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Belarus in the CES: Advantages and Disadvantages of Economic Integration

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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%.¹

The main reason for Belarus to join the CES was the economic crisis of 2011.² By this time, energy costs for Belarus had increased greatly,³ 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.⁴ 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 inflation 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%.⁵ 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

¹ 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.

² 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.

³ 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.

⁴ In Poland, this is above 70%, while in Ukraine it is above 60%.

⁵ The National Bank Republic of Belarus, "Byulleten' bankovskoy statistiki", no. 6 (168), www.nbrb.by/statistics/bulletin/2013/bulletin2013_6.pdf.

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 which led to the growth of rouble deposits.⁶ 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.⁷ 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.⁸ 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 enterprises, 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

⁶ 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.

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

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

9.1%. Moreover, foreign trade deficit decreased.⁹ Economic growth was achieved due to the good results of refineries.¹⁰ 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.¹¹ As a result, Belarus stopped exporting those products. Russia has also limited oil supplies to Belarus, tightened the conditions of oil products back supply,¹² 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 2012 it was 18th).¹³

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

⁹ 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.

¹⁰ 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.

¹¹ 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.

¹² Belarusian refineries are obliged to sell Russia some of their oil products.

¹³ 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.

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 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.¹⁴

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)¹⁵ and for the first six months of this year it was BYR 285 trillion (\$31.9 billion).¹⁶ 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 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.¹⁷ To

¹⁴ 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.

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

¹⁶ The National Bank Republic of Belarus, "Byulleten bankovskoy statistiki", no 6 (168), www.nbrb.by/statistics/bulletin/2013/bulletin2013_6.pdf.

¹⁷ 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.

counteract this trend, the authorities raised wages to reduce the significant¹⁸ 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%.¹⁹ 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.²⁰ 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.²¹

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 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

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

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

²⁰ 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.

²¹ 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.

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.