as a rule does not exceed half of the annual need of public debt repayment – an indicative target.

Status: not met.

This measure included into the Public Debt Management Strategy of the RB for 2015-2020[9] aims at bringing down the level of the country's public debt and improving its external investment position.

During two months of 2016, the Government of the RB engaged only in borrowing in the domestic market in the amount of BYR 7.8 trillion. Domestic debt repayments totalled BYR 6.4 trillion. External debt repayments were US $102.3 million (equivalent to BYR 2.1 trillion). The ratio of public debt mobilisation to repayment was 0.9. The Manager is concerned about the failure to comply with this condition. Under the agreements reached, failure to meet this target for the second tranche can result in reclassifying this indicator as a control one.

While the total need for public debt repayment was equivalent to BYR 56.8 trillion (6.5% of GDP) in 2015, the RB MoF mobilised new borrowing in the amount equivalent to BYR 67.0 trillion (7.7% of GDP) that makes 118% of the amount to be repaid. This ratio was 41% for external debt and 213% for domestic debt.

In 2015, the domestic public debt[10] grew from 16.6% of GDP to 22.7% of GDP that is somewhat below the national security threshold (25% of GDP).

The domestic public debt increased from 5.7% of GDP in 2014 to 9.8% of GDP as at end-2015. The high rates of domestic debt growth were a result of issuing new debts, a

[8] For the purposes of this document, non-project related loans signify loans not associated with implementation of investment projects with a significant import component.
[9] Approved by the RB Government on 17 March 2015.
[10] Less the SDRs.

significant part of which was used to address financial difficulties of state-owned enterprises, as well as depreciation, taking into account that about 83% of domestic debt is foreign currency denominated. To stabilise the financial position of a number of enterprises in 2015, domestic foreign currency denominated bonds were issued in an amount equivalent to BYR 22.8 trillion (US $1,361.1 million and BYR 2,152.9 billion) that makes 2.6% of GDP. With this borrowing not taken into account, the ratio of government loan mobilisation to public debt repayment was 73.7% in 2015. These funds were fully used for public debt repayment.

Target 1.15 (2). Unconditioned implementation of the Public Debt Management Strategy of the Republic of Belarus in 2015-2020, including:
- using the export customs duties from crude oil and selected oil products exported from the territory of the RB outside the customs territory of the Customs Union to make payments in foreign currency related to public debt repayment and service – an indicative target.

Status: met.

In January-February 2016, export customs duties received by the budget from oil and oil products were BYR 2.1 trillion (US $0.1 billion or 1.5% of GDP). The non-augmented consolidated budget surplus for that period was BYR 5.3 trillion.

II. Goods and services market reforms and reduction of state support

This package of reforms is aimed at developing market pricing mechanisms to ensure efficient allocation and use of commodity, financial, and labour resources and improve the competitiveness of the Belarusian economy. Specific measures to meet the objective include price liberalisation, raising utility and transportation tariffs for households to achieve the level of full cost recovery in the medium-term perspective, as well as reduction of the share of lending under state programmes in total bank lending as its scale is a fundamental factor of structural imbalances distorting pricing in the money, foreign exchange, and commodity markets.

Target 2.1. A decision should be adopted by the Government to create an independent anti-monopoly authority – a control target.

Status: met.

On 18 January 2016, the Council of Ministers of the RB adopted Resolution No. 28/2 *On Package of Measures to Address Issues of Social and Economic Development of the Republic of Belarus in 2016 and Ensure Macroeconomic Balance*. This resolution includes the decision of the Government to create an independent anti-monopoly authority. In accordance with instruction of the Council of Ministers of the RB No. 32/102-45/1791r of 11 February 2016, the Ministry of Trade is drafting a Decree of the President of the Republic of Belarus envisaging creation of an anti-monopoly ministry on the basis of the Ministry of Trade through delegation thereto of additional functions of competition development and anti-monopoly regulation. The relevant draft Decree is to be presented to the Council of Ministers of the RB in March 2016.

This measure aims at preparing the ground for creating an independent anti-monopoly authority with its core functions including facilitation of formation of market relations based on developing competition and entrepreneurship, prevention and restriction of monopoly activity and unfair competition, *inter alia* through controlling monopoly prices, and state control over compliance with the anti-monopoly legislation.

Target 2.2. Adoption of a Resolution on full elimination of regulation of prices and trade mark-ups for socially important goods specified in Resolution of the Government No. 35 of 17 January 2014, except for fruit and vegetables, solid fuel, fuel briquettes, and fuel wood for households – a control target.

Status: met.

On 11 January 2016, the Council of Ministers of the RB adopted Resolution *On Making Amendments and Addenda to Resolution of the Council of Ministers of the RB No. 35 of 17 January 2014*. This resolution abolishes regulation of prices on all socially important goods, except for fruit and vegetables and some types of fuel for households.

This measure is aimed at eliminating the practice of administrative control over prices and setting relative prices based on market signals. The practice of price controls negatively affects the financial condition of producers of controlled goods and distorts price signals for economic decision-making.

According to the authorities, the price liberalisation implemented in January 2016 helped reduce the share of administratively controlled prices in the CPI basket from 23% to 12%. The Manager's estimates differ—reduction from 29% to 19%—as the Manager has no information needed to clarify the weights of regulated items.

Target 2.3. The level of cost recovery through utility tariffs for households should be at least 40% as at end-February 2016 – a control target.

Status: met.

As at end-February 2016, the level of cost recovery through utility tariffs for households was estimated—based on the average annual cost of providing the services and average weighted tariffs for the year—at 40% compared to 42% as at end-February 2015.[11] The cost recovery decline during the year was a result of the effect of depreciation, which exceeded the tariff growth[12].

This measure will facilitate consolidation of budget expenditures through cutting budget subsidies to the utilities sector and will improve the competitiveness of Belarusian enterprises owing to elimination of cross-subsidisation.

The low level of cost recovery through utility tariffs for households has a number of negative effects for the Belarusian economy and complicates achievement of macroeconomic stabilisation. Tariffs for households are maintained at a level significantly below the cost recovery level—that leads to unsustainable utility service consumption—by means of setting excessively high tariffs for industrial consumers that boosts their costs and weakens their competitiveness. According to some estimates of the Ministry of Energy of the RB, electricity tariffs for households are 5 times lower in the RB than in the RF. At the same time, tariffs for industrial enterprises are mostly above the average European level although the price of Russian

[11] In 2015, the level of cost recovery through utility tariffs for households was 30.5% against 29.5% in 2014.

[12] In February 2016, the 12-month depreciation reached 43.5%, while tariff growth was 37.2%.

gas used for electricity generation is noticeably lower for the RB than for European countries. Another tool of off-setting low tariffs for households is budget subsidies to utility companies. In 2015, they amounted to around BYR 8.1 trillion or 0.9% of GDP against BYR 8.7 trillion or 1.2% of GDP in 2014.

The objective of achieving the level of full cost recovery through utility tariffs for households calls at least for adjusting the tariff policies and developing adequate social safety nets. Tariff increases are currently limited in the RB to US $5 per year (for all services taken together) and quarterly indexation within the limits of the actual rate of nominal economy-wide wage growth. In the opinion of the Manager, the key target of tariff policies should be achievement of the established level of cost recovery that would determine the rate of tariff growth. That should be accompanied by developing mechanisms of providing state support to vulnerable groups of the population. The source of financing such mechanisms should be the resources saved through cutting subsidies to utility companies.

Target 2.4. The level of cost recovery through transport tariffs for households should be at least 60% for 2015 – a control target.

Status: met.

As at 1 January 2016, the level of transportation cost recovery through tariffs for households was 60.3% compared to 58% in 2014.

This measure aims at reducing budget subsidies to transportation companies and improving the efficiency of passenger transportation.

Target 2.5. The Government adopted a Resolution *On Approving Regulations on Procedure of State Programme Formulation, Financing, Implementation, and Performance Evaluation, on Procedure of Formation and Revision of State Programme List* and a Resolution setting the ceiling for lending under state programmes in 2016 at no more than BYR 28 trillion – a control target.

Status: met.

Resolution of the Council of Ministers of the RB No. 167 *On Some Measures of State Programme Formulation, Financing, Implementation, and Performance Evaluation* was adopted on 29 February 2016. Resolution of the Council of Ministers of the RB No. 103 *On Lending under State Programmes Activities in 2016* was adopted on 8 February 2016. The Resolution envisages a ceiling for financing state programmes set at BYR 28 trillion, of which BYR 10 trillion will be financed with the funds of the Development Bank and BYR 18 trillion – with the funds of commercial banks. These provisions also include priority areas of lending under state programmes.

This measures aims at stabilisation of the macroeconomic situation through reduction of inefficient investment and budget consolidation through cutting interest rate subsidies. Resolution No. 167, in particular, envisages annual monitoring and performance evaluation of all state programmes from the point of view of achieving declared programme objectives, as well as their impact on macroeconomic, financial, demographic, social, environmental, and other parameters. The results of this evaluation are to be published on the website of the Ministry of Economy of the RB in accordance with the resolution.

The condition of limiting the financing of the state programmes is related to the fundamental role of this type of lending in expanding external imbalances, strengthening depreciation and inflation expectations, and persistent decline of the GIR. Massive expansion of financing of the state programmes, which started in 2007, has resulted in imbalanced growth of domestic demand, including demand for imports, and deterioration of the balance of payments due to their inefficiency and focus on development primarily in the non-tradable sectors of the economy; lead to expansion of budget expenditures on subsidising preferential interest rates; reduced the efficiency of the NBRB's interest rate policies and brought down the quality of banks' credit portfolio. In 2015, the Government had to expand domestic debt limits for the amount of around BYR 23 trillion (2.6% of GDP) to address the situation with bad debts of enterprises of a number of industries by buying those debts out or restructuring them by means of issuing long-term debt obligations.

III. Commercialization / privatization of state-owned enterprises and strengthening social safety nets

The measures in this section are aimed at optimising the role of the state in managing state-owned assets.

Target 3.1. The President of the RB has adopted the Decree *On Issuing and Circulation of Shares Using Foreign Depository Receipts* that will facilitate the reduction of the share of the state in equity capital – an indicative target.

Status: met.

Decree of the President of the RB No. 84 *On Issuing and Circulation of Shares Using Foreign Depository Receipts* was adopted on 3 March 2016.

This measure is aimed at developing mechanisms for bringing down the share of the state in equity capital by mobilising foreign capital to finance the activity of joint-stock companies that should promote their better performance.

The Decree grants the right to open joint-stock companies to transfer their shares based on contracts to foreign organisations, which, in their turn, would issue foreign depository receipts against those shares and place (sell) those in the international market instead of shares. Implementation of the decree would facilitate mobilisation of foreign capital from international financial markets.

Target 3.2. Abolishing gross directed targets for state-owned enterprises in 2016 – a control target.

Status: met.

Resolution of the Council of Ministers of the RB No. 1085 *On Addressing Tasks of Social and Economic Development of the RB in 2016* abolishing the practice of setting gross directed targets for enterprises in 2016 was adopted on 24 December 2015.

This measure is aimed at putting the operation of state-owned enterprises on a commercial basis and improving their performance.

The key negative effect of the practice of setting gross directed targets for enterprises is a significant restriction of their flexibility in the environment of changing external and domestic market situation. The focus on meeting directed targets irrespective of demand for the produce or changed prices and costs results in deteriorating financial standing of enterprises and building up inventories. This method of enterprise management has led to massive hidden unemployment. In spite of the proved inefficiency of this system, the practice of using it, with certain, modifications in the list of targets over time, has been preserved until 2016 and has been backed with large-scale state support.

The intentions of the RB authorities to put enterprises of the state-owned sector on a commercial basis, *inter alia* due to a significant reduction of sources of financing for state support, have called for a significant revision of planning principles. The above Resolution establishes a limited list of performance indicators for enterprises, which are mainly associated with achieving a certain level of profitability.

The Manager is of the opinion that abolishing directed planning combined with reduction of state support under state programmes will strengthen incentives for enterprises to optimise their operation, including the number of their employees. Nevertheless, the Manager points out the risks associated with the provision in the Resolution requiring that implementing enterprises must rigorously comply with gross directed targets in the framework of state programmes. The Manager is of the opinion that introduction of competitive selection of entities implementing state programmes will off-set these risks.

Target 3.4. Adoption by the Parliament of the *Law on Public Private Partnership in the Republic of Belarus* – an indicative target.

Status: met.

Law No. 345-Z of 30 December 2015 *On Public Private Partnership in the Republic of Belarus* came into force on 1 January 2016.

This law aims at facilitating the private sector development through formation of additional legal provisions focusing on protection of private investments, improvement of the role of the private sector in rendering public services, and mobilisation of additional extrabudgetary resources to develop the infrastructure.

The Law defines the legal terms of the public private partnership (PPP) in the RB, regulates public relations formed in the process of awarding, execution, and termination of PPP contracts, and focuses on mobilising investments in the country's economy.

Target 3.5. Proposals are presented to the Government of the Republic of Belarus to change the composition of the Supervisory Board of Belinvestbank OJSC to make it consistent with international standards – an indicative target.

Status: met.

The proposals on changes in the composition of the Supervisory Board of Belinvestbank OJSC to meet international standards requirement were submitted by the bank to the Government in its letter as of 31 December 2015 № 01-02-05/6417.

The objective of this measure is to improve efficiency of the corporate governance of the bank, to strengthen its positions in the market, and, finally, to ensure successful privatization of the bank as it is envisaged by the agreement between Republic of Belarus and European Bank of Reconstruction and Development

The proposals on changes in the composition of the Supervisory Board have been prepared in accordance of the requirements on corporate governance in the banking system contained in legislation of the Republic of Belarus and international standards, as well as with recommendations of the international audit company based on the results of the audit on compliance of the bank's corporate standards with the national and international standards conducted in November 2015. The proposals contain recommendations to reduce number of members of the Supervisory Board from 12 to 9 people, including due to exclusion of the corporate clients of the bank from the Board members, which will diminish the conflict of interest in the process of decision making. Simultaneously, the Board will be appended by the independent directors of newly established at the Board committees on strategy and corporate governance, human resources and awards.

IV. Business climate improvement / private sector development

The measures in this section are aimed at developing the legislative and institutional frameworks facilitating the private sector development[13].

Target 4.1. The State Programme to Support Small and Medium Businesses in the RB in 2016-2020 has been adopted – an indicative target.

Status: met.

Resolution of the Council of Ministers No. 149 approving the state programme Small and Medium Businesses in the Republic of Belarus was adopted on 23 February 2016.

The key objective of this condition is the private sector development as a factor of sustainable growth of Belarus' economy.

The main challenges of small and medium business development in the RB included the unfavourable business climate characterised, *inter alia*, by a large number of administrative procedures for business entry[14] and barriers in accessing financial resources. The share of small and medium businesses in the gross added value was around 25%, while their share in total employment was 28%[15].

The programme includes a wide list of measures aimed at improving the business environment through expansion of state financial support of small and medium business development, simplification of administrative procedures, and formation of a positive perception of citizen's entrepreneurial initiative by the population. According to the RB authorities, implementation of the programme should generate growth of the share of small and medium businesses in gross added value up to 32% in 2020.

Target 4.3. Introduction of international financial reporting standards and mandatory independent audit of such reporting. Consideration of the practicability of expanding the

[13] Other measures under the section serve as conditions for further tranches.

[14] Including start of construction, connection to lines of communication, property right registration, etc.

[15] In 2014.

list of companies required to prepare their annual reports based on the IFRS – an indicative target.

Status: met.

In accordance with Law of the RB No. 57-Z of 12 July 2013 *On Accounting and Reporting* and Law of the RB No. 56-Z of 12 July 2013 *On Audit Activity*, the following economic entities and organisations should prepare their reports based on the IFRS and should subject those to external audit:

- open joint-stock companies, which are founders of unitary enterprises and/or main companies in relation to subsidiary companies, and insurance organisations; and
- banks, non-bank credit and financial organisations.

Application of the IFRS is an essential step towards creating a favourable investment climate in the RB by means of providing integral and quality information on the financial position of enterprises to superior authorities and potential investors.

The Manager and the RB authorities will develop criteria for evaluation of this measure, including a list of new companies to switch to the IFRS, for further tranches to monitor the progress.