

30 December, 2011

**ACF's Financial Credit to the Republic of Belarus:
Fulfilment of the Prior Conditions for the Second Tranche Release Set by the
Fund Council**

The meeting of the Fund Council held on 28 November, 2011 approved the disbursement of the second tranche of the Financial Credit to the Republic of Belarus (RB) in the amount of US\$440 million based on the ACF Resources Manager's Review of the Report of the Ministry of Finance of Belarus on the fulfilment of Second Tranche Conditions of the above-mentioned credit, provided that the Borrower fulfils the following conditions:

- (1) The Decree of the President of the Republic of Belarus on the transfer of non-core assets of the National Bank of the Republic of Belarus (NBRB) is signed; and
- (2) The NBRB raises in December 2011 the rates of instruments to provide liquidity in the interbank market by 5 percentage points compared to the level in effect on the date of the decision of the ACF Council.

Presidential Decree "On the Optimization of the Asset Structure of the National Bank of the Republic of Belarus" was signed on 23 December, 2011.

The Resolution of the Board of the NBRB No.564 dated 6 December, 2011 raised the refinancing rate from 40% to 45% from 12 December, 2011. Simultaneously, the rate on liquidity support instruments was raised from 65% to 70% (according to the Minutes of the NBRB meeting No.53 as of 6 December, 2011).

Thereon the fulfilment of the prior conditions and based on the decision of the Fund Council, the Manager disbursed the second tranche of the ACF's credit to the Republic of Belarus on 30 December, 2011.

Annex: Review of the Report of the Ministry of Finance of the Republic of Belarus on the fulfilment of the ACF Financial Credit Second Tranche Conditions (7 pages)¹

¹This document is published with the consent of the Borrower and in compliance with the rules of publication of the ACF Manager that allow making excerpts from the published documents of the information that could influence market conditions.

22 November, 2011

Review of the Ministry of Finance of the Republic of Belarus' Report on the fulfilment of the ACF Financial Credit Second Tranche Conditions

Having reviewed the progress in implementation of the Stabilization Program of the Government and the National Bank of the RB in general and fulfilment of the second tranche conditions of the ACF's Financial Credit in particular, the Manager submits the following conclusions and recommendations for the Fund Council consideration:

1. Due to the continued excessive stimulus applied to domestic demand in 2011, the key problem of the Belarusian economy – critically high current account deficit – has not been solved yet.

Implementation of such policy has caused three-digit inflation and accumulation of problems in the banking sector. In order to stabilize the macroeconomic situation as soon as possible, the Manager urges the Belarus' authorities to significantly constrain domestic demand by terminating the emission lending under government programs and by tightening monetary policy, including through raising real interest rates to positive levels. These measures will stabilize prices and the exchange rate of the national currency, replenish international reserves to the economically safe level, and guarantee the improvement of the external trade position.

2. Given the growth of crisis phenomena in the world economy and the rapid increase of the country's external debt, the Manager recommends the Government of the Republic of Belarus to expedite the privatization of state-owned enterprises as a non-debt source of international reserves build-up.

3. Taking into account that the "cheap money" policy is one of the main factors that exacerbates internal and external imbalances, the Manager recommends the Fund Council to approve the disbursement of the second tranche of the ACF's Financial Credit in the amount of US\$440 million once the real interest rates are raised to positive levels.

4. The Borrower, based on the consultations with the Manager, is advised to update the Letter of Intent and the conditions of the third and subsequent tranches in order to bring them into line with the Government Program for 2012 aimed at the stabilization of economic development.

I. Key Economic Trends of 2011

High domestic demand and favourable external economic conditions remained the fundamental factors of rapid economic growth in Belarus this year. Domestic demand was fuelled by continued excessive lending to the economy, including through emission channels, negative real interest rates, and rapid growth of real household incomes in the first half of the current year.

Implementation of such policy during recent years has resulted in substantial deterioration of external trade position, depletion of international reserves, depreciation of national currency, and substantial growth of the country's external debt.

The problems with the foreign currency availability in the beginning of this year, active emission lending under government programs (7% of GDP in the first 5 months of the year) and substantial increase in wages caused deeper than expected devaluation of the Belarusian Rubel and rapid price growth. Consumer prices grew by 89% over the ten-month period, while producer prices more than doubled. It is expected that the CPI will exceed 120% by the end of the year.

Financing from emission sources slowed down somewhat in the second half of the year, partly because the NBRB stopped its directed lending to the economy. Nevertheless, over the nine-month period of this year emission lending under government programs by the NBRB and the Ministry of Finance of Belarus amounted to 10 trillion Rubels (5.3% of GDP)², and continues, compromising the disbursement of the third tranche, which requires total amount of lending under government programs in 2011 to remain not higher than 4% of GDP.

With high inflation and devaluation accompanied by the multiplicity of rates, investment and consumer activities started to slow down in the second half of the year. GDP growth slowed down from 13.1% in January-May to 7% in January-October with an expected further deceleration to 4.5% for the full year. The same factors started to affect the position of the banking sector by increasing the vulnerability of the banks' foreign currency liquidity and worsening their asset quality.

Despite recent certain improvements in trade in goods and services, current account deficit over the nine-month period remained high – 11.9% of GDP (in the same period of 2010 - 13.1% of GDP). If in 2010 it was funded by privatization proceeds, this year it was financed through the accumulation of external debt, interest payments on which, in turn, lead to the further deterioration of the current account. Meanwhile, the level of international reserves remains unacceptably low at 1.2 months of imports. Replenishment of international reserves to the economically safe level requires at the very least reducing credit expansion and raising real interest rates to positive levels.

In the current conditions the role of the domestic demand reduction as an

²According to the World Bank, at the end of 2010 the accumulated amount of loans under government programs was 25% of GDP.

overall stabilization factor for the economy is growing manifold. Its further stimulation as an instrument of spurring GDP growth will inevitably lead to another upsurge in inflation, further Rubel devaluation and external debt growth. In this regard, the Manager welcomes the Government's and the National Bank's intentions to stabilize the economic situation in 2012 through reducing emission lending to the economy, controlling unfunded growth of the households' monetary incomes, and achieving real positive interest rates in the interbank market.

II. Second Tranche of the ACF's Financial Credit: Fulfilment of the Prior Conditions

As of 16 November 2011, six out of nine conditions of the second tranche included in the Matrix of Economic Policy Measures, which constitutes part of the Letter of Intent dated 2 June, 2011, and described below, were met. One condition was at the final stage of fulfilment, while two others were not met. Among them, the increase of real interest rates to positive levels is the key indicator.

1. Structural control target 1.1: Submission to the House of Representatives of the National Assembly of a draft law aimed at strengthening the independence of the National Bank and at prohibiting the functions that are non-core for central banks.

Status: Met.

The law on amendments to the Banking Code has been drafted, endorsed by the Government and submitted to the Administration of the President. Proposed amendments prohibit the NBRB from carrying out the functions that are non-core for central banks and strengthen its independence. In particular, the NBRB is prohibited to lend to the economy through emission mechanisms and to participate in businesses and other legal entities. In addition, the draft abolishes the Board of Directors as the governing body of NBRB and changes the status of the Chairman of the Board from the member of the Government to the participant in Government meetings in advisory capacity.

The draft law is satisfactory to the Manager. It is planned to submit this draft law to the House of Representatives at the end of 2011. Given this, and in order to comply with the conditions of the second tranche, NBRB drafted corresponding amendments to its Charter, which were approved by the Decree of the President No. 477 dated 21 October, 2011 "On the Amendments and Additions to the Decree of the President of the Republic of Belarus No.320 dated 13 June 2001".

Since the Decree of the President in fact introduces the amendments provided for by the draft law, the Manager considers this condition as met.³

2. Quantitative control target 1.2: As of 1 October, 2011, the level of gross international reserves (GIR) should be no less than 1.3 months of imports.

Status: Not met.

According to IMF's Special Data Dissemination Standard (SDDS), GIR increased by US\$921 million under the Stabilization Program and as of 1 October, 2011 amounted to US\$4.7 billion (1.23 months of imports⁴), which is

³The condition of the third tranche –enactment of the Law on Introducing Amendments to the Banking Code – remains in effect.

⁴Based on the data on imports of goods and services in September.

somewhat lower than the target indicator.

Since the deviation from the target level is insignificant, the Manager suggests granting a waiver for this condition.

3. Quantitative control target 1.3: As of 1 October, 2011, the level of net international reserves (NIR) should not be lower than it was on 1 May, 2011.

Status: Met.

4. Quantitative control target 1.4: As of 1 October, 2011, the NBRB's liabilities to commercial banks should be decreased by US\$55.6 million.

Status: Met.

In compliance with the Matrix of Economic Policy Measures of the Government and the National Bank of the Republic of Belarus, which is supported by the ACF's credit, the NBRB discontinued borrowing currency from commercial banks. Debts on the transactions of exchange of deposits are repaid according to the schedule.

5. Indicative target 1.5: Regular revision of the refinancing rate to ensure its real positive level.

Status: Not met.

Given the significant inflation, the nominal refinancing rate was raised from 10.5% in the beginning of 2011 to 40% at present. Considering the inflation forecasts for 2011 (128%) and for 2012 (60%), the real refinancing rate increased from minus 122% in January 2011 to minus 35% in November 2011.

From the perspective of the NBRB the main factor determining the cost of the credit resources in the banking system of the country now is the overnight rate, the nominal level of which currently stands at 60%. Based on the assumptions made above, the real overnight rate is minus 15%. Besides this, the NBRB has recently made a decision to cut by half the resources directed at supporting the liquidity of commercial banks, which should reduce their lending capacity and raise borrowing costs⁵.

The Manager stresses that extending negative real interest loans to economic entities is one of the principal factors of the high inflation and exchange rate weakening, and also undermines stability of the banking system.

The Manager will consider this target as met provided that the nominal interest rates are raised to 70-75%.

6. Structural control target 1.6: Adoption of the Presidential Decree on the sale

⁵As of now, the Manager has no information on the influence of this decision on the volume and dynamics of the lending to the economy.

and/or transfer non-core assets of the NB RB.

Status: Not met.

The Decree of the Head of the State “On the Optimization of the Structure of the NB RB Assets” has been drafted. It provides for the transfer of non-core assets of the NB RB as follows: (a) the shares of the agricultural organizations are to be transferred without compensation to the State Property Committee of the Republic of Belarus; b) other assets are to be transferred to the Development Bank (DB) of the Republic of Belarus in exchange for bonds issued by the DB.

The Manager will consider this condition as met on the date when the Decree is signed.

7. Quantitative control target 2.1: Fiscal deficit of the General Government should not exceed 1.2% of GDP in January-September 2011.

Status: Met.

The budget was in surplus over the nine-month period, equivalent to 2.9% of GDP. The Government intends to allocate most of the surplus to repay the debt owed on guarantees of local budgets to the banks and to finance interest rates on subsidized loans of commercial banks. This will bring the budget surplus down to 0.5% of GDP by the end of 2011.

8. Structural control target 2.3: Housing and public utility tariffs should be raised on average by at least 10% by the time of the tranche disbursement.

Status: Met.

Since 1 August, 2011, housing and public utility tariffs have been raised by 10% on average. At present, the tariffs cover, on average, about 20% of the actual costs. According to the Ministry of Economy, the tariffs will be raised again till the end of the year so that they cover 30% of the actual costs.

9. Indicative target 3.1: A list of state-owned assets for sale is developed and published with indication of the real value of these assets and the likelihood of their sale.

Status: Met.

Privatization program for 2011-2013, that includes 276 enterprises, specifies neither the value of the enterprises nor the privatization method.⁶ Nevertheless, as the respective documents are prepared, the State Property Fund publishes the list of the assets put on sale together with their prices (normally based on their balance sheet value, and indexed for inflation) and selling method. As of 1 October 2011, shares in 29 enterprises with the total value of 110 billion Rubels (about US\$28 million⁷) were sold. Privatization proceeds in

⁶This program does not include large strategically important facilities.

⁷On the basis of an average exchange rate for January-September 2011.

the amount of US\$2.5 billion in 2011 is the indicative target of the third tranche. No target for the proceeds from the privatization of state-owned enterprises was set for the second tranche.

Negotiations for the sale of shares in “Beltrargas” (US\$2.5 billion) and “MTS” (US\$1 billion) are conducted according to a separate schedule. Closing of these transactions is scheduled for the end of November 2011 and the end of January 2012, respectively.