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## PRIVATISATION IN BELARUS: FAR FROM WESTERN STANDARDS

Belarus authorities have not considered privatisation as an important part of the country's economy for a long time but the 2011 financial crisis broke the economic model based on loans and donations from Russia, so new laws to boost foreign investments were launched.

However, it did not take long to understand that the privatisation process in Belarus is only pursued as long as it does not threaten to reduce the power of the regime. Moreover, the authorities in Belarus are privatising big companies for investors from Russia in exchange for some short-term benefits. Thus, it is clear that privatisation in Belarus is much different not only from Western standards, but even from processes in some post-Soviet states, where privatisation happened more or less successfully.

In the first article Maryia Akulava, a junior researcher at BEROC, reviews the investment climate in Belarus and states that there is no reason to expect activation of the privatisation process in the near future. Despite the much better

ranking in Doing Business rating, there are still many obstacles for investors in Belarus.

In the second article Aliaksandr Sinkevich, an independent economist, reviews the current situation of the privatisation process in Belarus. Regardless of the problems of the Belarusian economy, privatisation is still not open enough to be seen as 'normal' from the point of view of Western standards. However, the author gives two possible scenarios for future prospects.

This issue of *The Bell* also features a third article, which was produced under the project "Raising the Expertise of Grassroots Level Researches in Belarus", carried out by EESC. The article about the advantages and disadvantages of Belarusian participation in CES was written by economist Nataliya Ryabova in cooperation with Anna Maria Dyer from the Polish Institute of International Affairs (PISM). We hope you will enjoy reading the new issue of *The Bell*!

*Vytautas Keršanskas, Editor*

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## REALITY OF THE BELARUSIAN PRIVATISATION PROCESS

*Maryia Akulava*

Privatisation of state assets is one way to attract strategic investors and accumulate foreign capital. However, despite the declared approval and acceptance of the privatisation plan for 2011-2013, it is still not a priority for the Belarusian government, and privatisation continues to be evaluated only from the fiscal perspective, with the result that the authorities intend to sell state property at the maximum price without negotiating with potential buyers. It could be said that the privatisation process was almost fully defeated in 2012 with only a few state assets being purchased. And the same trends are observed in 2013. Even though the amount of foreign direct investment remains stable (Table 1), most of this is in the form of reinvested earnings and not financial sources accumulated through privatization.

The competitiveness and effectiveness of Belaru-

sian state assets are presently causes for concern as there is a large gap between the state and private sectors. The World Bank's estimations of productivity in the machine building industry revealed that private companies are 25% more effective compared with state-owned enterprises.<sup>1</sup> These estimations were conducted using 4 different econometric techniques and all of them showed a significant gap between the total factor productivity (TFP) of private and state sector. This allows us to be confident in the reliability and credibility of the results. The main reason for such

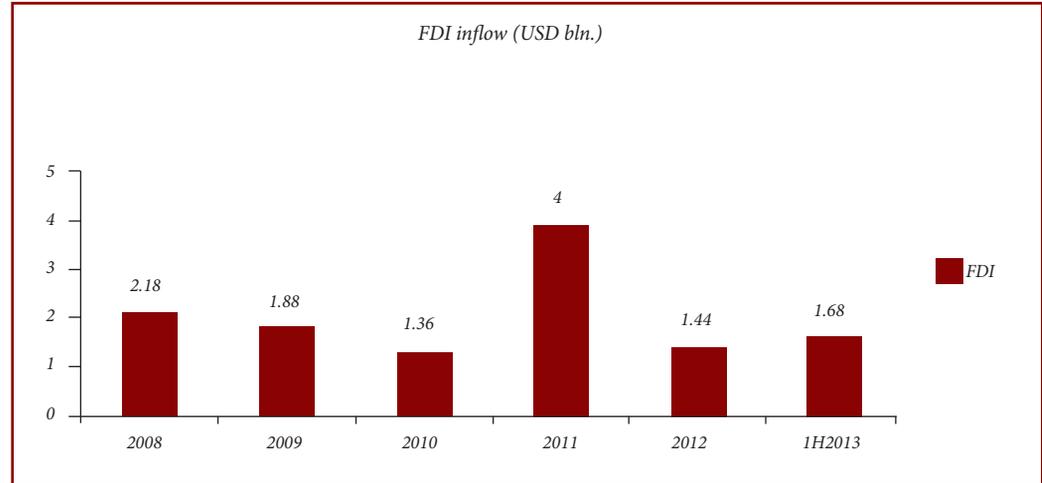
<sup>1</sup> For more information see: "Structural Challenges for SOEs in Belarus: a Case Study of the Machine Building Sector" <http://documents.worldbank.org/curated/en/2012/03/15967918/structural-challenges-soes-belarus-case-study-machine-building-sector>

**Steps, taken in Belarus to increase the competitiveness of the state sector are ineffective and there are no signs of improvement.**

a gap in productivity is the inefficient allocation of resources (excessive employment and non-earning investments).

Thus, it becomes obvious that steps, taken in Belarus to increase the competitiveness of the state sector are ineffective and there are no signs of improvement. Therefore, the importance of the privatisation of state assets becomes more and more evident.

Picture 1. Inflow of FDI to Belarus



Source: Balance of Payments of the Republic of Belarus

It should be noted that Belarus has certain advantages, which can be used by investors.

- Access to markets of EEA states (Belarus, Russia, Kazakhstan). This is beneficial in different directions:
  - Territory with unified customs tariff.
  - Equal economic conditions, including costs of major energy resources.
  - Unified rules of technical regulation, common sanitary, veterinary and phytosanitary standards.
  - Free movement of goods, services, capital and labour.
  - Exemption of import duties on technological equipment and raw materials, which are imported for the implementation of investment projects.
- Belarus is to some extent the transportation and logistics hub of the Eurasian region. More than 100 million tonnes of European cargo pass through Belarusian territory annually (around 90% of which are between Russia and the EU). Belarusian transit potential is far from being exhausted. Belarusian transit corridors are actually only using about 25-40% of their real carrying capacity.
- There are several preferential regimes for foreign companies:
  - Seven free economic zones, which offer 0%

- profit tax for the first 5 years and 10% VAT;
- High-Tech Park with 0% profit tax for the first 15 years and 0% VAT;
- China-Belarus Industrial Park with 0% profit tax for the first 10 years;
- Belarusian small and medium cities with 0% profit tax for the first 7 years and 0% VAT for the first 5 years.

During the last few years the business environment in the country has improved slightly. Mea-

sures taken by the authorities have helped to increase Belarus' position in the Doing Business rating (from 106<sup>th</sup> position in 2005 to 58<sup>th</sup> in 2012). However, there is still long way to go in order to become an attractive and stable economy. One of the main problems is connected with investment attractiveness, where Belarus is ranked 82<sup>nd</sup>. In turn, this results in a slow privatisation process and accumulation of external financing.

Table 1. Position of Belarus in Doing Business Ranking

Ease of Doing Business Rank	2005	2008	2011	2012
Belarus	106	85	60	58

Source: Ranking of Doing Business in Belarus

The reasons for such unsatisfactory privatisation have been the same for many years. They include the following obstacles that prevent enterprises from going private.

- Multiple administrative bodies, which are in charge of privatization. This leads to misunderstandings as to which body has responsibility for what, with resultant time-consuming negotiation processes.
- Differences in methods of asset valuation. The authorities keep focusing on the book value of enterprises as a minimum price, while potential investors are more interested on ability to generate cash flows.
- Additional requirements, which investors are obliged to fulfil in order to obtain a state asset. These requirements include preservation of jobs, investment of additional financial re-

**Current trends show that there is no reason to expect activation of the privatisation process in the near future**

- sources, and preservation of production volume. Thus, a potential investor is not able to take independent decisions.
4. Lack of transparency. The main negative here is that periodically information regarding certain deals, which were finalised through unofficial negotiations rather than through auctions, leaks out.
  5. Lack of interest of management and local officials in privatization. This results in unwillingness to provide full and credible information due to the fear of losing control over the asset.
  6. Under-development of HR and consulting services in the country.
  7. Macroeconomic instability.
  8. Property rights protection. The renationalisation of OJSC Kommunarka and Spartak, which happened in October had a negative effect and raised concerns regarding property rights protection in the country. As a result, during the Belarusian Investment Forum 2012 that took place right after these events, no contracts or agreements were signed and just 12 protocols of intention were recorded.
  9. Probable renewal of "golden share". The main concerns are triggered by possible acceptance of the bill "On Amendments to the Law on Privatization of State Property and Transformation of State Enterprises into Joint Stock Companies". The draft of that document was approved at the first reading in June 2013. Thus, should it be approved at the second reading, this bill will officially come into force. The official goal of the bill is to improve the protection of minority shareholders, who will be presented by state representatives. Acceptance of the bill will allow officials to vote at shareholders' meetings and to veto the decisions of shareholders should they contradict the interests and well-being of the country. Thus, the possibility of increased state control and power will likely decrease the interest of investors in the privatisation of Belarusian assets and make this process even slower than it is now.

On the other hand the authorities are taking measures to make the privatisation process more dynamic and smooth. In March 2013, the Council of Ministers issued a resolution, which intends to support and protect the representatives of the private sector. This bill suggests setting a ban on the revision of privatisation deals after their closure. Taking into account all the concerns regarding property rights protection, this bill is a sort of signal to investors about the improving economic situation. Thus, it is the right measure in terms of improving the investment climate. However, the strength of its impact is unclear due to probable changes in regulation and increase in the power of the state. Therefore, it is very likely that there will not be any significant change in the privatisation process in the nearest future.

On the other hand Belarus should expect an increase in demand for enterprises, formed in the form of greenfield investments. The reasons for that statement are twofold. First, from the investors' side this is a relatively protected placement of capital. On the other hand, the state is also interested in this form of investment. Such enterprises usually show a high level of efficiency and competitiveness and they are oriented on exports and not on the domestic market. This motivates the authorities to attract this form of foreign financing. The priority industries for such investments are renewable energy, pharmaceuticals and biotechnologies, automobile construction, IT sector and food industry.

So what measures could be taken in order to activate an inflow of foreign capital to the economy and the privatisation process in particular. Basically Belarus can follow the experience of other countries that have had positive results.

First, the country should continue working on the creation of special economic zones as was done in China. The idea was that at the beginning of reforms, 1979-1980, there were high political and economic risks in the country. The authorities chose the city of *Shenzhen not far from Hong Kong*. *As the interest of investors was low it was decided to sell land (lease) on more favourable terms compared with Hong Kong and Beijing. Thus, land was offered at a price of 1 to 11 compared to the price of land in Hong Kong. Moreover, a favourable tax regime was also introduced: tax on profit was removed for the first 3 years, and during the next 3 years just 50% of profit tax had to be paid. However, there was only one condition – attraction of high technologies. As a result the city was transformed into a metropolis, where the amount of money in investments attracted by enterprises was USD 30 bln. The enabling technologies of an urban economy are industries of new and high technologies, modern logistics, banking and financial services and culture. Moreover, as one of the main foreign trade border check points Shenzhen is number 1 among all large and medium cities of China in terms of gross volume of exports and imports during the last 10 years.*

*Second, qualified and English speaking labour force. There is currently a problem connected with limited opportunities of professional training and the need for retraining. One possible solution is a softening of immigration policy that would facilitate the inflow of the required highly skilled employees from abroad.*

*Third, incentives for investors in the form of grants for the purchase of equipment, industrial intake, R&D, personnel training (with the provision that a company must return the grants should they terminate operations before a specific period time has elapsed).*

**Even uneasy conditions did not encourage the government to choose privatisation as a priority in resource mobilisation.**

*Fourth, investment grants for small and medium enterprises (covering part of investment costs).*

*Fifth, construction of hotels not just in Minsk but also in regions. On the one hand, this will reduce the costs of potential buyers. On the other hand, the level of development of the hotel industry and the range of services provided have an impact on the volume of tourist revenues in the regions of the country.*

*Implementation of these recommendations will help to foster the accumulation of foreign capital by the Belorussian economy, which in turn will increase the productivity and competitiveness of the country in external markets.*

## Conclusions

Thus, current trends show that there is no reason to expect activation of the privatisation process in the near future. There is still a need for reforms and qualitative changes in the economy and unless this is recognised it will likely lead to a decrease in investment attractiveness. Moreover, ambiguity of legal acts on the privatization process brings uncertainty and additional risks for potential buyers. Therefore, it is likely that investors will focus on greenfield projects. As for privatization, structural reforms and strengthening of the protection of private property are inevitable in order to make the selling process of state assets realistic and effective.

# PRIVATISATION IN BELARUS: CURRENT SITUATION AND PROSPECTS FOR THE FUTURE

*Aliaksandr Sinkevich*

## Background

Launched in autumn 1993 with the goal to reduce the share of the state sector in GDP by two thirds, privatisation in Belarus was delayed in comparison to neighbouring countries. Aliaksandr Lukashenka became president a year later and succeeded in radically slowing down, and almost completely terminating privatisation by 1998. Later, privatisation was targeted and GDP in the private sector grew slowly, reaching 30 per cent in 2012.

The Belarusian economy boomed in 2000s, the boom was based on processing industries, thanks to the rapid rise in the price of Russian energy sources. As a result, there was a dramatic growth in the negative credit balance deficit of current account operations, which rose to 15 per cent of GDP in 2010. To finance the deficit, the government borrowed extensively, with external debt exceeding 40 per cent of GDP and reaching the average level of other Eastern European countries.

However, even such uneasy conditions did not encourage the government to choose privatisation as a priority in resource mobilisation. Between 2008 and 2012, gains from privatisation amounted to just about 4 billion USD, well below the 10.5 billion growth of foreign national debt in the same period.

## Why privatisation is almost frozen now

Lukashenka's statements indicate that limitation of privatisation processes is an informed choice of the Belarusian leadership. It is based on their certainty that profit is not always the core criterion of economic activities, that private business does not

always act in the best interests of society, and its functions should be limited to the small business sector. This is why one cannot claim that Belarusian privatisation is just a measure of reacting to cash deficiencies in the system of state finances.

There are clear reasons behind the fact that Lukashenka harshly criticised and rejected the plan by Miasnikovich's government to privatise 2000 enterprises in autumn 2011, during a serious currency crisis.

Rather than unwillingness of the Belarusian authorities to engage in privatisation, the unhurried dynamics of privatisation processes after the beginning of the global economic crisis in 2008 testify to the rejection by potential investors of two key conditions:

1. Maximum price for a privatisation deal;
2. Guarantees of full use of production capacities at a privatised enterprise.

If an investor and the authorities agree on the abovementioned two points, the privatisation of any, even strategic, state-run enterprise is possible. If a consensus is not found, the privatisation is stopped regardless of previously announced plans, the list of companies for privatisation, demands of the IMF or the Bank of the Eurasian Economic Community (EurAsES).

A deal with Gazprom on Beltransgaz gas transportation enterprise in 2011 is a good example. Concluded after the currency crisis, it met the Belarusian conditions: maximum price, an obligation to enhance gas transit, and a discount of 50 per cent in the price of gas. Simultaneously, the Russian oligarch Kerimov received a tough reproach and was exposed to public mockery by

**The conditions of the Belarusian government are not attractive for venture capital, but they are acceptable for real-sector investors who need Belarusian capacities to expand their production.**

Lukashenka for an attempt to bribe him in 2012 with USD 5 billion, with a goal to reduce the Belaruskaliy price by half.

So, the privatisation processes have been halted by external (global downturn) and internal reasons (government's tough conditions), resulting in hesitation by investors to put up money for Belarusian companies and the fear of the Belarusian government to undersell.

Belarus is not even rushing to introduce the IFRS reporting scheme, something that could considerably facilitate their communication with investors. Only the biggest companies introduce IFRS. This is yet another indication that massive privatisation is not on the government's agenda.

In fact, re-nationalisation is a more visible trend recently, their new private owners suspected of shadow schemes or financing the opposition. It was because of these reasons that Marat Novikau lost his shares in the Kommunarika and Spartak factories in 2012. The government explained that the privatisation of the 1990s was premature, with many companies grabbed for next to nothing. In spirit, this campaign resembles the windfall tax in the UK.

#### **How long will the status quo endure**

The conditions of the Belarusian government are not attractive for venture capital, but they are acceptable for real-sector investors who need Belarusian capacities to expand their production. Such investors can tolerate falling profitability in the Belarusian segment of their technological chain, and enjoy extra profits brought by the growing scale of overall production and sales.

However, an inflow of such investors is likely to be very limited until the recovery of the global or at least the Russian economy. The recovery will improve the capacity of Belarusian companies to generate positive cash flows and result in growing attractiveness for investors.

Therefore, the declared plans to raise USD 4.5 billion by selling state property in 2014 are likely to remain just another unbinding plan indicator. The hopes of some experts that the crisis should force the leadership to soften their positions are not justified: crisis manifestations in 1998, 2009 and 2011 have never resulted in mass privatisation, price-cutting for assets or reduced demands on investors. Indeed, Belarus is now even more resilient to dramatic developments in the economy thanks to forex reserves of USD 7 billion, more than twice that of the crisis in 2011.

#### **Can privatisation step up?**

For sure, one cannot rule out a complete reconsid-

eration by the leadership of privatisation issues, but it can only happen gradually. If the stagnation of the Belarusian economy since 2012 continues and the old methods to tackle structural unbalances prove inefficient, the so-called 'liberal lobby' can intensify in the Belarusian government. They will push the President and his entourage to see privatisation as the only way out of the crisis; their influence is already visible, with government officials increasingly including slogans of profitability and systematic privatisation in their rhetoric and expecting even cultural and social projects to be self-financing.

The experience of privatisation in Russia and Ukraine in the 1990's shows that local officials primarily chose the selling of state property as a way of addressing pressing challenges and to monetise their powers. If oriented towards such goals, privatisation only leads to deindustrialisation, depopulation and a close group of actively lobbying oligarchs.

Therefore, the intensifying 'top-down' privatisation would be a product of the power elite's demoralization and corruption by easy privatisation money, resulting in the deterioration of governance. Lukashenka is obviously not interested in such developments, and this is one more reason for him to dislike the idea of privatisation.

#### **Effects of targeted privatisation**

The political effect of hypothetical privatisation is directly linked to its massiveness. However massive privatisation is hardly realistic. The targeted privatisation adopted during the last 15 years is much more likely, primarily with the participation of Russian investors.

The privatisation of big companies by a few loyal businessmen is not able to provoke short-term political change. Large investors and the authorities share the goal of long-term social and economic stability. Gazprom and Sberbank serve as examples of such investors, purchasing Beltransgaz and BPS, respectively. Therefore, this kind of privatisation can even stabilise the regime in the short run. In the long run, however, the dependence on big businesses, especially foreign ones, can lead to a business-government conflict or a degradation of power elites down to typical compradors.

Mechanisms of public-private partnership can help to manage these risks. This is why all major Belarusian businessmen are already integrated into the local economic model. To avoid surprises and obtain leverage on privatised companies, a 'golden share' draft law was launched in 2013, giving the state privileged rights to defend public interest or security. The government will also get a say in the boards on behalf of minority shareholders.

Transnational companies are another type of partnership with foreign private capital which Belarus is also trying out. The Belarusian Potash Company, a joint trader of Belaruskaliy and Uralkaliy, was one of the first fruits. The scandalous collapse of the cartel in summer 2013 demonstrated an unsatisfactory level of management by the Belarusian side that was supposed to prevent the breach. Belarus responded with tough actions and these proved rather effective. Still, creating transnational corporations is ongoing, and the Belarusian leadership might learn from mistakes.

### Effects of massive privatisation

Should massive privatisation happen instead of a targeted one, it might be a landslide for the social landscape of Belarus. The state will fail to defend its properties from speculators and raiders. Massive closures of unprofitable companies are likely, inevitably resulting in social tensions with unpredictable prospects.

What one can predict is the concentration of pri-

vatized assets in the hands of a few new oligarchs. The ordinary people of Belarus have no savings to allow them to participate in a real people's privatisation. The survey of shareholders and managers in 2012 showed that minority shareholders are seeking to sell their shares as soon and for as much as possible, rather than engaging in management and expecting dividends. This is proved by the experience of the IPO of Minsk sparkling wine plant in 2012 and 2013, when the Triple company of Yury Chyzh consolidated 15 per cent of shares out of 25 per cent offered to physical minority holders.

Therefore, a full-fledged and quick people's privatisation process is hardly possible, since it demands long-standing efforts to educate responsible ownership skills in citizens. On the other hand, if successful, it could increase the share of small owners in Belarusian society, and they are likely to be interested in playing a role in public life. This option is also quite possible, though less likely than targeted or landslide privatisation.

## BELARUS IN THE CES: ADVANTAGES AND DISADVANTAGES OF ECONOMIC INTEGRATION\*

Anna Maria Dyner, Natalia Ryabova

*Belarusian accession to the Common Economic Space (CES) was forced by two factors—the 2011 crisis and the necessity to gain cheap energy resources. Although Russia fulfilled its promises, decreasing gas and oil prices, Belarus is now feeling the negative results of the integration. According to CES rules, Belarusian authorities will have to tighten monetary policy, and reduce social spending and public financing of state-owned enterprises. The situation may be improved by foreign investments, but among the three CES countries, Belarus is the least attractive, especially since Russia joined the WTO and the because of the possible accession of Kazakhstan in the near future. Because of the need to carry out the major reforms in Belarus, the European Union has a greater chance to influence the situation in that country, for example by supporting modernisation projects.*

The Common Economic Space (CES) of Russia, Belarus and Kazakhstan is the transitional stage between the existing Customs Union and the Eurasian Economic Union, due to be established by January 2015. The main argument for Russia, Belarus and Kazakhstan in favour of integration in the framework of the CES is that of establishing close economic connections, which will become the main driving force for their economic growth. However, despite declaring the economic benefits of the integration, many questions about the

possibilities and prospects of such integration arise.

While assessing the basic principles of the CES, one could admit that it was, theoretically, created along the lines of the European Union. In the framework of the CES, 17 agreements aimed to establish “four freedoms”: movement of products, services, labour and capital, were adopted. Equal conditions for all CES member states should be ensured by removing barriers, alongside coordinated macroeconomic policies and the gradual transition to a single currency. The harmonisation of macroeconomic policies also was modelled on EU rules. The countries undertake fulfilment of strict liabilities on budget deficit, state debt and inflation. Hence, the budget deficit threshold was established at 3% of GDP, in accordance with that of the EU. The limit on state debt is even stricter than the benchmark for European Union Member States, at 50% of GDP. Besides this, inflation should not exceed the lowest inflation rate in the CES countries by more than 5%.<sup>1</sup>

\* This article was firstly published in PISM Policy Paper no. 24 (72): [http://www.pism.pl/files/?id\\_plik=14504](http://www.pism.pl/files/?id_plik=14504)

<sup>1</sup> Eurasian Economic Commission, “Soglasovannaya makroekonomicheskaya politika gosudarstv-chlenov Tamozhennogo soyuza i Yedinogo ekonomicheskogo prostranstva”, [www.eurasiancommission.org/ru/act/integr\\_i\\_makroec/dep\\_makroec\\_pol/Pages/sogl.aspx](http://www.eurasiancommission.org/ru/act/integr_i_makroec/dep_makroec_pol/Pages/sogl.aspx).

The main reason for Belarus to join the CES was the economic crisis of 2011.<sup>2</sup> By this time, energy costs for Belarus had increased greatly,<sup>33</sup> which led to serious problems in the Belarusian economy. Therefore, entering the CES was considered as a means to access the financial resources and cheap energy supplied from Russia. The low cost of energy resources, alongside additional profits from exporting Belarusian oil products to the world markets, which sustained economic growth without serious structural reforms, was treated as a price that Russia had to pay for the integration.

### Peculiarities of the Belarusian Economy

Prominent features of the Belarusian economy are the predominance of state ownership and the underdeveloped private sector. According to the Ministry of Economy, the private sector produces only 30% of GDP.<sup>4</sup> Moreover, state-owned enterprises are usually managed using administrative rules and regulations. As a result, the key aim of the administration is to ensure quantitative growth of the relevant indicators, even if this does not reflect market demand. Therefore, state enterprises are more focused on fulfilling the plan than modernising their production according to demand. Moreover, technical improvements require considerable investment, and companies do not have the necessary resources. As a result, the Belarusian real sector entered the CES with serious structural problems, high-cost industry and an outdated equipment base, which influenced not only the competitiveness, but also the general macroeconomic situation in the country.

The next problem is massive government support for state-owned enterprises. What is more, Belarusian authorities provide support to financially unstable enterprises, thus preventing bankruptcy and redundancies. However, the average amount of assistance is not enough for the complex restructuring of an enterprise, which results in further deterioration of its condition. A similar situation can be observed in agriculture, despite tax preferences and huge financial inflows. Moreover, such a policy leads to an increasing infla-

tion rate and a growing conflict of interests in the economy. On one hand, the government has to finance state programmes and stimulate economic growth. On the other hand, it should keep to a strict monetary policy, which is in contradiction to support of state-owned enterprises.

An important source of financing for Belarusian enterprises is subsidised borrowing provided by commercial banks, at below market interest rates (the banks are compensated for the difference from the state budget). The consequences of this practice are the depreciation of the national currency, and inflation. Meanwhile, in the framework of integration processes, Belarus should maintain the acceptable rate of inflation, which severely limits the possibility of using monetary policy to stimulate economic activity. The value of the consumer price index (annual average) for the year 2012 in Belarus was 59%.<sup>55</sup> But if regulations of the acceptable level of inflation had been in force in 2012, the acceptable level of inflation for Belarus would have been only 15%.

Realising the need to stabilise the monetary situation in the country, the National Bank (NB) has tightened the monetary and credit policy, and, in particular refused to give credit to the real economy and set the discount rate at a positive level. As a consequence, the budget expenditures for compensating the difference between reduced and market rates grew, and banks are periodically faced with a shortage of resources for government programmes. Due to the suspension of the credit facility, the NB planned to reduce the pressure on the exchange rate and lower inflation. The discount rate, to which value of loans and deposits in the national currency are attached, was chosen as the main instrument of monetary policy. Despite pressure from the government and the gradual reduction of the discount rate, it is currently keeping the cost of credit high. Expensive loans in Belarusian roubles led to the growth in demand for loans in foreign currencies, the value of which, taking into account the exchange rate, was considerably lower than loans in the local currency. For the first half of 2013, the growth of bank loans for the economy amounted to 11.3%, loans in the local currency to 7.4%, and loans in foreign currency to 16.7%. These trends could increase the risks for the financial system of the country. By conducting the interest rate policy, the National Bank, through the policy of high interest rates on deposits, sought to increase the demand for domestic currency, which will strengthen control over the exchange rate and inflation. In practice, high interest rates on rouble deposits in 2012 increased the demand for the national currency

<sup>2</sup> In 2011, inflation exceeded 120%, and during the year, relative to a basket of currencies, the rouble lost value by about 56%. For more see: A.M. Dyner, "Belarus in 2011. The hardest year of the last decade", PISM Bulletin, no. 114 (331), 20 December 2011, [www.pism.pl/publications/bulletin/no-114-331](http://www.pism.pl/publications/bulletin/no-114-331).

<sup>3</sup> In the second quarter of 2010, Belarus paid \$184.20 for 1,000 cubic metres of gas, while in the second quarter of 2011 it paid \$244 for 1,000 cubic metres. "Ponizhayushchiy koeffitsiyent dlya pravitel'stva Myasnikovicha", *Ezhednevnik*, [www.ej.by/news/economy/2011/08/16/ponizhayushchiy\\_koeffitsiyent\\_dlya\\_pravitelstva\\_myasnikovicha\\_1108162111.html](http://www.ej.by/news/economy/2011/08/16/ponizhayushchiy_koeffitsiyent_dlya_pravitelstva_myasnikovicha_1108162111.html).

<sup>4</sup> In Poland, this is above 70%, while in Ukraine it is above 60%.

<sup>5</sup> The National Bank Republic of Belarus, "Byulleten' bankovskoy statistiki", no. 6 (168), [www.nbrb.by/statistics/bulletin/2013/bulletin2013\\_6.pdf](http://www.nbrb.by/statistics/bulletin/2013/bulletin2013_6.pdf).

which led to the growth of rouble deposits.<sup>6</sup> However, lowering the refinancing rate in anticipation of devaluation caused Belarusians to convert rouble deposits to foreign currency savings.

Despite the fact that the NB's official main objective is to reduce inflation, the practice of financial support for special categories of population and enterprises, carried out through preferential crediting, is continuing; and the government plans to provide a further reduction of the discount rate. Moreover, the existing problems in the real economy, and the priority given to financing housing construction, make it difficult to curb inflation. A possible slowdown of the integration processes within the CES, and the search for external financial resources to stabilise the monetary situation in the country, are possible consequences of this trend.

### Advantages of Economic Integration

By entering the CES, Belarus achieved the desirable results, such as beneficial conditions for energy supplies. These concessions are generally considered to be the price that Russia had to pay for their integration projects. It was also treated as an incentive for Ukraine to join the CES.

In 2012, Russia provided its full share of crude oil to Belarusian refineries to operate at full capacity. Within the CES customs duties were removed, which lowered the oil price for Belarus by about \$30 a ton.<sup>7</sup> Another significant concession from Russia was a considerable decrease in gas prices. Whereas the average yearly cost of gas for Belarus in 2011 was, according to analytical reports, \$265 per 1,000 cubic metres, it was just \$165 in 2012. In this way, Belarus received the most favourable conditions among its neighbours: for example, in 2012 Ukraine had to pay \$414 for 1,000 cubic metres.<sup>8</sup> Belarus' profits from the 2012-2015 contract are assessed at \$7.5 billion. Despite the fact that Belarus sold Beltransgaz, a gas transit enterprise, to Gazprom in 2011, it kept the land rights, and the right to determine the internal gas price and levy transit fees. Thus, even after having sold Beltransgaz, Belarus ensured that it remained a source of income. Nevertheless, Gazprom's policy of reducing the cost of gas for Belarus did not result in reducing the cost of Belarusian products and increasing the competitiveness of local en-

terprises, as the prices for final customers remain unchanged.

In 2012, due to energy support from Russia, Belarus recovered from the 2011 economic crisis. GDP increased by about 5.5% (compared to 2011), and industrial production, measured in real terms, grew by 9.1%. Moreover, foreign trade deficit decreased.<sup>9</sup> Economic growth was achieved due to the good results of refineries.<sup>10</sup> Besides the export of oil products, Belarus was selling lubricants, solvents and thinners without paying customs duties to the Russian budget. So in 2012, in comparison with 2011, the production of petroleum coke, oil products and nuclear substances in real terms grew by 17.2%, while chemical substance production increased by 19.6%. However, using the maximum capacity of the refineries, Belarus fulfilled only 2% of its obligations to Russia on the reverse supply of refined petroleum products. But the main controversy stemmed from the export of solvents and thinners, which Russia opposed.<sup>11</sup> As a result, Belarus stopped exporting those products. Russia has also limited oil supplies to Belarus, tightened the conditions of oil products back supply,<sup>12</sup> and moved to quarterly contracts in terms of oil supplies.

In three months in 2013, Belarus received \$1.013 billion in Russian direct investment, i.e., 1.7 times more than Russia's entire investments in 2012 (\$593 million). Compared with the first quarter of 2012, the volume of direct investment of Russian residents in the Belarusian economy increased sevenfold (during the same period in 2012, Belarus received \$141 million from Russia). It means that in the first quarter of this year, Belarus has become the leader among the CIS countries in attracting direct foreign investment from Russia. In total, Russia's investments in the CIS region reached \$1.349 billion, of which \$1.013 billion was directed to Belarus. At the same time, Belarus was placed seventh in the global ranking of countries attractive for Russian investors (at the end of

<sup>6</sup> In January 2012, the average interest rate on deposits for up to one year was 53.9%. Gradually, interest rates on deposits decreased to 29.5% per year.

<sup>7</sup> For more, see: T. Manenok, "Pochemu belorusskomu benzinu mileye ukrainskiye, a ne rossiyskiye 'Mersedesy'", <http://nmbny.eu/news/analytics/4875.html>.

<sup>8</sup> T. Manenok, "Energeticheskiy sektor: rastsvet v kanun rasprodazhi", <http://nmbny.eu/by-2012ru/manionok12-ru.html>.

<sup>9</sup> In 2011, the foreign trade balance amounted to \$5.45 billion, and in 2012 it amounted to \$2.9 billion. For more, see: "Statisticheskiy spravochnik Belarus' v tsifrakh, 2013", [http://belstat.gov.by/homep/ru/publications/belarus\\_in%20figures/2013/about.php](http://belstat.gov.by/homep/ru/publications/belarus_in%20figures/2013/about.php).

<sup>10</sup> Petroleum products account for 36% of Belarusian exports. For more, see: Trade and Investment Promotion Section, Embassy of the Republic of Poland in Minsk, "Gospodarka – handel zagraniczny", [http://minsk.trade.gov.pl/pl/belarus/article/detail,1717,Gospodarka\\_-\\_handel\\_zagraniczny.html](http://minsk.trade.gov.pl/pl/belarus/article/detail,1717,Gospodarka_-_handel_zagraniczny.html).

<sup>11</sup> In 2012, Belarus exported huge amounts of solvents and thinners instead of selling regular oil products, because for those categories of products it does not have to pay export duties to Russia.

<sup>12</sup> Belarusian refineries are obliged to sell Russia some of their oil products.

2012 it was 18<sup>th</sup>).<sup>13</sup>

The inflow of foreign direct investment may also improve the economic situation, which will contribute to the reform of the Belarusian economy. The provisions of the CES agreements create the necessary conditions for activation of this process. One of the main principles of the functioning of the Common Economic Space is the freedom of movement of capital. Creating the conditions for effective economic development, within the framework of integration, should contribute to the harmonisation of national investment laws, in accordance with the Agreement on encouragement and reciprocal protection of investments in the CES states.

### Disadvantages of Economic Integration

Paradoxically, while receiving energy preferences, Belarus has fallen into total energy dependence on Russia. Having cheap Russian oil, Belarus lowered supplies from other countries (for example, it stopped importing crude oil from Venezuela) while its own oil extraction covers only 5% of annual demand. At the same time, Belarus cannot fully use the possibility of cheap oil supplies, because of the reduction in volume, the need to provide a back supply of oil products to Russia, and the obligation to pay customs duties on the export of oil products. Moreover, in exchange for crude oil price preferences, Russian companies acquired the right to refine up to 50% of the monthly supplied oil at Belarusian refineries. Additionally, Belarus can use duty-free oil only for domestic consumption. When exporting oil products outside the CES, it must pay the export duty to the Russian budget.

At the same time, due to the entry into force of the other CES agreements, Belarusian authorities are gradually losing their own mechanisms of economic policy tools. As a result, Belarus is starting to feel the economic impact of fulfilling obligations in the framework of the CES. Therefore, in the first half of 2013, the GDP growth in comparative prices was only 1.4% compared to 3.2% in the previous year. Despite the administrative efforts of the authorities to increase economic growth, the problem of tumbling industrial production remained. For the first half of 2013, the industrial production index in real terms decreased by 4.2% in comparison to the same period of the previous year. The reason for this negative trend was a significant decline in production volumes in industries such as production of fuel coke, oil

<sup>13</sup> Central Bank of Russia, "Pryamye investitsii rezidentov Rossiyskoy Federatsii za granitsu v 2007-2012 godakh i I kvartale 2013 goda", [www.cbr.ru/statistics/print.aspx?file=credit\\_statistics/inv\\_out-country.htm&pid=svs&sid=ITM\\_43221](http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/inv_out-country.htm&pid=svs&sid=ITM_43221).

products and nuclear material (down by 20.3%) and chemical production (down by 25.9%). Along with the decline in production volume, the problem of selling manufactured goods emerged. For the first six months of 2013, the correlation of stock and the average monthly volume of production in industry amounted to 71.8%, which can lead to a decrease in enterprises' working capital. As a result, the share of unprofitable enterprises increased to 10.3% (against 7.7% in the first half of 2012) and they increased in number, by 32.4%. Moreover, sales profitability for the first six months of the year 2013 fell to 7.2% against 10.6% the year before.<sup>14</sup>

As a participant of the integration process, Belarus will also lose the ability to stimulate exports by gradual devaluation of the national currency. Since 2013, with the aim of creating equitable macroeconomic conditions, a macroeconomic indicator index of the real effective exchange rate of the national currency will be used. At the same time the government is trying to maintain the stability of the exchange rate policy. Balancing the budget, stabilising the exchange rate, and thus slowing down the inflationary processes, will probably be carried out through external borrowings. However, in the framework of the CES, limits on the amount of external public debt were established. At the same time, the fulfilment of the requirements of external debt will be a serious problem for Belarus, because of the rising governmental debt. By June 2013 it had reached BYR 178 trillion (\$19.9 billions)<sup>15</sup> and for the first six months of this year it was BYR 285 trillion (\$31.9 billion).<sup>16</sup> This means that share of public debt to GDP has grown to 62%, which is above the limit established in the CES.

### Possible Problems

The implementation of the CES principles in Belarus may face difficulties in such fields as reducing budget spending and cross-subsidisation, and outflow of labour force.

First of all, in a situation where the budget revenues are lower than planned, authorities have to adjust their spending to carry out quantitative restrictions on the budget deficit. In the first half of 2013, an increase of budget revenues compared

<sup>14</sup> National Statistical Committee of the Republic of Belarus, "Sotsial'no-ekonomicheskoye polozheniye Respubliki Belarus' v yanvare-iyune 2013", [http://belstat.gov.by/homep/ru/indicators/doclad/2013\\_6.php](http://belstat.gov.by/homep/ru/indicators/doclad/2013_6.php).

<sup>15</sup> National Statistical Committee of the Republic of Belarus, "Ekonomicheskoye dannye", <http://belstat.gov.by/homep/ru/specst/np.htm>.

<sup>16</sup> The National Bank Republic of Belarus, "Byulleten bankovskoy statistiki", no 6 (168), [www.nbrb.by/statistics/bulletin/2013/bulletin2013\\_6.pdf](http://www.nbrb.by/statistics/bulletin/2013/bulletin2013_6.pdf).

to the same period in 2012 was observed: growth rate of revenues at constant prices (taking into account the expected GDP deflator index 11%) was 24.1%. At the same time, the growth of tax revenues was lower than planned. According to estimates of the Belarusian Ministry of Finance, the budget decreased in the first half of this year the budget decreased by about BYR 2.6 trillion (\$291), due to growth stocks, and by about BYR 1.3 trillion (\$145.5 million), due to the fact that GDP growth was lower than planned. That is why the government has to cut public spending and the structure of budget expenditures has changed in comparison to 2012. On the background of rising financing costs for housing and communal services, housing construction spending for other state activities, especially in social services, health care, education, and science has decreased. As a consequence, the social situation in the country has deteriorated.

That is why Belarus has had a problem of workforce migration since joining the CES. Independent research estimates that the outflow of unregistered migrant workers from Belarus is at least 150,000 people annually. In general, the negative balance of migration is estimated to be at least 140,000 people each year, or nearly 3% of the economically active population. Russia is one of the main directions of migration flows, because of the lack of borders. Moreover, independent experts predict that this pattern will continue.<sup>17</sup> To counteract this trend, the authorities raised wages to reduce the significant<sup>18</sup> difference in earnings between Belarus and Russia. However, the earnings gap remains wide (in Belarus, the average salary is now equivalent to 60% of that in Russia) and the problem of outflow from Belarus has not been solved. Moreover, raising wages intensified other problems: in the first five months of 2013 real wages grew by 21.5%, but labour productivity rose only by 2.6%.<sup>19</sup> This means that the cost of production has increased but the competitiveness of Belarusian goods has decreased, which has in turn affected the financial condition of local producers such as the Minsk Automobile Plant. What is more, the growth of wages increased consumption of imported goods, which affected the exchange rate negatively. Moreover, to prevent the migration, the authorities resorted to administrative methods: for example, President Lukashenka

issued a decree prohibiting the termination of long-term contracts in the wood industry without the consent of the employer. However, using such tools does not help to create a positive investment image of the country and is not an efficient way to retain the workers.

On entering the CES, Belarus considered the Russian market as one of the main destinations for its exports. After Russia's entry to the WTO, the rules of the organisation were expanded to cover the Customs Union's legislature. But for Belarus, Russia's membership of the WTO also means strengthening competition in the Russian market, which will influence export volumes. At the same time, competitiveness will also be strengthened in the internal market, because of the import of consumer goods. But the most serious problem lies in strengthening the sanitary and technical demands, which Belarus will have a problem fulfilling. Moreover, Russia's accession to the WTO definitely increases the investment attractiveness of Russia (as it will for Kazakhstan, when this country joins the WTO), which will lead to the gradual emergence of new technologies and the improvement of existing production in these countries. The lag in Belarus's accession to the WTO will also lead to a decrease in the interest of foreign investors in the implementation of investment projects in Belarus, and facilitate the transfer of capital from Belarus to the WTO member countries belonging to the CES.<sup>20</sup> The future of joint commercial ventures may also prove problematic, as it was when Uralkali (the Russian company producing potash fertilisers) declined to participate in a joint sales network with Belaruskali in the framework of the Belarusian Potash Company. What is more, the Russians signed a half-year contract of supply potash with China, blocking access to this market for Belarusians. These actions were probably motivated by the prospect of weakening Belaruskali's condition and purchasing it for less than the \$30 billion proposed by the Belarusian authorities.<sup>21</sup>

### Conclusions and Recommendations for Poland and the EU

By joining the CES, Belarus received the desired benefit of lower energy costs, which will in the short-term perspective benefit the Belarusian budget due to decreasing the cost of production and introducing the possibility of selling oil products to the EU. However, Belarus may, in the long-term perspective, serious problems connected

<sup>17</sup> For more, see: A. Luchenok, I. Kolesnikova, "Vliyaniye migratsionnykh potokov na sotsial'no ekonomicheskiye pokazateli strany: opyt Belarusi", Belarus Public Policy Fund Policy Paper, [http://bppf.eu/sites/default/files/bppf22011ru\\_pp.pdf](http://bppf.eu/sites/default/files/bppf22011ru_pp.pdf).

<sup>18</sup> The average annual salary in Russia in 2012 was \$808, compared to \$553 in Belarus.

<sup>19</sup> National Statistical Committee of the Republic of Belarus, "Ofitsial'naya statistika", <http://belstat.gov.by/homep/ru/indicators/main1.php>.

<sup>20</sup> For more, see: A.M. Dyner, "Prospects of Belarus' membership in the WTO", *PISM Bulletin*, no. 81 (534), 31 July 2013, [www.pism.pl/publications/bulletin/no-81-534](http://www.pism.pl/publications/bulletin/no-81-534).

<sup>21</sup> For more, see: V. Kirienko, "Dempingovat' ne sobirayemysya", *Belarusy i rynek*, no 33 (1066), [www.belmarket.by/ru/238/60/18955/Валерий-КИРИЕНКО-Демпинговать-не-собираемся.htm](http://www.belmarket.by/ru/238/60/18955/Валерий-КИРИЕНКО-Демпинговать-не-собираемся.htm).

with integration. First of all, it will be more and more dependent on Russia, not only in the field of energy resources, but also on foreign investment. Russia will also insist on privatisation, which would mean dominance of its monetary capital in the Belarusian market.

On the one hand, integration within the CES offers an opportunity for the implementation of market tools in the economy, and for using industrial, labour and financial capacities to reduce costs through specialisation and cooperation in the industrial sector. On the other hand, the countries integrated in the CES have serious imbalances in their levels of economic and social development. In this, case the implementation of the “four freedoms” principle could lead to the loss of economic independence for the less developed countries, such as Belarus. Authoritarian regimes, which are in power in member states, are also a serious problem for integration and cause considerable problems in the practical realisation of this project, because they very often perceive any kind of reform as a threat to their power. It should be also noted that the CES is a Russian political tool to reintegrate the post-soviet area, and is definitely dominated by Russia regarding politics and economy.

The next problem which may occur is the creation of equal terms of competition for all CES countries. By 2015, all CES agreements will have entered into force, and therefore state support will be strongly limited. It means that Belarus will have to reduce its own internal support, which could cause economic and social problems. Moreover, if the Belarusian authorities want to avoid these problems, they will have to implement the market mechanisms of economic regulation. To do this, they should create a favourable investment environment and strengthen the processes of privatisation. However, the implementation of this policy may threaten the existing model of governance in Belarus and facilitate the inflow of

Russian capital. Belarus will also lose most opportunities for macroeconomic regulation of the economy. The implication of this would be an even greater deterioration of the economic situation, further outflow of highly skilled professionals, and the reduction of the country’s investment attractiveness.

All this means that Belarus will, in the near future, need support in carrying out economic reforms. That is why the European Union should revise and update its “dialogue for modernisation” programme, focusing on such problems as privatisation, reforms of the real sector, and monetary reforms. The EU should do this for two reasons. First, because the removal of trade barriers is always beneficial for both sides, and second, because the EU would gain the opportunity to influence the market changes in Belarus. Moreover, the whole project may be also accepted by the Belarusian authorities who do not have the capabilities to carry them out on their own. In the framework of the “dialogue for modernisation”, Polish authorities and experts should be active primarily in privatisation issues by preparing information about possible advantages and problems.

Poland could also intensify technical cooperation between national banks by providing Belarusians with the opportunity to study Polish reforms in fields such as monetary policy, monetary union or reforms in the banking sector. Such cooperation may be also offered by the European Central Bank.

At the same time, all this cooperation should not be treated as political support for the regime in Belarus, especially considering that these reforms will be necessary for Belarus regardless of who is in power. Moreover, they will strengthen small and medium enterprises, who may call for further economic liberalisation. However, this will not amount to the abolition of the sanctions imposed on the Belarusian authorities for political reasons.