

## On the verge of crisis? Mounting economic problems in Belarus

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Belarus's financial condition has visibly worsened since the beginning of this year. The severe falls in the country's foreign currency reserves and its shortage of foreign currency on the international market pose an increasing threat to the stability of the Belarusian economy. Fearing an outbreak of public dissatisfaction, the government has so far been trying to avoid devaluing the rouble or structural economic reforms. Maintaining full control inside the country and the stability of the authoritarian regime are still the main concerns for President Alyaksandr Lukashenka. For this reason, the actions taken by the Belarusian government have been limited to imposing short-term administrative restrictions on the foreign currency market and obtaining external support in the form of loans. Given Belarus's falling creditworthiness, Minsk is only able to ask Russia for financial support, thus offering the Kremlin more opportunities to realise its desire to take over strategic industrial plants in Belarus. However, the present economic problems of Belarus are so serious that no loan will be able to safeguard its government from the need of carrying out serious economic reforms.

### The special features of the Belarusian economic model

Belarus's economy is based on the command-and-distribution governance model inherited from the Soviet period. This involves management by means of the central planning of exports, imports, investments, production modernisation, etc. As a result, the Belarusian economy is particularly inflexible and inefficient in comparison to the neighbouring countries' economies, where free-market rules apply (albeit to various extents). At the same time, since a significant part of its industry is export-oriented, it is very vulnerable to the changing situation on the global market. The operation of the Belarusian economic model has long been based on Russian cheap energy and trade subsidies. Thanks to lower oil and gas prices, Belarus was able to generate significant revenues (for example, from exports of oil products (mainly to the EU and the USA), which enabled it to support the inefficient branches of its economy and finance its extensive social welfare system. Moreover, access to the Russian market on preferential conditions guaranteed many Belarusian firms, especially in the machine-building and food sectors, high level of exports for their goods (which would be rather uncompetitive on Western markets). Thus the industrial production rose continually and leveraged high economic growth, which ranged between 7 and 9 percent over the past decade.

## The causes of Belarus's economic problems

In an attempt to force the Belarusian government to make concessions (including selling its strategic petrochemical, machine-building, metallurgical and food plants), Russia has been gradually reducing these preferences since 2007. The rise in Russian oil and gas prices caused a significant increase in the costs of operation for the unreformed and energy-consuming Belarusian economy and a worsening of its trade balance, which had already been negative. The trade deficit (in the exchange of goods) reached US\$9.6 billion (including US\$8.3 billion with its main trade partner, Russia). This is the highest deficit level in the history of independent Belarus. The total value of trade turnover reached approximately US\$60 billion. A good illustration of the negative economic trends is the condition of the Belarusian petrochemical sector, which is one of the country's main sources of budget revenue (around 10 percent in preceding years). Belarusian refineries were barely able to remain profitable in 2010; and since new, even less favourable conditions for Russian oil supply and processing were introduced at the beginning of this year, the Belarusian petrochemical industry has fallen into the red, and is now generating losses. Another factor which has significantly contributed to the worsening of the economic situation in Belarus is the fall in demand for and prices of the key Belarusian exports (oil products, artificial fertilisers and metallurgical products) on Western and non-European markets due to the global crisis.

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As a result, the demand for foreign currency increased among entrepreneurs at the end of last year, due to the growing costs of their foreign debt service and the higher costs of importing raw materials and equipment. The demand for foreign currency also increased among Belarusian citizens, who were expecting a devaluation of the rouble. Thus the Belarusian central bank was forced to make frequent interventions

on the foreign currency market in order to maintain the fixed exchange rate for the rouble. An additional burden on the state's finances resulted from rises in public sector wages (the average wage was increased from approximately US\$370 in the middle of 2010 to approximately US\$500 at the end of 2010), which the government made before the presidential elections last December. As a result, the Belarusian gold and foreign currency reserves in 2010 fell to as low as 9.5 percent of GDP, which was the worst result among all countries in this region (for comparison, it reached 32 percent in Russia and 25 percent in Ukraine).

Paradoxically, despite these processes, Belarus maintained a high level of GDP growth, which reached up to 7.6 percent (the result for the first two months of this year is similar). This surprisingly good result is to a great extent artificially inflated by the centrally planned industrial production, which is carried out regardless of current demand for given goods; in connection with this, a significant part of goods from Belarusian manufacturers (especially in the textile and machine-building sectors) end up being stored in warehouses.

## The worsening of the state finances in 2011

The dynamics of the negative processes in the area of state finance have clearly increased since the beginning of 2011. The central bank's foreign currency reserves fell by approximately US\$1 billion (20 percent) in January-February alone, and on 1 March were as low as approximately US\$4 billion, which was far below the equivalent of three-month imports, the amount necessary to maintain financial stability (estimated to reach approximately US\$9 billion). This decrease took place despite the Belarusian government's issue of Eurobonds worth US\$800 million this January and the frequent borrowing of foreign currency in exchange for the rouble equivalent by the central bank from commercial banks. The value of funds thus obtained over the past year increased by fifty times, to US\$4 billion, and now the central bank's debt to other banks is higher than the level of its foreign currency reserves.

At the same time, Belarus's foreign debt has risen significantly. According to official data, on 1 January 2011 its foreign debt exceeded US\$28 billion (approximately 52 percent of GDP), which means an increase of almost 30 percent compared to the beginning of 2010. Although the country's foreign debt reached only 21 percent [of GDP], its remaining part is de facto generated by state-owned companies and therefore needs to be treated comprehensively. It is worth noting that Belarus will have to repay as much as US\$8 billion to its creditors within the next five years, and the repayment peak is expected in 2013–2014. Servicing the foreign debt alone generates high costs, estimated to reach US\$695 million this year alone.

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The trade balance deficit is also deepening. According to the latest data, the negative balance in January-February 2011 reached US\$1.96 billion, while at the same time last year it stood at US\$468 million. Inflation is also growing at an alarming rate. In the first two months of this year, it grew by 4.2 percent, half the rate which this year's budget provides for. Prices of goods in Belarus increased more in this period than was the case, for example, in Lithuania, Ukraine or Russia.

At the same time, the general public is increasingly distrustful of the Belarusian rouble, and demand for foreign currency is rising. At present it is quite difficult to buy foreign currency in Belarus. More and more reports are also received of further restrictions aimed at inhibiting demand for foreign currency among individual buyers. The shortage of foreign currency has also forced some Belarusian firms to limit their operations. In response to the mounting problems in the Belarusian economy, the international agencies Moody's and Standard & Poor's lowered Belarus's credit ratings this March, which will adversely affect its creditworthiness on international financial markets.

## Measures taken by the government to improve the situation

As a consequence of the worsening condition of the state finances, the Belarusian government has applied instruments typical of the command-and-distribution model. A number of

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restrictions have been imposed on the purchase of foreign currency by business entities, which have been most responsible for the pressure of demand on the currency market. For example, a ban was imposed on importers purchasing foreign currency from the market in the case of transactions exceeding €50,000. An obligation to report the intention to buy foreign currency on the

Belarusian foreign currency exchange 30 days in advance was also introduced. All those moves were aimed at stemming the outflow of foreign currency from the internal market, mainly by limiting imports, which at the same time was intended to reduce the negative balance in trade exchange.

The government has been acting chaotically and inconsistently. New solutions have been superseded by other administrative regulations after a few days, which has made the situation on the financial market even more complicated. Over the past few weeks, the Belarusian government has trying to calm public sentiment by ensuring that the situation is under control. At the same time, the central bank on 28 March agreed to expand the currency fluctuation range to 10 percent on the inter-bank market, which can be seen as a preliminary sign that the government has indirectly accepted the gradual devaluation of the Belarusian rouble. Furthermore, to stabilise the situation, on 31 March the central bank decided to suspend any new regulations on the foreign currency market for one month. At present, the Belarusian government is pinning its hopes on obtaining a loan of US\$1 billion from Russia and a loan

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of approximately US\$2 billion from the Anti-Crisis Fund of the Eurasian Economic Community (EurAsEC). These funds will be allocated to supplementing the evaporating foreign currency reserves.

At the same time, the government has disregarded suggestions which experts from the International Monetary Fund have been making over the past few months, and avoided any radical moves to reduce budget

spending, for one possible measure. The Belarusian regime fears that any tough economic decisions could give rise to public dissatisfaction, and thus undermine the system's stability.

However, it seems that under the pressure of the mounting problems, Minsk is becoming increasingly aware of how serious the situation is. On 31 March, Deputy Prime Minister Siarhey Rumas announced the imposition of stricter budget discipline, including significant cuts in the financing of state investment programmes. At the same time, the government has undertaken to submit a plan for macroeconomic reforms to Moscow in the near future, since Russia has made its loan decision dependent on that.

## The political and economic consequences of the mounting economic problems

Belarus's deteriorating economic situation will have far-reaching political and economic consequences. The government's restrictions on the financial market have led to the emergence of two different foreign currency rates, and the difference between the official rate and

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the market rate is now around as much as 25–30 percent. Therefore, it is reasonable to state that the rouble is gradually devaluing, contrary to the central bank's assurances. Although this gradual per se devaluation may have a positive effect on the condition of the Belarusian finances over time, this process is now out of the central bank's control, which calls the effectiveness of the Belarusian government's policy into question. Foreign debt is also becoming an increasingly serious problem. Although it has not as yet reached a critical level, the rate of its growth alone may pose a threat, especially that the funds which will be obtained from the loans will not be allocated to financing reforms, but only to underpinning the existing inefficient model. Furthermore, the unfavourable debt structure makes the situation even worse: most of the loans will have to be repaid within the next three years. As a consequence, Belarus finds itself in a debt spiral, and must take more loans to pay off the ones it took before.

The deepening economic problems are not temporary, as the Belarusian government argues, or the effect of a market slump. The present situation results from the specific policy pursued by President Lukashenka, whose main priority is to keep and reinforce absolute control over all the key areas of the country's political and economic life. For this reason, all other issues, including overcoming the economic crisis, are totally dependent on the Belarusian president's political goals. The Belarusian government, fearing public destabilisation, has been maintaining the post-Soviet economic system, which has been possible for an extended period thanks to Russian energy and trade subsidies.

The Belarusian economic model, which is now deprived to a large extent of Russian support, consumes much energy and has an outdated infrastructure, and is no longer able to function without thorough reforms. The administrative actions taken by the government

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and a further increase in the foreign debt are provisional, and may only stabilise the situation for the next few months. According to Belarusian economists' estimates, the government needs approximately US\$1 billion monthly to keep the rouble exchange rate at the present level, which means that Belarus will need an additional US\$6-7 billion by the end of this year.

At the same time, the lowered credit rating will make any new issue of Eurobonds significantly more difficult for Belarus. On the other hand, the cooling of relations with the West after the rigged presidential elections last December and the repression used against the opposition afterwards have now made it impossible for Minsk to seek support from the International Monetary Fund and other international financial institutions. Therefore, Minsk may only ask Russia for loans, an opportunity the Kremlin is likely to use to negotiate more favourable conditions Russian investors

doing business in Belarus, and to take over at least some of the strategic assets in the Belarusian economy. Aleksei Kudrin, Russia's deputy prime minister and finance minister, announced on 15 March that Russia could respond positively to Minsk's request for granting two loans worth US\$3 billion in total, on condition that a plan for structural reforms based on the IMF's previous suggestions was presented. It is possible that this reform package will also include privatisation of the Minsk vehicle plant MAZ, which the Russian company KAMAZ is at present seeking to take over. This means that not even the Russian government is not ready to continue supporting Belarus, unless its economic situation becomes at least partly more stable, so that Belarus can meet its loan and trade obligations to Russia.

## Forecast

Deprived of other possibilities to obtain funds, Minsk is likely to yield to pressure from Moscow for the time being. The Belarusian government presented Russia with an action plan to stabilise the economy at the beginning of April.

However, in the longer run, Lukashenka will have to choose between Russian support at the expense of increasing dependence on Moscow, and an attempt to resume dialogue and co-operation with the West, in exchange for refraining from repression against the opposition. Therefore, it cannot be ruled out that the regime will take actions to improve its relations with the EU and the USA in the next few months, and will exploit the problem of political prisoners for this purpose. One preliminary sign of this may be the bringing of milder charges against those opposition members who have been in prison since the post-election demonstration on 19 December 2010.

However, regardless of this strategic decision, it seems to be inevitable that Minsk must make more radical economic moves (principally the devaluation of the rouble) than hitherto; otherwise the Belarusian economy may very soon collapse. This move is expected by Belarus's key real and potential creditors, namely Russia and the West. Everything seems to indicate that the mounting economic problems are already so serious that they will force Minsk to make (at least partial) changes to its previous economic, internal and foreign policies.



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