

### **3<sup>rd</sup> Belarus Reality Check**

#### ***Policy Review***

**Non-Paper, April-May 2014**

On April 10, 2014, the 3<sup>rd</sup> Belarus Reality Check meeting took place in Brussels organized by the Eastern Europe Studies Centre (EESC, Lithuania) in co-operation with the European Endowment for Democracy (EED, Brussels) and Pact (US) with the kind support of Konrad Adenauer Stiftung (Germany) and USAID (US).

The event gathered together key international and Belarusian experts as well as donors and policy makers. The Reality Check policy review is held under Chatham House rules. This allows different local and international perspectives to be presented and encourages the emphasis on facts and evidence. This peer reviewed non-paper is released aiming to contribute to the policy debate on Belarus, in particular at a time when it is being strongly influenced by the crisis in Ukraine. For previous non-papers please visit [CEPI](#) and [EESC](#).

#### **Conclusions**

After the annexation of Crimea, Belarus is in an even more complicated situation due its dependency on Russia. The economy is slowing down dangerously, while the government lacks a new economic vision. However, subsidies from Russia and the change in the social contract may save the day for Lukashenka's regime. Despite Russia's dip into recession as well as the hefty Crimea absorption costs, the necessary \$4-5 bln is still likely to be found by Russia to support the Belarusian economy. After all, Belarus is Russia's only formal ally and the poster child of Eurasian integration. Lukashenka has also been maneuvering successfully in the Ukraine crisis: wavering between the position of Kyiv and Moscow but maintaining a high level working relationships with both.

Minsk's small scale but recognizable steps to move from an industrial pattern towards a local development and information/knowledge based economy may lead to a subsequent change in the social contract as the state will no longer be in a position to offer all social actors the previous level of state support. Already there is less bureaucracy and more private business initiatives. But to continue such a reform trend Belarus needs to ease its isolation: allow qualified labor force to enter the country, adopt Western-style management and decrease state control over the economy. At the same time it needs to manage such reforms gradually by maintaining Russian subsidies to keep Belarusians employed in ineffective state factories.

The traditional opposition is in an identity crisis since the Ukraine conflict: according to the latest polls, only 3.6 % of Belarusians support a "revolutionary" scenario similar to Kiev's example<sup>1</sup>. The already low support for the opposition dropped further. After Ukraine, a successful revolution may bring Russian troops to Belarus. it is no wonder that Lukashenka's position has strengthened<sup>2</sup>.

#### **Economy: Debt and subsidies**

Belarus' economy is in a slow decline: GDP growth amounted to only 0.5% yoy (year over year) in March 2014 while the "potential" GDP growth rate – potential growth of the economy assuming that the given structure remains the same and no positive or negative shocks take place - stays around 2%.

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<sup>1</sup> «После событий в Украине белорусы выбирают интеграцию с Россией, а не Евросоюзом», TUT.BY, April 19, 2014, <http://news.tut.by/politics/395833.html>.

<sup>2</sup> «НИСЭПИ: электоральный рейтинг Лукашенко вырос почти до 40%», TUT.BY, April 16, 2014, <http://news.tut.by/politics/395306.html>.

Boosting domestic demand to stimulate GDP growth has not yielded results. Exports are falling mostly due to weakening Russian demand: between January and February 2014, the volume of exports to Russia fell by 3.9% yoy, while the volume of exports to other CIS and non-CIS countries increased by 6.3 and 10.7% yoy, respectively. External trade deficit amounted to almost \$6 billion in 2013 making the current account deficit exceed 10% of GDP, while international reserve assets fell by more than \$0.9 billion in the first quarter of 2014.

The current account deficit was financed, “as usual”, through borrowing: gross external debt in 2013 increased by \$5.4 billion and amounted to \$39.1 billion, or 55% of GDP. Public external debt grew by \$1.3 billion plus another billion in foreign currency was borrowed domestically<sup>3</sup>. The scale of public borrowing becomes more evident if one compares Belarus’ public external debt in 2007 - \$0.6 billion or 1.6% of GDP – with the beginning of 2014 when it reached \$14.3 billion or 20% of GDP.

External imbalances are growing not only as a result of quite lax macroeconomic policies implemented by Belarusian authorities in 2012 - 2013, but also because of the overvalued national currency. According to the most recent estimates of the IPM Research Center, as of the 1<sup>st</sup> quarter of 2014, the Belarusian ruble was overvalued by about 25% (in real terms)<sup>4</sup>. According to BEROC estimates in the 4<sup>th</sup> quarter of 2013, the Belarusian ruble was over-valued by around 20%<sup>5</sup>. As a result, a more balanced current account would require nominal depreciation of about 40%<sup>6</sup>.

At the moment the authorities prefer gradual devaluation and rely on tighter macroeconomic policies as a tool against growing external imbalances. Tighter fiscal and monetary policies have been implemented since the 4<sup>th</sup> quarter of 2013 and include cuts in government spending on subsidies to the real<sup>7</sup> sector<sup>8</sup>, a tight interest rate policy, and rather slow growth of money supply: compared to November 2013, when monetary base grew by 24.7% yoy, in March 2014 it grew only by 12.9% yoy.

Most economic modernization efforts have failed: high level officials understood modernization mainly as fixed capital investment without changes in management and incentives structure. Although in some cases modernization of fixed capital had a positive effect, several criminal cases against the former management of state owned enterprises and the announced results of the State Control Committee inspections tell a different story. The government’s response was to revise modernization by reducing the list of projects entitled to state support.

### **Social contract: Less state more private**

There are small scale yet recognizable steps towards sustainable development as a reaction to global and regional changes. A very slow move from an industrial model to one based on information/knowledge based economy is noted. Signs of this are cuts in public administration and a growing number of private businesses. Yet at the same time, the state is maintaining or even increasing Russian subsidies in order to keep Belarusians employed in ineffective state companies. Security sector control over private business remains unabating. Debt and devaluation is not that important within this context as Belarus can still sell its

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<sup>3</sup> The scheme works in the following way: daughter Russian banks in Belarus borrow from their mother banks in Russia and buy government bonds nominated in foreign currency.

<sup>4</sup> Calculations by IPM RC, presented during the meeting (not public).

<sup>5</sup> Calculations by BEROC, presented during the meeting (not public).

<sup>6</sup> Taking into account the pass-through effect and in case of solid monetary and fiscal policies.

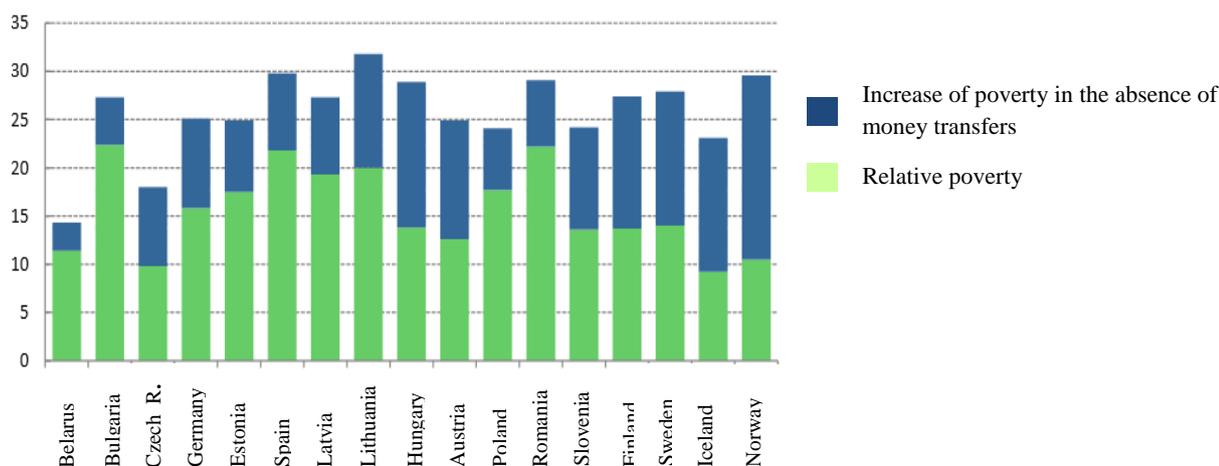
<sup>7</sup> Due to the growing importance of the financial sector in modern times, the term real economy is used to denote the part of the economy that is concerned with actually producing goods and services.

<sup>8</sup> In January-February of 2014, outlays on economy fell by 1.1% of GDP (data from the full version of the report «Социально-экономическое положение Республики Беларусь» by Belstat for the period of 1st quarter of 2014. Short version of the report can be found here: [http://belstat.gov.by/homep/ru/indicators/doclad/2014\\_3.php](http://belstat.gov.by/homep/ru/indicators/doclad/2014_3.php)).

companies or fixed assets. But the main challenge of keeping the educated work force remains: Russia continues to attract qualified Belarusians with higher salaries and better opportunities.

Although the general feeling in the West is that nothing changes in Belarus, it is important to highlight that 25% of the government employees were laid off<sup>9</sup> as well as various additional criteria were added for recipients of targeted social support<sup>10</sup>. One third of obligatory pension system has been cut due to these changes. This pattern of dwindling social obligations – government first, citizens later - is important to show example and thus keep political support: from 2015, each household is expected to cover the full costs of utilities, but these will depend on the gas price which in 2013 was only \$175/cubic meter.

**Graph 1. Effectiveness of social protection system (money transfers) in Belarus compared to other European states (the level of relative poverty before obtaining money transfers, % of population)<sup>11</sup>**



Source: Eurostat and IPM RC data

As the graph above shows, despite the wide spread “social welfare myth”, the effectiveness of Belarus’ social protection is low compared to Western countries. Taking into account the measures undertaken to further decrease the targeted social assistance, the effectiveness and scale of the welfare state in Belarus is likely to decline further.

However, the over-reaching issue here is the tolerance (toward these changes) as well as the expectations of the society. Due to the effective control of society Belarus’ government is in a much stronger position to carry out such reforms compared not only to Ukraine and Russia but also to the Baltic States. Pattern matters as well: Lukashenka cutting state administration first makes his appeal stronger for Belarusians.

Cutting social benefits, though, is not as painful as cutting subsidies to state enterprises – this would mean the real redrafting of the social contract that has been in place since Lukashenka came to power. Yet without such measures, international financial institutions would not be willing to provide credits to the Belarusian economy and the question of Russian subsidies and their availability becomes a key question.

<sup>9</sup> According to official data, see «Указ Президента Республики Беларусь № 169», April 12, 2014, p. 6, <http://www.pravo.by/main.aspx?guid=3871&p0=P31300168&p1=1>. Yet this figure should be assessed with caution, see for example, «Сокращение госаппарата: реальность или пропаганда?», April 19, 2014, <http://udf.by/subekt/78597-sokraschenie-gosapparata-realnost-ili-propaganda.html>.

<sup>10</sup> Елена Спасюк «Адресную социальную помощь профильтруют», December 9, 2013, [http://naviny.by/rubrics/society/2013/12/09/ic\\_articles\\_116\\_183901/](http://naviny.by/rubrics/society/2013/12/09/ic_articles_116_183901/).

<sup>11</sup> «Бедность и социальная изоляция в Беларуси 2012», Yearbook, RC IPM, <http://www.research.by/webroot/delivery/files/poverty2012r.pdf>.

What Belarus requests in exchange for signing the Eurasian Economic Union is the right to keep oil export duties. The duties Minsk paid to Russia amounted to \$3,8bln in 2012 and to \$3,3bln in 2013. Such funds would practically solve the problem of 'cash gap' in the Belarus budget as well as give more freedom from Russia's pressure and requirements (like privatization). Therefore Moscow is unlikely to agree with such a requirement, while the other Eurasian Union partner but Kazakhstan is also not supportive of these demands.

### **After Crimea: Eurasian Economic Union in Making**

The crisis in Ukraine has further decreased the trust between the EEU partners but it is unlikely to undermine the integration process. The Eurasian Economic Union treaty will be signed in May 2014 in Minsk despite tough negotiations: Kazakhstan wanted access to the Russian oil transit system, Belarus seeks to keep oil duties. The other objective of Minsk is to keep the high number of exemptions in the treaty, particularly in the movements of (third of all) goods and (two-thirds of all) services to protect members' interest<sup>12</sup>.

Beside Russia, no country aims for political gains from the EEU: economic benefits are at stake meaning that Belarus' rationale to join the EEU is access to both the transit route from Asia to Europe and to the Russian market. Russia reduced a number of external tariffs as a result of EEU negotiations - contrary to the general opinion that Russia dictates conditions of the Eurasian integration – the consequences for its economy was even estimated by some at \$40 bn/year<sup>13</sup>.

Lukashenka de facto acceptance of the Crimean referendum was an act of reciprocity: Russia has always accepted the result of Belarus's dubious elections (and referendums). However, Lukashenka continues to maintain balance as he came out strongly against the federalization of Ukraine. Yet the balancing framework has changed: given the weakness of the Western response to the Ukraine crisis, Belarus finds itself no longer between Russia and the West but between the Eurasian Economic Union and the "Russian World" policy. In the latter, there is no independent Belarus.

The scale of penetration of Russian financial capital into the Belarusian market is a more powerful tool than all other agreements within the Eurasian integration. Currently Russian capital controls seven out of 31 banks operating in Belarus<sup>14</sup>. It is expected that the influence of Russian capital will grow after signing the EEU treaty as a result of better entry conditions into the Belarusian banking sector. It is important to note that Russian banks, besides playing an important commercial role, also serve as a tool for the Russian government to analyze and understand the economic, political and social developments in the country. In other words, they are not only performing a commercial, but also a political function.

Until now Lukashenka was able to cunningly solve the problem of Russian investors: he allowed them to invest in Belarusian enterprises without giving them access to management functions. Conflict in the potash cartel last summer - when Belarus arrested the Uralkali CEO for months - showed very well how Lukashenka treats Russian business. Another example is his refusal to import oil through Rosneft: Russian oil companies continue to sell oil to firms identified by Minsk.

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<sup>12</sup> Charles Grant "Can the EU help Belarus to guard its independence?", April 3, 2014, <http://centreforeuropeanreform.blogspot.com/2014/04/can-eu-help-belarus-to-guard-its.html>.

<sup>13</sup> Маргарита Папченкова, Максим Товкайло, Михаил Серов, «За российскую нефть надо платить в России», March 18, 2014, <http://www.vedomosti.ru/finance/news/24095481/za-rossijskuyu-neft-nado-platit-v-rossii>.

<sup>14</sup> Мария Акулова, ВЕРОС, «Российские коммерческие банки в Беларуси», January 6, 2014, Наше Мнение, <http://nmnby.eu/news/analytics/5377.html>.

Minsk has been able to control local economic elites by controlling their income: small scale corruption is possible but under the watchful eye of the secret services. Frequent corruption cases ensure loyalty of these elites as there is “kompromat” for everyone. Lukashenka has also created his own business elite. Improving business conditions does not only serve Belarus’ rank in the Doing Business rating<sup>15</sup> (doing business is easier in Belarus than in Russia): a businessman who is satisfied with the current establishment and infrastructure will not have aspirations to change the leadership.

Belarus could be described as a positive counter-example to Russia with respect to its rather low corruption and absence of uncontrolled organized crime. In the eyes of the Belarusian population, Belarus is a positive counter-example to the entire region with its stability particularly when bearing in mind the unrest in Ukraine.

### **Relations with the EU: Silent dialogue**

The annexation of Crimea has further reduced the Lukashenka regime manoeuvring toward the EU: Ukraine overshadows Belarus to a much larger extent than before, while Moscow is now more suspicious and vicious. At the same time Belarus is the only country of the Eastern Partnership in control of its territorial integrity and its borders. Within this context the West is likely to be balanced toward a more pragmatic policy.

The main question – how the EU can achieve its grand vision, the democratization of Belarus – remains unanswered. There has been no realistic strategy and clear steps to achieve this. Moreover, the Ukraine crisis raises the issue of destabilization of the entire region via the spinning zero sum internal politics to the extreme. As seen from Minsk, there is no offer on the table from the EU that is comparable to the EEU. As much as the issue of release of political prisoners is crucial for widening the ‘critical engagement’ policy, the absence of political prisoners in Belarus is a ‘weak’ goal for the EU in Belarus. In the current circumstances Minsk has no rationale to give concessions to the EU, that is, to release political prisoners.

The challenge of the EU’s policy on Belarus is not the so much heralded lack of unity - it’s the absence of serious interest and attention. Very few care about Belarus at the moment, most of the issues are stuck at the technical (working) level, without reaching any strategic depth (apart from whether Russia would use Belarus’ territory to invade Ukraine). Before 2006, the EU didn’t care much because of the lack of knowledge. Now the EU doesn’t care because it knows too much (and therefore doesn’t expect or now even fears “democratic change”) and is preoccupied with Ukraine. The EU has gone a full circle not only in terms of its relations with Minsk but also in terms of its interest in Belarus.

The current critical engagement - basically a silent (mostly technical) dialogue - is likely to develop further. Brussels could deepen this dialogue through an assistance package to give a helping hand to Minsk where it is needed (see social contract changes) while maintaining its human rights stance along with support for the opposition as well as civil society.

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<sup>15</sup> Belarus is ranked 63<sup>rd</sup> among 189 countries by *Ease of Doing Business in Belarus 2014*, The World Bank, <http://doingbusiness.org/data/exploreconomies/belarus>.