EFSD Eurasian Fund for Stabilization and Development

Republic of Belarus

Social and economic development in 2020 and medium-term prospective*

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REPUBLIC OF BELARUS: SOCIAL AND ECONOMIC TRENDS IN 2020

Real Sector and Labour Market

Refraining from quarantine measures, combined with support to state-owned enterprises, prevented a deep economic recession in the Republic of Belarus. In 2020, the country's GDP contracted by 0.9 percent, compared to the aggregate GDP decline in the EFSD member countries by 3.0 percent[1]. The key factor supporting the economy was net exports of goods and services, whose positive contribution to the evolution of the GDP at the level of 3.4 p.p. was generated because of imports of goods and services declining faster than exports (Figure 1). Enterprises were building up their inventories that led to stocks of finished products in manufacturing peaking at 91.8 percent of the average monthly output at the end of the first half of the year (71.6 percent a year earlier) and supported industrial output. In the second half of the year, amid some improvement of the external demand that supported merchandise exports, the inventories fell to 75.7 percent. In the environment of lower revenues from sales and a sharp increase in the loan debt burden as a result of significant BYN depreciation, the functioning of state-owned enterprises was supported by the state through replenishment of their authorised funds and directed lending in the amount of 3.8 percent of GDP[2]. The contribution of the general government sector was also positive (1.7 p.p.) due to a marked increase in state support for the economy in the form of capital transfers (1.9 p.p.). However, a significant drop in the contribution of the private sector led to a negative trend of the real GDP. The contribution of private consumption was negative (-0.8 p.p.), despite an increase in real disposable incomes of the population by 4.6 percent as at year-end against the background of high real wage growth (8.2 percent) and pensions (4 percent). The main factors contributing to lower consumption included households switching to the savings model of behaviour[3] amid rising uncertainty and stagnation of consumer lending, which had traditionally served as one of the drivers of consumption—that indicator grew by 1 percent as at year-end, compared to 27.4 percent a year earlier. The global slowdown in investment activity, weaker economic activity in the country, and poorer profitability of enterprises resulted in the formation of a negative contribution of private investment to the evolution of the GDP at 4.3 p.p.

In terms of sectors, the most significant drop in output was recorded in transport, warehousing, and domestic trade due to the decline in oil imports (-11.1 percent) and petroleum product exports (-19.3 percent). The negative contribution of these sectors to GDP amounted to 0.6 p.p. Against the background of the falling output of all its branches, except for manufacturing, the contribution of industry was also negative at 0.1 p.p. Only information services and communications, as well as agriculture made a positive contribution to the GDP at 0.4 p.p. each (Figure 2).

Against the background of the weaker economic activity, the labour market recorded an acceleration in the rate of employment decline. In 2020, the number of wage earners decreased by 2.8 percent against 0.4 percent a year earlier. The decline began to accelerate in Q2 (-3.7 percent, against the corresponding quarter of 2020), and its rate peaked in Q4 (-4.8 percent). A retrenchment in employment in the budget sector[4] (-1.1 p.p.), industry (-0.8 p.p.), and trade (-0.5p) contributed most to the annual plunge of employment. However, there was a slight improvement in unemployment, based on the ILO methodology—4.0 percent versus 4.2 percent a year earlier.

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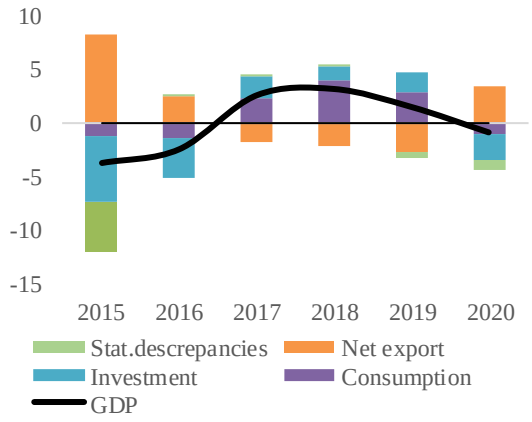
[1] Based on EDB estimates. Of the EFSD member countries, only the Republic of Tajikistan experienced positive economic growth at the level of 4.5 percent.

[2] Regarding the restructuring of debts of state-owned enterprises, the EFSD has got only limited information on that support mechanism. In particular, it is aware of the restructuring of debts of state-owned bakery complexes in the equivalent of 0.9 percent of GDP.

[3] Mostly as informal savings (outside the banking system, in the form of cash).

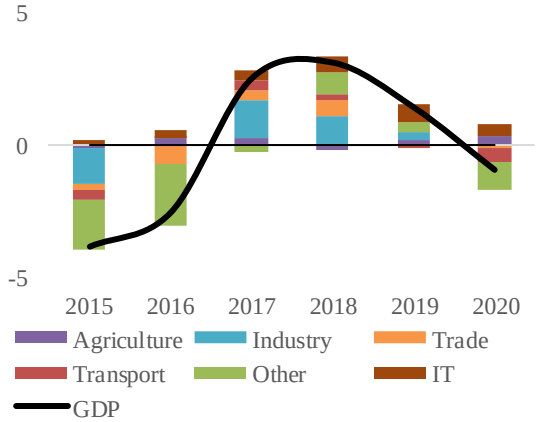
[4] Public administration, health and education.

Figure 1. *Contribution to GDP growth, by expenditure components (p.p., y-o-y)*



Source: Belstat

Figure 2. *Contribution to GDP growth, by production components (p.p., y-o-y)*



Source: Belstat

Inflation and Monetary Policy

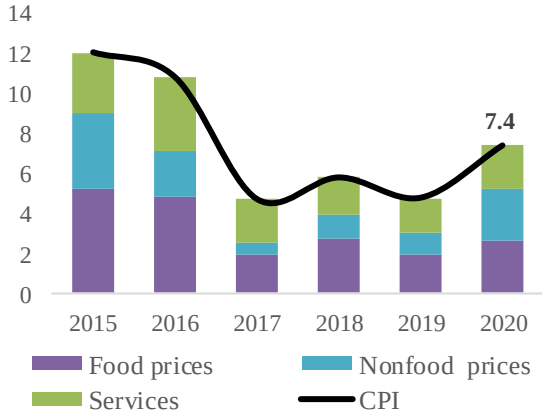
The acceleration of inflation recorded in 2020 was mainly caused by the BYN depreciation, as well as supply shocks concerning some food products. As at end-December, the consumer price growth amounted to 7.4 percent in annual terms compared to 4.7 percent in December 2019, while the NBRB targeted no more than 5 percent (Figure 3). The US$ to BYN exchange rate increase in 2020 contributed 22.6 percent, primarily by boosting prices of imported non-food goods, the share of which in retail sales for this segment is about 60 percent. As a result, the annual growth of non-food prices was 8.1 percent. The planned increase in utility tariffs for households, the size of which largely depends on the BYN exchange rate[5], led to a hike in prices for services as at year-end by 8.4 percent. The state regulation of prices for socially important goods (mainly food), as well as a lower share of imported goods in food sales (about 40 percent), which helped mitigate the effect of the depreciation, limited the growth of food prices to 6.2 percent, despite supply shocks concerning some types of food (vegetables, fruit, vegetable oil, sugar). However, the supply shock, combined with the BYN depreciation, resulted in the underlying inflation more than doubling—up from 3.5 percent as at end-December 2020 to 7.1 percent.

The efforts of the monetary authorities in 2020 were aimed at balancing the goals of supporting the economy and ensuring macroeconomic and financial stability in the context of negative impacts of the COVID-19 pandemic. The first half of the year saw a significant monetary policy easing in response to weaker economic activity and against the relatively low annual inflation between 4 and 5 percent. The refinancing rate was reduced three times – to 7.75 percent compared to 9 percent at the beginning of the year. In addition, the National Bank temporarily relaxed several prudential requirements to boost the business activity. In the environment of the mounting socio-political tensions at the beginning of the second half of the year, accompanied by a significant outflow of bank deposits and increased pressure on the BYN exchange rate due to feverish demand for foreign currency, the monetary authorities took several measures to tighten the monetary policy. For the stabilisation measures to take an early effect on the situation, primarily in the foreign exchange market, the key policy tool chosen was not the interest rate channel, but containment of the money supply, which was manifested, among other things, in suspension by the National Bank of its liquidity support standing facilities. In that environment, the broad money supply growth as at year-end decreased to 4.7 percent against 12.2 percent as at end-2019, with the entire increase explained by the depreciation effect. Exchange

[5] In accordance with the decree of the President of the Republic of Belarus No. 107 of March 23, 2016, utility tariffs are raised annually in total by a US $5 equivalent.

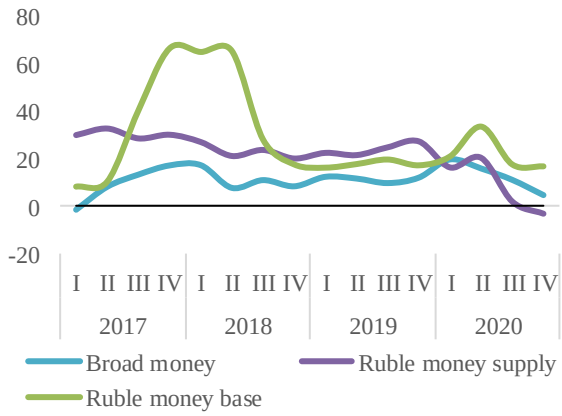
rate differences aside, the broad money supply decreased by 5.3 percent due to outflows of both BYN (-6.7 percent) and foreign currency bank deposits (-8.6 percent). The share of the foreign exchange component in the broad money supply composition remained at the level of about 60 percent. The BYN base money growth in 2020 remained almost at the level of 2019 (17.3 percent). In 2020, unlike in previous years, when the NBRB's foreign exchange operations were a key driver of the base money growth, the National Bank was selling foreign exchange to support the BYN exchange rate that led to sterilisation of BYN liquidity estimated at BYN 4.7 billion. As a result, the banking system shifted from structural excess of liquidity to its deficit. To replenish their liquidity, banks actively used their deposits previously placed with the NBRB, that resulted in the NBRB's liabilities to banks dropping by BYN 2.7 billion over the year. In addition, banks received loans in the amount of BYN 2.0 billion. The Government spent part of its BYN deposits held with the NBRB to support the economy in the amount of BYN 1.8 billion that also contributed to the BYN base money growth (Figure 4).

Figure 3. *Inflation (percent, y-o-y, end of period)*



Source: Belstat

Figure 4. *Monetary indicators (in percent)*



Source: NBRB

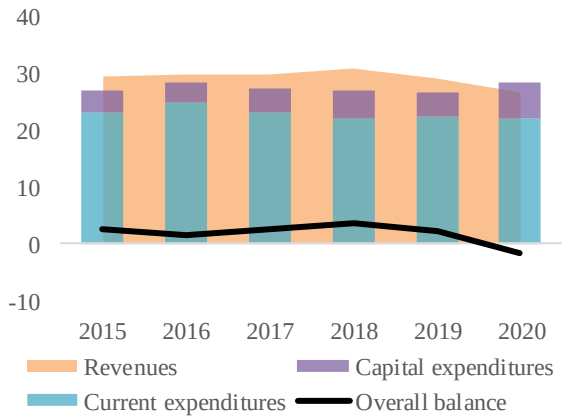
Fiscal Sector and Public Debt Sustainability

The key drivers of the 2020 budget deficit were lower exports of petroleum products and higher state support for enterprises amid the deterioration of their financial status. In 2020, for the first time ever since 2014, amid falling revenues combined with growing spending, the consolidated budget was executed with a deficit of 1.6 percent of GDP against a surplus of 2.3 percent of GDP a year earlier (Figure 5). Budget revenues decreased by 2.3 p.p. to 26.7 percent of GDP. This was driven primarily by lower customs revenues and gratuitous receipts (-1.7 p.p.) due to a decline in the volumes of exported petroleum products and discontinued transfers from the Russian Federation under the "customs re-clearance" arrangement for 6 million tons of oil, combined with lower oil imports, falling world oil prices, and the continued tax manoeuvre in the oil refining industry of the Russian Federation. The second most important contributor to lower revenues was a drop in profit tax revenues (-0.9 p.p.). This was a result of the overall decrease in net profits in the RB economy (-43 percent against 2019) as enterprises faced higher labour costs combined with lower sales and growing loan debt burden due to the significant BYN depreciation. The increase in spending to 28.3 percent of GDP (+1.6 p.p.) is explained solely by an increase in capital transfers to replenish authorised funds of state-owned enterprises in the amount of 2.1 percent of GDP, while in 2019, those expenditures were almost zero. Current expenditures decreased by 0.2 p.p. of GDP regarding all items, except for wages, which grew by 0.7 p.p. GDP, *inter alia* in the framework of anti-epidemiological measures.

The deficit was financed through net external borrowings, which led to an increase in the RB public debt. As at end-2020, the public debt amounted to 37.3 percent of GDP, having

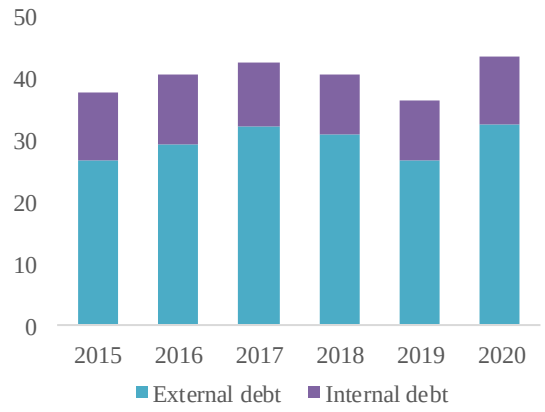
increased by 4.3 p.p. compared to 2019 (Figure 6) solely due to external borrowings—the domestic debt decreased by 0.1 p.p.

Figure 5. *State budget (percent of GDP)*



Source: MoF RB

Figure 6. *Public debt (percent of GDP)*



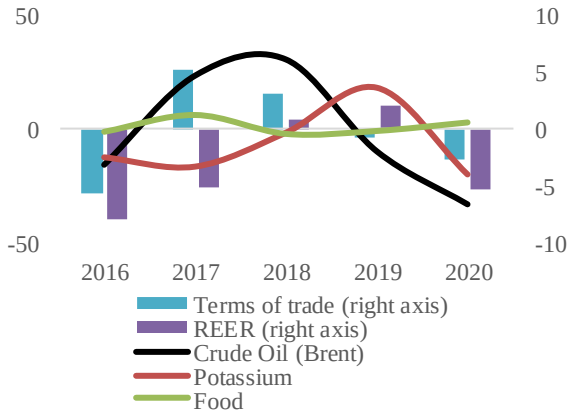
Source: MoF RB

External Sector

Despite a significant decline in foreign trade and an increase in income outflows, the current account (CA) balance improved significantly, primarily due to an increase in physical volumes of non-commodity exports against the background of a drop in imports. With the physical volumes of total exports declining by 0.4 percent in 2020 (y-o-y), non-commodity exports grew by 3.3 percent, *inter alia* due to the BYN real effective exchange rate depreciation (Figure 7), which contributed to a more significant reduction in export prices for that category of goods (-6.3 percent) compared to import prices (-4.3 percent). In turn, a suspension of oil supplies from the Russian Federation in Q1 2020 and lower domestic demand led to a decrease in physical volumes of imports by 9.5 percent, including non-commodity imports by 8 percent. As a result, the trade deficit halved, dropping from 6.5 percent of GDP in 2019 to 3.2 percent of GDP in 2020 solely owing to improved trade in non-energy goods. This positive effect was offset by an expansion of the deficit through primary and secondary incomes to -3.5 percent of GDP, against -1.3 percent of GDP year, which was driven by higher outflows of incomes accrued to foreign investors, lower wage incomes under the quarantine in the neighbouring countries, as well as discontinued transfers from the budget of the Russian Federation under the oil and gas agreements. With the surplus of trade in services at last year's level of 6.4 percent of GDP, the CA was almost balanced at the level of -0.3 percent of GDP, against -2 percent of GDP in 2019 (Figure 8).

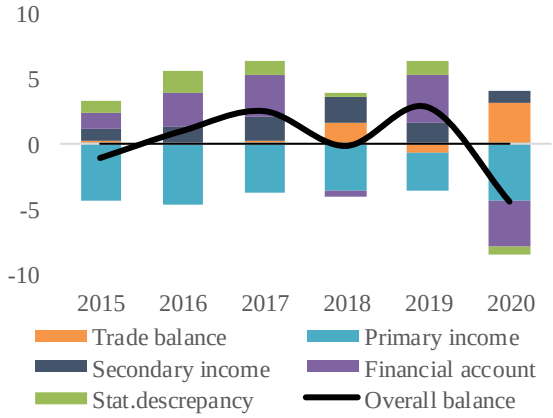
Higher devaluation expectations and unfavourable external economic conditions led to outflows under the financial account and, as a result, a decrease in gross international reserves. The total outflow of funds as at end-2020 amounted to US $2.1 billion or 3.5 percent of GDP. At the same time, the significant size of outflows under other investments (US $4.8 billion) was partially offset by inflows of FDIs (US $1.3 billion) and the Government's issue of bonds in foreign markets (US $1.4 billion). The financial flows under other investments were mainly generated through net acquisitions of financial assets by economic agents, which was manifested in significant purchases of foreign exchange by households and conversion of their foreign exchange savings into cash, as well as an increase in trade credit and advance payment made by enterprises to their foreign counterparts. As a result, the gross international reserves decreased in 2020 by US $1.9 billion to US $7.5 billion or 2.5 months of imports of goods and services. The GIR decline was driven by net sales of foreign exchange in the domestic foreign exchange market, as well as net repayments made by the Government and the National Bank to service the foreign exchange debt. At the same time, the factor contributing to maintaining the reserves was a revaluation of assets associated with an increase in the world gold price.

Figure 7. *Terms of trade (in percent, y-o-y)*



Source: World Bank, Belstat, NBRB

Figure 8. *Balance of payments (in percent of GDP)*



Source: NBRB

Financial Sector

The deceleration of business activity in 2020 led to a slowdown in the growth of banks' claims on the economy in comparable prices. The main driver of the loan portfolio growth by 22.1 percent (in current prices), against 10.8 percent a year earlier, was the BYN depreciation. With the exchange rate factor netted out, the growth was 10.9 percent and 12.2 percent, respectively. With a slight increase in foreign exchange claims (1.7 percent against 10.1 percent a year earlier), there was an increase in BYN loans (19.3 percent against 14.2 percent a year earlier) (Figure 9). The main driver of banks' BYN loan portfolio growth was corporate lending, combined with a significant slowdown in the retail segment. In the enterprise segment, the BYN lending grew significantly in case of both state-owned commercial enterprises[6] (36.4 percent) and in the private sector (22.1 percent). The expansion of the lending activity was facilitated by measures taken by the National Bank, including easing of its prudential requirements and provision of liquidity to commercial banks through substandard operations, as well as the Government's decisions to raise the directed lending ceiling from BYN 0.7 billion to BYN 2.4 billion. The growth of lending to households halved (11 percent against 22.2 percent a year earlier) and was mainly generated by loans to finance real estate. At the same time, the growth of consumer lending ceased almost completely and amounted to 1 percent against 27.4 percent a year earlier.

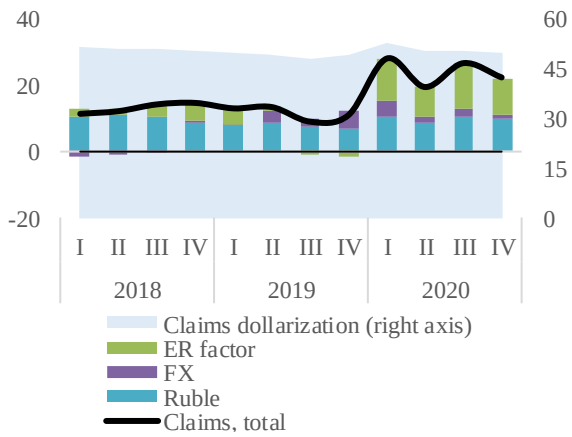
The policy of the monetary authorities aimed at restoring the public confidence in the banking system, against the background of the political crisis, accelerated inflation, and depreciation expectations of households, slowed down the outflow of deposits, but negatively affected the profitability of banks. In general, term BYN deposits declined by 7.1 percent in 2020 against an increase of 33.9 percent a year earlier, and foreign exchange deposits dropped by 8.6 percent against an increase of 8.4 percent a year earlier[7]. To enhance banks' capacity to respond to emerging shocks, the NBRB ceased to apply the estimated values of standard risk[8] (hereinafter referred to as the EVSR) to deposit market instruments starting in March 2020. As a result, the interest rates for new term deposits increased from 7.5 percent per annum in March to 13.1 percent per annum in December 2020. At the same time, the application of the EVSR to the interest rates for new BYN loans helped maintain them at about 11 percent per annum. As a result, starting from September 2020, the lending and deposit market faced an unusual situation when the interest rate

[6] State-owned commercial enterprises are commercial organisations with a stake of the state of 50 percent or more.
[7] Including the accrued interest. If the accrued interest is netted out, the BYN deposit decline could be 16.9 percent against an increase of 23.2 percent a year earlier, as estimated by the EFSD.
[8] The EVSR is a macroprudential tool aimed at limiting the business models of banks with increased risk appetite. The risk indicator used is calculated based on average interest rates of Group I banks of systemic importance, taking into account a measure of the interest rate variation. Banks implementing such business models are subjected to higher regulatory requirements in terms of their capital adequacy, loan loss provisioning, and required reserves.

for new term deposits significantly exceeded the interest rate for new loans (Figure 10). This situation resulted in the share of interest profits of banks in their gross income going down to 14.1 percent from 17 percent in early 2020.

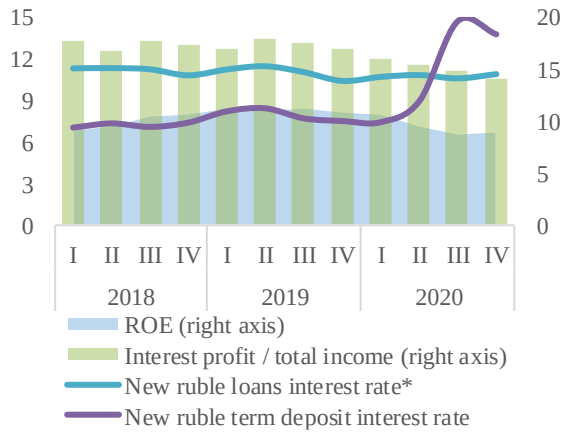
Overall, banks' financial performance shows relative stability. Compared to 2019, the return on equity decreased slightly from 10.9 to 8.9 percent but remains at an acceptable level (Figure 10). The regulatory capital adequacy decreased from 17.8 percent to 17.2 percent. The share of non-performing assets in total credit risk bearing assets increased slightly in 2020 from 4.6 percent to 4.8 percent. Nevertheless, in the first half of 2020, this figure reached 5.7 percent. The transfer of debts of certain entities to the Asset Management Agency contributed to containing the growth of non-performing assets[9]. The dollarization of banks' claims on the economy remained at around 50 percent.

Figure 9. *Bank lending (in percent, y-o-y)*



Source: NBRB

Figure 10. *Banking sector indicators*



Source: NBRB

Medium-Term Outlook and Risks

Under the baseline macroeconomic outlook for 2021-2024 (Table 1), the economic growth is expected to be low against the background of structural constraints of the existing economic model. Consumer and investment activities would remain weak. The main growth factor would be external demand associated with the recovery of the world economy and the economies of major trading partners after the easing of the restrictive measures taken to contain the COVID-19 pandemic. As a result, the annual growth rate of the economy would not exceed 1 percent.

The fiscal and monetary policies are expected to be based on the priority of ensuring a macroeconomic equilibrium. Weak domestic demand would help the inflation slow down and gradually approach the targeted level in 2022 (5 percent). Limited sources of the budget deficit financing would necessitate fiscal consolidation. The budget deficit is expected to gradually decrease to 1 percent of GDP by 2024.

The debt service needs will significantly strengthen the pressure on the budget. Gross payments to service and repay the foreign currency denominated public debt will average at about US $3.5 billion (about 5 percent of GDP) in 2021 to 2024. At the same time, the assumption under the baseline scenario is that the Government would be able to tap foreign markets and mobilise non-project related borrowings in the amount of 75 percent of principal repayments. The remainder of the debt would be repaid using foreign exchange revenues (including export duties) and Government foreign exchange deposits. Under such conditions, the gross international reserves

[9] In accordance with Decree of the President of the Republic of Belarus No. 166 of May 14, 2020 "On Debt Restructuring", the loan debt of certain organisations in the amount of BYN 1.85 billion is to be restructured.

would be at the level of about US $5.0-5.5 billion, which would mean their gradual decline to 1.5 months of imports.

The risks under the outlook include the following:

1. Deterioration of the epidemiological situation (the third wave of the pandemic) and slower recovery of the economies of the trading partner countries, especially Russia.

The risks associated with deterioration of the epidemiological situation and slower recovery of the economies of the major trading partner countries would negatively affect the economic activity in country. In turn, low economic growth would impact budget revenues and, as a result, the rate of the budget deficit reduction. With the average annual growth rate of the Russian economy declining to 1 percent, the real GDP growth in Belarus is expected to be close to zero.

2. Building up political tensions and restricted access to external borrowings.

With the political tensions building up and limited availability of external borrowings, the Republic of Belarus is likely to be able to borrow only in the framework of refinancing its debt to Russia and China (US $4.2 billion). Subject to maintaining the GIR at the level of 1.5 months of import (the floor under the baseline scenario), the use of Government foreign exchange deposits to fulfil its obligations should not exceed US $2.7 billion.

3. Easing of macroeconomic policies to stimulate economic growth.

The authorities may review their plans to reduce the budget deficit and strengthen the economic stimulus, including, for example, another expansion of directed lending or maintaining the rate of wage growth in the economy above the rate of productivity growth, despite the threat of eroding the macroeconomic equilibrium. Such actions may accelerate the emergence of financial gaps and boost their potential size.

Table 1. Republic of Belarus: Key macroeconomic indicators and medium-term prospective

	2020 Act.	2021 Forecast	2022 Forecast	2023 Forecast	2024 Forecast
National accounts and prices(%)					
Real GDP growth	-0,9	0,3	0,5	0,7	1,0
CPI (December, yoy)	7,4	6,7	5,0	5,0	5,0
Money and credit (as of the end of the period)					
Broad money growth, %	4,7	9,6	9,1	9,3	9,7
Key interest rate	7,75	7,75	7,75	7,75	7,75
Public finance (as % of GDP)					
Budget revenue	26,7	25,0	25,6	25,2	24,9
of which taxes	20,3	19,8	20,3	20,2	20,1
Budget expenditure	28,3	27,4	26,8	26,4	26,0
Balance ("-" deficit / "+" surplus)	-1,6	-2,5	-1,3	-1,2	-1,0
Public debt*	48,0	47.3	45.9	44.9	45.5
External sector (as % of GDP)					
Current account	-0,3	-0,1	-0,6	-0,9	-1,3
Export of goods and services	61,5	67,0	66,4	66,2	66,0
Import of goods and services	58,3	64,0	64,0	63,9	64,1
Foreign direct investment	2,1	2,0	1,9	1,9	1,8
Gross international reserves, months of import of goods and services	2,5	1,8	1,7	1,5	1,5

**Including guarantees of the Government, debt and guarantees of local authorities*
Source: RB authorities and EFSD estimations

MEDIUM-TERM PRIORITIES OF STRUCTURAL AND INSTITUTIONAL REFORMS IN THE REPUBLIC OF BELARUS

A sharp slowdown in the economic growth in the Republic of Belarus over the last decade indicates that the key growth factors of the early 2000s have exhausted and the potential for growth has significantly decreased due to mounting structural and institutional constraints. One of the key contributors to the slowdown of the average economic growth from 7.3 percent (2000-2010) to 0.9 percent (2011-2020), apart from the regional crisis of 2014-2015 and the 2020 crisis associated with the COVID-19 pandemic, was the exhaustion of the potential for accelerated capital formation, which was a driver of growth in the early 2000s, and the mounting structural constraints, including those related to the absence of effective reforms of the large-scale and poorly performing state-owned enterprise sector. These restrictions have had a significant negative impact on the private sector investment growth and, thus, on the total factor productivity growth. The country's fiscal position and balance of payments are extremely vulnerable to external shocks due to the insufficient geographic and product diversification of Belarusian exports[10] and low potential economic growth in general.

The key structural and institutional reforms needed to improve the potential and sustainability of the economic growth in the RB include:

(1) State-owned enterprise sector reforms aimed at improving its performance.

(2) Developing competition and creating a more favourable environment for private sector development.

(3) Improving the labour market efficiency.

(4) Reducing the high level of dollarization of the economy.

(5) Geographic and structural diversification of exports.

Efforts to improve the performance of the state-owned sector, which holds a dominant position in the economy, should be based on a systemic approach taking into account the specifics of individual SOEs, including their efficiency, financial sustainability, and role within existing value chains. The performance of the state-owned sector can be improved in a sustainable way through a combination of transition to a new corporate governance strategy in the state-owned sector—addressing the "owner-regulator" issue through transfer of all departmental enterprises to the State Property Committee (SPC) and their corporatisation—and adoption of decisions on SOEs on a case-by-case basis. The latter should be based on the results of diagnostic analysis performed with a view to classify enterprises depending on their type (strategic, open to privatisation commercial, non-profit) and financial status (sustainable, unsustainable). The transformation of the form of governance and classification of SOEs should result in lower, but more systemic and targeted state support; higher quality of sector-specific policies *inter alia* by relieving ministries of the day-to-day management of state-owned enterprises; and improved investment attractiveness of the Belarusian economy and FDI growth. Private capital could be mobilised through privatisation of commercial SOEs, as well as through re-profiling financially weak SOEs and placing them under trust management, in addition to standard bankruptcy procedures.

Withdrawal of numerous preferences for state-owned enterprises, combined with measures to improve the business climate, should give added impetus to the development of the private sector. Enhanced competition and a more favourable environment enabling the development of the private sector would be facilitated by curtailing exclusive preferences for the state-owned sector—e.g. the system of "commodity zones" in agriculture and food processing, directed lending provided in many cases without a proper assessment of project efficiency—and other essential measures, including strengthening the protection of property rights, reducing intra-country barriers to trade, and improving antitrust and price regulations.

A package of measures with different execution periods will be needed to improve the efficiency of the labour market. Short-term measures consist of strengthening and improving the effectiveness of social safety nets, including an increase in unemployment benefits. Long-term measures should consist of further pension system reforms, including those aimed at changing the system of social contributions to more equitably distribute the burden between employer and employee and creating a voluntary defined contribution pension system; education system reforms to adapt it to meet the needs of the labour market, including the

[10] In 2020, the share of Russia in total foreign trade of the Republic of Belarus was 47.9 percent, with that of exports of 45.2 percent and that of imports of 50.2 percent. The share of mineral and chemical products in total exports is about 40 percent.

introduction of new retraining, advanced training programmes and changes in the career guidance system for graduates; and boosting the development of the private sector.

Stronger confidence in the local currency and dedollarization of the economy would significantly reduce the volatility of many processes associated with exchange rate changes, improve the effectiveness of monetary policies, and lay the ground for using local currency savings to implement long-term investment projects. It is impossible to create conditions for financing projects with long payback periods without using debt instruments in local currency and reducing the share of foreign currency savings. These goals could only be achieved on condition that the macroeconomic stability is maintained over a long-term period, there is a change in the government's debt policy and prudential regulations to promote transactions in the local currency.

The diversification of exports would be facilitated by the overall growth of the economy of the Republic of Belarus, as well as measures aimed at deeper integration of the country's economy into global value chains. The diversification of the range of exported goods and services and expansion of markets could only be achieved through enhanced competitiveness of the goods and services produced—which should be facilitated through improved performance of SOEs and private sector development, as stated above—and better incorporation the RB economy into global value chains—thanks to the country's accession to the WTO, deeper regional economic cooperation and FDI mobilisation. If implemented, these measures, in addition to improving the composition of the economic growth, would reduce the vulnerability of the balance of payments and the state budget to external shocks.