Belarus Economy Monitor: trends, attitudes and expectations

FINANCIAL STABILITY

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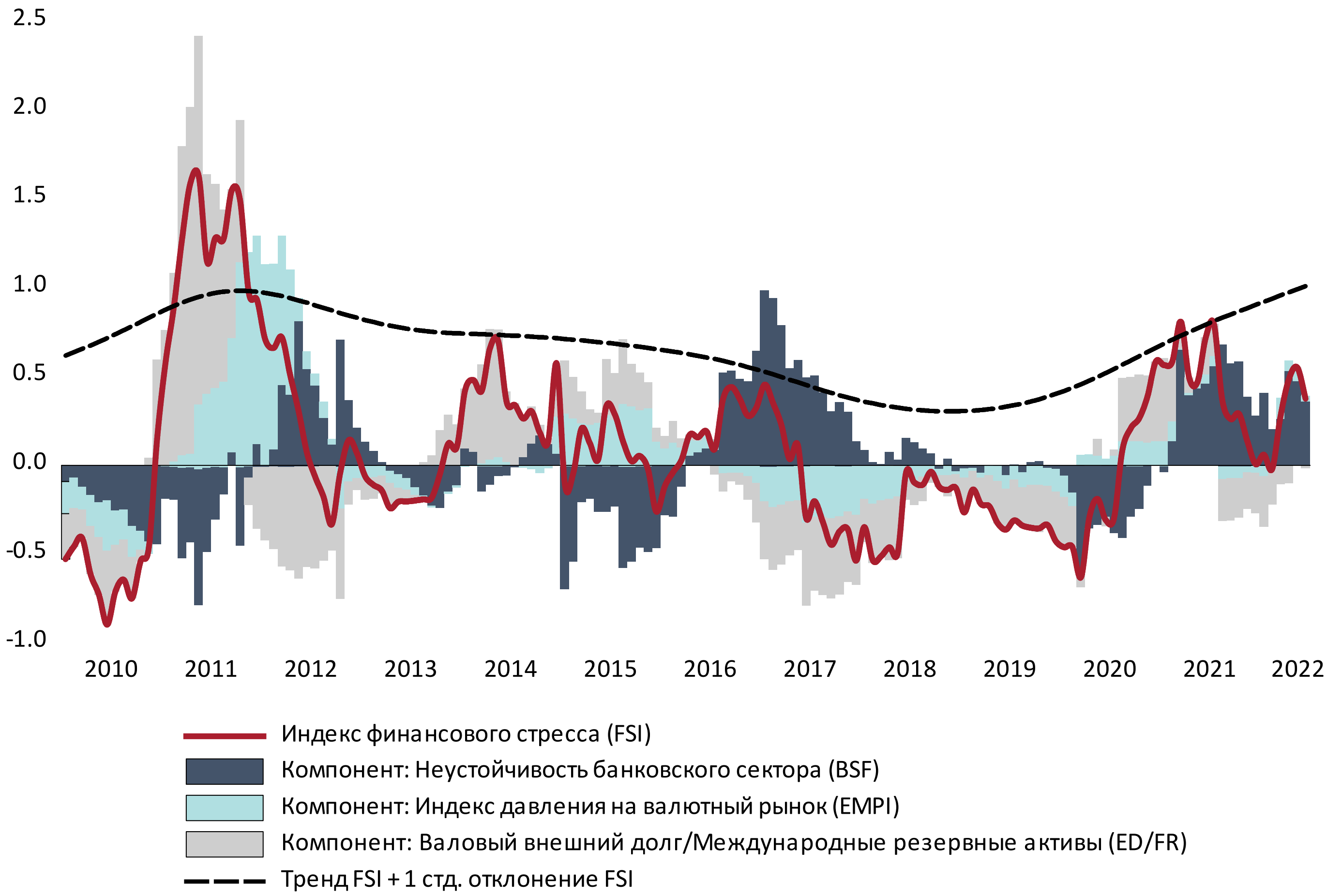
Financial stability risks persist in Belarus: the financial system has suspended the initial shock



Financial Stress Index (monthly data)

The Financial Stability bulletin is an expert analysis of the key vulnerabilities of the Belarusian financial system. The bulletin presents the Financial Stress Index and analyzes the key financial stability indicators. The bulletin identifies negative trends that can form, amplify or signal financial shocks. It should be noted that indicators characterizing the quality of assets of Belarusian banks are beyond the scope of this analysis. This is largely due to doubts whether such data presented in regular statistics correspond to reality. Alternative indicators (e.g., based on IFRS 9) are available irregularly and with a significant delay. Therefore, financial stresses caused by the credit risk of banks can be partially taken or not taken into account in this bulletin.

The Financial Stress Index (FSI) is calculated based on the Principal Component Analysis (PCA) under three components: (1) Banking Sector Fragility (BSF); (2) Exchange Market Pressure Index (EMPI); (3) the ratio of External Debt to Foreign Reserves (ED/FR), which characterizes the risk associated with external debt. The index is designed in such a way that its standardized mean would be zero. Positive index values indicate an increased financial stress, while negative index values indicate a decreased financial stress. If FSI exceeds a given threshold – the FSI trend (calculated using the Hodrick-Prescott filter) + 1 standard FSI deviation – then this situation is classified as financial instability. Methodological procedures of the current index version are close to those presented by Mazol (2017, https://beroc.org/upload/iblock/bbc/bbca9d55e12e6504bd5df1ffeca36aa3.pdf).

Financial Stress Index: anticipating a new sanctions shock?

The value of the Financial Stress Index (FSI) for Belarus increased on average in Q2-2022. The level of financial stress can be characterized as increased, but not classified as financial instability (Table 1). The key contributor to the FSI value growth in Q2-2022 was the Banking Sector Fragility (BSF). Nonetheless, the index was decreasing in the last month of the quarter. This is due to the fact that the first shock from the war and the sanctions that followed it has passed, and their impact has begun to smooth out also because of some positive shocks inter alia.

The potential for the further FSI growth is associated, first, with the external debt component (ED/RF): due to shrinking budget revenues from the oil sector, and the risk of further non-fulfillment of external financial liabilities by the state increases. In addition, a new shock is likely to occur between December 2022 and February 2023, when the European embargo on Russian oil and petroleum products comes into force.

The key factor for increasing the level of financial stress is the decrease in the banking sector's ability to perform credit and deposit transactions

The BSF increase in Q2-2022 was driven by two factors. The first factor is a 7.8% decrease in lending to the non-financial sector in real terms against the backdrop of a general macroeconomic shock due to the war outbreak. The second factor is the deposits outflow from the banking system by 11.3% in real terms. The war has become a key factor that has changed the behavioral patterns of economic agents.

Debts on external liabilities and reserves are the factors to reduce financial stability in the near future

The FSI's potential for its further increase is determined by two factors. The first factor is shrinking forex reserve assets of Belarus by 10.8% versus Q1-2022. The second factor is a growing gross foreign debt by 4.3% over this period. At the same time, the impact of the growing debt burden on financial stability may significantly change in future periods due to the de facto refusal of the authorities to fulfill their foreign currency liabilities to Western creditors.

Table 1. Financial Stress Index

Period	Quarterly average
Q3 2021	0.50
Q4 2021	0.16
Q1 2022	0.14
Q2 2022	0.47

Analysis of indicators: financial stability and bank performance

Capital adequacy indicators improved in Q2-2022, especially for Tier 1 regulatory capital. The main reason for this was the large-scale recapitalization of state-owned banks (by about BYN 2.5 billion). At first glance, this step can be interpreted as an unconditional financial stability strengthening. However, the mechanism for implementing recapitalization — by increasing the budget deficit and by directly buying out the bonds issued in connection with this by the National Bank — gives grounds to assert that strengthening of one of the elements of financial stability (banking stability) is fraught with a gradual weakening of other components (debt and currency stability). Another important reason for the growth of capital adequacy ratios is the excessively conservative bank policies in offering loans against the backdrop of a recession and large-scale uncertainty. As a result, bank assets exposed to credit risks are growing at a slower pace.

The **profitability indicators** of the banking sector have somewhat improved; in particular, the rate of return on both assets and equity has grown. In the context of a decreasing share of interest income and an increasing share of non-interest expenses, profitability growth in the banking sector is perhaps due to an increasing share of non-core operations in the banking sector (outside the credit and deposit market).

Table 2. Selected financial performance indicators of banks

Indicators	At quarter end			
	Q3 2021	Q4 2021	Q1 2022	Q2 2022
Capital adequacy indicators				
Ratio of regulatory capital to risk-weighted assets	18.4	17.9	16,9	21.7
Ratio of Tier 1 regulatory capital to risk-weighted assets	15.4	14.8	15.4	19.6
Profitability indicators				
Rate of return on assets	1.9	1.8	1.7	1.8
Rate of return on equity	12.8	12.0	11.4	11.8
Ratio of interest income to gross income	14.1	14.2	12.6	12.1
Ratio of non-interest expenses to gross income	91.9	92.3	93.7	93.8
Liquidity indicators				
Ratio of liquid assets to total assets (liquid asset ratio)	17.0	16.0	17.9	17.4
Liquidity coverage ratio, in national currency	92.7	102.5	89.3	117.3
Liquidity coverage ratio, in foreign currency	68.8	79.8	126.3	159.2
Ratio of customer deposits to total loans and borrowings (excluding interbank loans)	80.6	84.3	83.5	85.3
Indicators of banking sector fragility to foreign exchange risk				
Ratio of net open currency position to equity	6.9	4.2	7.3	2.4
Ratio of foreign currency loans and borrowings to total loans and borrowings	47.0	46.9	48.3	46.0
Ratio of foreign exchange liabilities to total liabilities	62.6	62.4	63.9	63.4

Liquidity indicators of banks showed a positive trend in Q2-2022. The liquidity coverage ratio grew both in national and foreign currencies to a level above the regulatory value. Despite the positive effect on the stability of the banking sector, a significant growth of these ratios indicates a business activity decrease in the economy as a whole. This argument is also supported by the growing ratio of customer deposits to total loans and borrowings. The influx of deposits into the banking system does not overflow into the real sector of the economy through lending, and banks are not willing to expose themselves to excess risks associated with lending or with inability to adequately assess risks in the current context.

Sensitivity of the banking sector to the foreign exchange risk lowered in Q2-2022 due to positive impulses. The banking sector's fragility to foreign exchange risks has decreased: the relative value of the net open foreign exchange position has significantly decreased, which has reduced the banking sector's exposure to exchange rate fluctuations. The share of foreign currency credits and loans in total credits and loans has decreased to the minimum for the 4 quarters, and the share of foreign currency liabilities in total liabilities has slightly decreased. Such trends can be explained by the effect of sanctions on the economy of Belarus, which has been generally reducing foreign economic transactions and, accordingly, the foreign exchange component in the assets and liabilities of the banking sector.