

LUKASHENKO RUNS OUT OF LUCK

Is the 'Belarussian model' crumbling? Omni Bridgeway examines the factors behind the political and economic crises in Belarus.



Is Europe's 'last dictatorship' on its last legs? Over the past few months, alarm bells have been ringing across key parts of Belarus' political and economic landscape. The imposition of sanctions by the European Union and US, the devaluation of the Belarusian ruble, and the recent provision of emergency loans by Russia and the Eurasian Economic Community (EurAsEC) have reflected the gravest political and economic crises yet faced by President Alexander Lukashenko.

How have various political and economic problems caused the collapse of the Belarusian economic model? And what does its demise mean for those who are trading with, and investing in, Belarus?

The country's domestic political scene has quite literally been explosive for several years. Lukashenko has been in power since 1994 and opposition, although fragmented, has grown. Bombs exploded in Vitebsk in 2005, and in Minsk in 2008 and April 2011.

Although the culprits have yet to be identified, a small group called the Belarus Popular Liberation Army claimed responsibility for the 2005 bombings. The most immediate cause of such instability was the Presidential election of December 2010.

Lukashenko claimed to have secured almost 80% of the vote, but thousands of people protested against the result in Minsk, triggering a violent clampdown on all opposition. Hundreds have been arrested, including seven of the nine



is likely to persist in the lead up to the 2012 legislative elections.

Such moves have also driven the EU and US to impose both travel bans and asset freezes on Lukashenko and his key associates. After two years of rapprochement with Belarus as part of its Eastern Partnership initiative, the EU has sent a clear signal that Belarus' efforts to observe a minimum standard of freedom and decency in public life have been inadequate.

Frosty relations

Belarus' international political problems are so acute that Russia can be considered its only real ally – and even here the relationship is tepid. Frozen out of the EU and US, with both thinking about levying harsher sanctions upon the Belarusian regime, Lukashenko now has little choice but to stop playing off Russia and the West against each other and to join Russia's orbit.

The irony is that frosty relations with Russia a few years ago were largely what caused Belarus' economic model, once admired in the region, to come unstuck. The economy grew quickly in recent years, thanks to cheap Russian oil and gas. The proceeds were used to prop-up inefficient state-run industries that largely produced goods for markets in the former USSR and pariah states, such as Iran and Venezuela. Loose fiscal and monetary policies helped fuel this growth.

However, three shocks have broken the fragile economic model. First, Russia increased its energy prices significantly – including a 30% increase in natural gas prices, killing off Belarus' lucrative trade in refining Russian crude oil for sale to Western Europe.

Second, already weakened by increased energy prices that helped fuel its energy-hungry factories, Belarus suffered further when the global economic crisis reduced demand for Belarusian heavy machinery. Third, Lukashenko has increased social spending to bolster living standards and waning support, and is even today planning a 35% increase in the salaries of employees in budget-financed organisations.

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presidential candidates. Various sentences have been meted out to opponents and activists, most notably five years of hard labour to one of the presidential candidates.

The Organisation for Security and Cooperation in Europe, which reported election irregularities, had its offices closed. Such moves have driven opposition underground or abroad, such as Belsat, an independent Belarusian television channel based in Warsaw. The clampdown

Widening deficits

It is little wonder that public debt has risen from 11% of GDP in 2008 to 22% in 2010, and that external debt rose 27.3% alone over the course of 2009, standing at \$19.3bn at the end of that year. Rating agencies such as Moody's and Standard & Poor's have accordingly downgraded Belarus, further compounding Belarus' difficulties in accessing affordable external financing.

Belarus can be seen to have four key economic crises, relating to its balance of payments, currency, fiscal and monetary policies; and, investor confidence.

Recent years saw a liberal and unsustainable provision of credit to state-owned enterprises, which account for 70% of the economy. This led to a

growth of 38% at the end of 2010. Serious structural change is required, such as privatising state enterprises, deemphasising central planning in heavy industries, and eliminating directed credit. One analyst has likened Belarus' policy responses to a series of plasters that are doing little to cover a gaping economic wound.

Given such problems, it is not surprising that investor confidence has been dented. For example, the price of Belarus' 2015 eurobonds fell 8.4% in just two days in late March. While there has been a partial recovery, as investors realised the debt repayment schedule is undemanding until 2014 – when principal repayments of \$3.7 bn fall due, bond prices could still fall without more effective policy responses.

companies greater access to the Belarusian economy through forcing the sale of up to \$7.5bn of government-held assets. This latter condition is expected to include selling the government's 50% stake in gas pipeline operator Beltransgaz to Gazprom, as well as the choice picks of the 244 state-owned companies scheduled for privatisation – which should also bring in welcome foreign reserves.

Good news?

Not all news from Belarus is wholly bad. The United Nations recently apologised to Belarus for falsely accusing it of violating an arms embargo by supplying attack helicopters to Ivory Coast, although Belarus' arms trade is indeed a significant contributor to Belarus' economy.

Also, Swedish furniture chain IKEA recently invested €76m in a wood processing factory, in a deal backed by a €26m loan from the European Bank for Reconstruction and Development. However, closer examination reveals that IKEA only invested in Belarus because the country is slightly less corrupt than Russia, where IKEA's expansion has struggled due to Russian graft.

Transparency International's latest ranking of countries by perceived corruption indeed placed Belarus at 127, higher than Russia's woeful 154th place. International comparisons appear to be the order of the day. Belarus' recent woes have elicited some assessments that should give cause for concern to those trading with, and investing in, Belarus. One foreign diplomat in Minsk was reported as saying "we are heading in the direction of Zimbabwe here", while an analyst of frontier markets described Belarus as being "like Venezuela without the oil".

Omni Bridgeway invites entities involved in legal proceedings against Belarusian entities to contact us for advice.

T. Feunteun on feunteun@omnibridgeway.com

H.J. Rijkens on rijkens@omnibridgeway.com

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boom in demand for imports, such that the current account deficit at the end of 2010 stood at 16% of GDP, and official reserves at the end of March 2011 covered only two weeks of imports.

Responding to an alarming drop in foreign exchanges reserves and increased fears of a sovereign default, the National Bank of the Republic of Belarus (NBRB) – the central bank – imposed various capital controls and implemented several moves that resulted in a *de facto* devaluation of 36%. This signalled a change in policy for the NBRB, which had resisted devaluation despite inflation running at almost 14% and a ballooning current account deficit.

Poor fiscal and monetary policies have compounded these problems. Although interest rates have been increased to 14%, this is still too low to curb inflation. High government spending means that, although GDP growth officially stood at 8% in 2010 – up from zero in 2009 – the fiscal deficit will increase from 1% to 4% of GDP. Credit policy is perhaps the weakest, with year-on-year credit

The default risk is low to moderate, but until the government both abandons quick wins and avoids 'shotgun privatisations' in favour of genuine reform, Belarus will remain a crisis-prone economy.

In addition to lower credit ratings, re-financing costs could therefore become significantly higher in the medium term. In the short-term, recent emergency loans appear to have bridged looming difficulties. The \$2.5bn bailout loan provided by the International Monetary Fund (IMF) in 2009 was hastily arranged and the conditions it attached failed to grapple with the roots of Belarus' problems. The experience has both dented the IMF's faith in Lukashenko's government and reinforced the government's desire to avoid the kind of conditions that the IMF would demand. The result is that Belarus' only source of emergency funding last month was Russia and EurAsEC.

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