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REPUBLIC OF BELARUS

SELECTED ISSUES

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December 17, 2018

Approved By
European Department

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DE-DOLLARIZATION IN BELARUS[1]

High financial dollarization is a significant systemic vulnerability to the economy. It increases liquidity and credit risks and reduces the effectiveness of monetary policy. The level of dollarization is high in Belarus, even though it has been gradually coming down in recent years due to more sustainable macro policies and better targeted prudential measures. Nevertheless, key challenges remain to reduce it to closer to its estimated benchmark level, including developing local currency capital markets.

A. Introduction

1. **Financial dollarization is high in Belarus, both for deposits and loans.** The level has been decreasing in recent years, but it is still higher than before the global financial crisis. High dollarization is mostly driven by historic factors. Past crises, hyperinflation and strong depreciation episodes undermined the trust in the local currency, therefore triggering economic agents to switch their savings and borrowings to foreign currency (FX).

2. **A high level of financial dollarization is a systemic risk and vulnerability to the economy, even when the financial sector appears stable and adequately capitalized.**

- Dollarization increases *liquidity risks*. In case of financial sector instability, or drop in confidence in the banking system, the lender of last resort can provide funding in domestic currency, while it is constrained by the level of existing reserves for FX funding.

- Dollarization exposes the economy to *credit risk* through possible currency mismatches and unhedged positions of borrowers or banks. It raises direct FX risk if the currency mismatch is on the banks' side, and indirect FX risks if substantial lending is extended to unhedged borrowers. A devaluation episode could offset the interest rate benefit from FX borrowing, limiting borrowers' ability to repay dollar debts.

- *Policy implications*: a high share of FX holdings weakens the interest rate channel of monetary transmission, reducing the effectiveness of monetary policy. It also reduces revenues from seigniorage.

3. **Belarus has taken recent measures to mitigate high dollarization.** Macro stability and lower levels of inflation in the last few years have contributed to higher confidence in the local currency. Appropriate prudential measures have also been introduced. But some key components are missing; in particular, domestic capital markets are shallow and in their current state act as a brake on de-dollarization efforts.

4. **This paper takes stock of the current level of dollarization, both in historic and international perspective.** By looking at recent measures and international best practice, it draws some recommendations for a successful de-dollarization framework.

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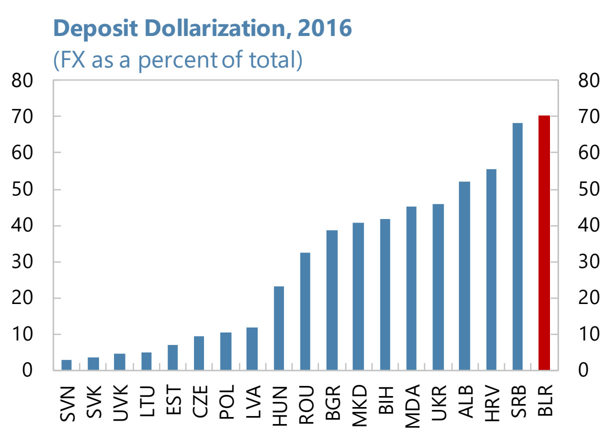
[1] Prepared by Dora Benedek.

B. Dollarization

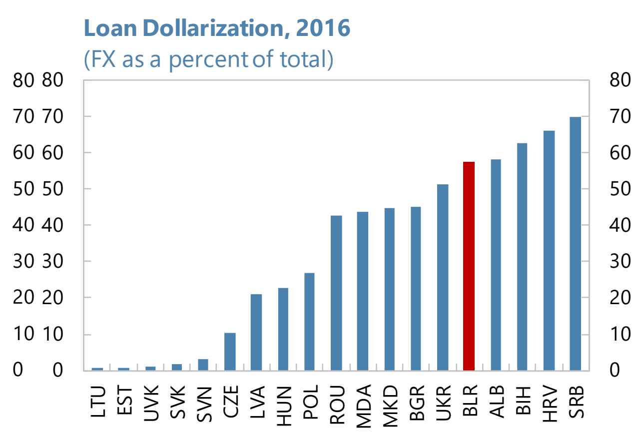
5. High dollarization is usually triggered by a period of acute macroeconomic instability, coupled with expectations on further deterioration. Instability can take several forms, such as a crisis experience, high inflation environment or other type of macroeconomic volatility, that results in large exchange rate depreciation. If agents expect further large depreciation, they will prefer to save in FX to hedge the risk. This is a rational choice to protect wealth at the time of instability. Dollarization is exacerbated if agents underestimate the risk of borrowing in FX to take advantage of lower rates. Dollarization is a persistent phenomenon that can only be addressed over a long time with good macro policies and stability. Conversely, in an unstable macroeconomic environment, policy measures that try to force de-dollarization may lead to capital flight, financial disintermediation, and banking sector instability.

Current Situation in Belarus

6. Belarus has a high level of loan and deposit dollarization as a result of repeated external crises and hyperinflation. Over the last 25 years Belarus often experienced high inflation periods. The record high inflation in 1994 was quickly followed by another period of price instability in 1999. The global financial crisis affected the Belarussian economy again. During the most recent hyperinflation episode in 2011 price increases were running at above 100 percent. Inflation stayed very high in 2012 at above 65 percent. The sharp devaluation and BOP crisis in 2014 again undermined confidence in the domestic currency. Belarus has the highest share of FX deposits among CEE countries at around 70 percent, and one of the highest shares of FX lending at close to 60 percent. Furthermore, Belarus is one of the few countries where both loan and deposit dollarization increased significantly between 2006 and 2016. The NBRB estimates that the high level of dollarization has led to a loss of seigniorage revenues of 2–3 percent per year on average.



Sources: Belarusian authorities, FSI, MFS, and IMF staff calculations.

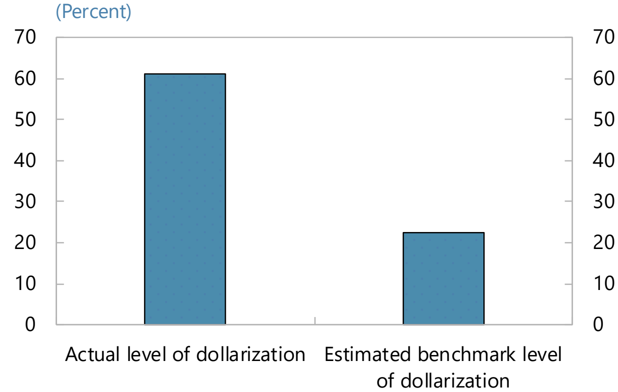


Sources: Belarusian authorities, FSI, MFS, and IMF staff calculations.

7. The optimal level of dollarization in an economy is not zero. Some positive level of dollarization has economic benefits. Any integration to the world economy may require hedging of foreign transactions. Having dollarized financial instruments may mitigate risks for foreign investors and offer diversification for residents. The possibility of FX lending may reduce the cost of capital, thus leading to higher investment and growth. The optimal level of dollarization depends on various structural factors of a country, such as the size of the economy, openness, the degree of financial integration, and market development.

8. Dollarization in Belarus is much higher than many other countries, accounting for various drivers of dollarization. Trade and financial linkages with the rest of the world predict a benchmark level of about 20 percent, but Belarus is well above this predicted level.[2] Not only that, but the gap between benchmark and actual dollarization in Belarus is among the highest in the region.

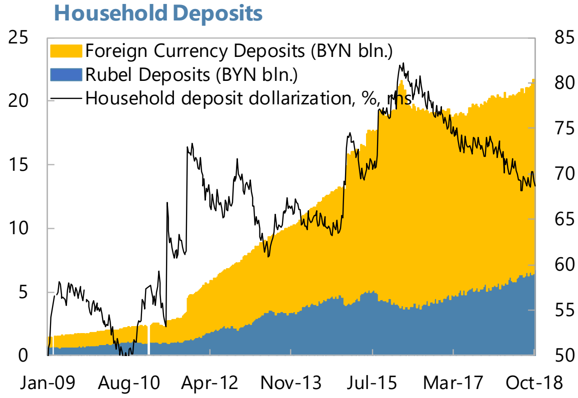
Actual and Benchmark Dollarization Levels in Belarus
(Percent)



Source: della Valle et al, 2018.

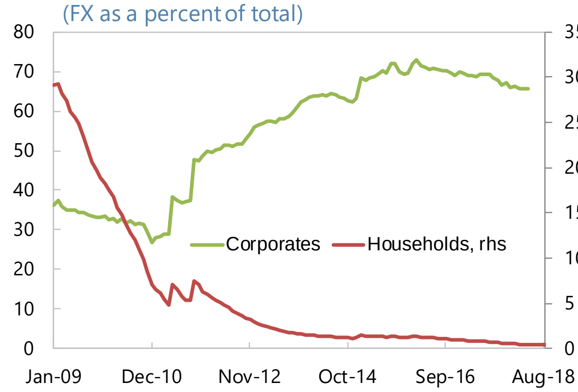
9. Dollarization has been decreasing but it is still higher than a decade ago. The share of household FX deposits has been decreasing from a peak of over 80 percent in 2015, but it is still around 70 percent of total deposits versus only 35 percent in 2006. Loan dollarization is high for corporations at 65 percent now, versus 40 percent in 2006. FX lending to household has fallen however as a result of the ban in 2009 on household FX borrowing.

Household Deposits



Sources: Belarusian authorities, MFS, and IMF staff calculations..

Loan Dollarization
(FX as a percent of total)



Sources: Belarusian authorities and IMF staff calculations.

[2] Structural factors determining the benchmark level of dollarization are the size of economy (population and real GDP per capita), degree of trade openness (export and import as a percentage of GDP), capital account openness, and remittances as a percentage of GDP to control for labor mobility. Policy variables include the Minimum Variance Portfolio, exchange rate volatility, and inflation, including lagged inflation to test for the impact of high inflation memory on dollarization. For a description of the estimation method see Della Valle et al, Euroization Drivers and Effective Policy Response, An Application to the Case of Albania, IMF WP/18/21.

POLICIES FOR DE-DOLLARIZATION

10. De-dollarization is a very long process that requires restoring confidence of economic actors in the local currency. Successful country cases of de-dollarization share the following set of key components:

- **A public de-dollarization strategy** to anchor expectations and signal commitment proved to be a very important communication device;
- **Better and sustainable macro policies**, that increase confidence in domestic currency;
- **Prudential policies and supervisory measures that reduce financial stability risks due to dollarization**, limit dollarization to the areas of the economy that can better withstand exchange rate fluctuations and increase buffers against exchange rate fluctuations. The role of prudential policies is to get banks and borrowers to properly internalize the true cost of FX borrowing; and
- **Developing local capital market is important to promote the local currency**. A deepening government securities market will lead the way towards capital market development. It requires diversifying the investor base of government securities, including foreign investors, and developing the secondary market. The goal is to establish a government yield curve along which bank and corporate issuances could be priced. The government should also encourage long-term savings in local currency to create a demand for long-term securities, for example via pension funds.

Box 1. Peru: A Case of Successful De-dollarization 1/

High dollarization in Peru was a legacy from hyperinflation in the late 1980s, following forced de-dollarization measures in the mid-80's that led to capital flight and financial disintermediation. As a result of macro and macroprudential measures, loans in FX fell from 80% to 30% between 2003-2016.

De-dollarization had several key components. It was driven by macroeconomic stability, both achieving fiscal surpluses and stabilizing inflation by introducing inflation targeting. Developing the capital market in local currency was another essential component. The authorities issued longer term public bonds in local currency to extend the yield curve, and maturity has now reached above 30 years. Macro stability was accompanied by macroprudential measures to target liquidity risks and excessive FX credit growth, and to protect the financial sector's capacity to absorb losses.

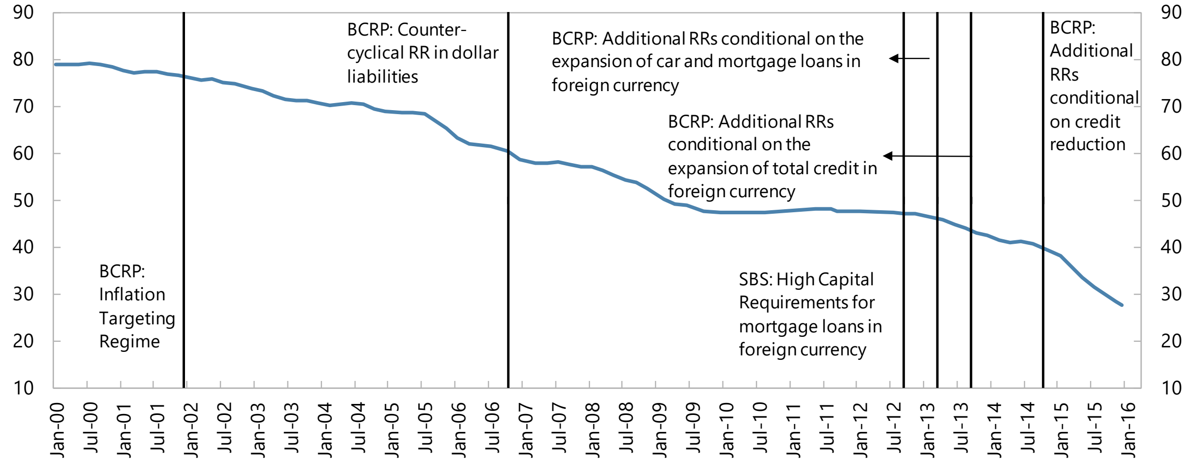
Instruments used in Peru:

i) Prudential: Higher capital requirements for FX loans and provisioning requirements
ii) Monetary: Cyclical Required Reserve Ratios and remuneration (FX vs. local currency)
iii) Quantitative: "De-dollarization repos"
iv) Regulatory: Stricter limit on net open FX positions and FX derivatives

Box 1. Peru: A Case of Successful De-dollarization 1/ (concluded)

De-dollarization in Peru

(Percent)



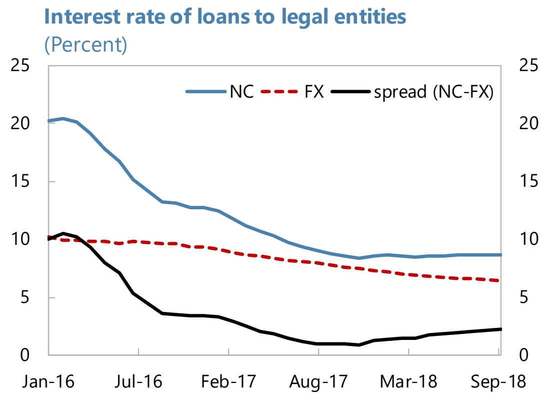
Source: Central Bank of Peru.

1/ Box based on M. Garcia-Escribano: Peru: Drivers of De-dollarization, IMF WP/10/169

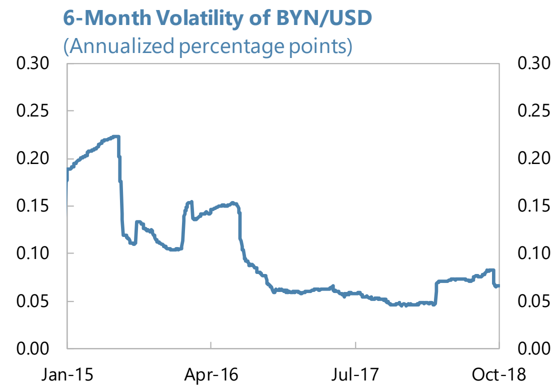
Current Situation in Belarus

Macro Policies

11. Recent gains in terms of de-dollarization are to a large extent due to more sustainable macro policies. Fiscal policy has remained relatively prudent in recent years. The overall general government deficit has stayed below 3 percent. Monetary policy has improved materially through a more rules-based monetary policy framework, less sub-servient to fiscal or SOE needs and with the objective of price stability. A monetary aggregate targeting framework was introduced in early 2015 with a focus on gradual transitioning towards inflation targeting. The central bank has been improving its communication, enhancing credibility. As a result of better policies, inflation has fallen sharply and ruble-FX lending spreads have been coming down contributing to lower demand for FX loans. Similarly, the exchange rate variance has also been gradually decreasing, reducing the insurance value of FX deposits. Reining in the insurance value of FX deposits is a key aspect of successful de-dollarization, and a great challenge for macroeconomic policy.



Sources: NBRB and IMF staff calculations.



Source: NBRB and IMF staff calculations.

12. **In parallel, the authorities have been taking welcome steps to liberalize the FX market, such as, for example, eliminating the FX surrender requirement and easing the registration procedure for FX transactions.** A new draft law also is currently being developed for a second wave of liberalization.

Macroprudential policies

13. **Prudential regulations have been introduced that help banks and borrowers better internalize the social costs of FX lending and borrowing**:

- On the liability side, differentiated reserve requirements (RR) have been introduced on domestic vs. FX deposits. The current RR for FX is 17 percent, while on domestic currency it is 4 percent.

- On the asset side: (i) a ban on household FX borrowing has been in place since 2009, on account of households rarely having FX earnings; and (ii) for corporates, banks are now required to assess the FX cash flow of borrowers to make sure it is sufficient to repay the loan and can no longer take ruble cash flow into consideration. Higher provisioning is also applied for FX lending.

- Measures also limit the open FX position of banks to 10 percent of regulatory capital. On this, it is fair to note that, in the presence of high FX deposits, closing the banks' FX position implies that banks have to either lend in FX potentially to unhedged borrowers, or have to accumulate substantial stocks of FX government bonds, which is the case in Belarus.

REMAINING CHALLENGES

14. **Despite improvements in recent years, there are remaining challenges on macro policies.**

- While the NBRB is gradually transitioning to inflation targeting, price stability remains a joint mandate of the monetary authority and government (Ministry of Antimonopoly regulation and Trade), weakening credibility and transmission channels. The share of regulated prices has come down significantly in the last several years, but it still stands at close to 20 percent of the CPI. In addition, unregulated prices can still be "frozen" by administrative decision.

- Despite the removal of various market distortions in recent years, the NBRB still applies a wide set of recommended interest rate levels for the banks. These also weaken the interest rate transmission channel of monetary policy, while also distorting market competition. In particular, the interest rate cap on household deposits, set well below competitive levels, limits the banks' ability to attract more local currency deposits, providing adverse incentives in terms of de-dollarization.

- There is a moral hazard related to SOE FX borrowing, in that SOEs internalize possible bail-outs by the government should their FX debts become unpayable.

15. There is a need to deepen domestic financial markets which in their current state act as a brake on de-dollarization. There are some encouraging steps in this regard. The EBRD is working jointly with the authorities in developing the local capital market; it has started to issue longer-dated paper in rubles and lending in rubles as well. The authorities are also planning some longer-than-one-year ruble-denominated issuance for 2019. These efforts will need to be stepped up for there to be a proper benchmark yield curve. In parallel, efforts are needed to create institutional demand for longer term bonds that is currently lacking.

16. An overarching, and publicly communicated national strategy to de-dollarize the economy is a missing piece of the puzzle. Such a strategy would be an important signaling and commitment device and would help educate borrowers about the risks (private and social) of FX borrowing. The strategy would contain an operational roadmap that would also ensure the coherence of existing policies, and coordinate policy and operational steps. Implementation should be conditions-based, where each step is conditional on progress achieved with previous milestones, focusing on progress in macroeconomic stabilization, financial stability, and structural reforms. The roadmap should focus on market-based and market-friendly measures; history in other countries has shown that heavy-handed administrative measures can backfire badly.