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Lukashenka has to choose: reforms or concessions to Russia

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The most serious crisis in the history of Russian-Belarusian relations has been taking place over the past few months. In 2007 Russia started the process of depriving Belarus of subsidies in the form of supplies of fuels at low prices, which have for more than a decade guaranteed the stability of the Belarusian economic model, and is continuing this process now at an accelerated rate. At the same time, the Russian media started attacks on Alyaksandr Lukashenka from the middle of this year. This toughening up of Russia's measures indicates that the Kremlin is determined to implement its goals regarding Belarus, including first of all taking over its strategic economic assets, which would result in a significant weakening of Lukashenka's position. The Belarusian government has been consistently avoiding meeting Russian demands, while at the same time insisting on the reinstatement of preferential conditions of co-operation. If the Belarusian leader continues resisting Russian demands, the crisis in Russian-Belarusian relations will be aggravated, and a conflict over energy issues around the turn of 2011 cannot be ruled out.

The reduction in preferences offered by Russia in the energy sector has significantly impaired the condition of the Belarusian economy, and may lead to its breakdown in a year or two. As his country comes under increasing pressure from Russia, Alyaksandr Lukashenka will soon have to make a strategic choice between yielding to the Kremlin's demands and embarking upon an at least partial restructuring of the economy.

Russia is toughening up its policy towards Lukashenka

Since the beginning of 2010, Russia has taken a number of economic and political measures which demonstrate that it is hardening its policy of reducing preferences for Belarus in the energy sector, which began in 2007. Under the protocol to the oil supply contract of 2007, which was signed on 27 January 2010, the customs duty on oil supplied to Belarus was raised from 35% of the normal rate to 100% (the duty-free contingent covers only 6.3 million tonnes of the approximately 22 million tonnes of oil Belarus imports annually). Additionally, this June saw a gas crisis between Russia and Belarus, as a result of which Russia enforced payment for gas according to the price formula set in the gas contract as of late 2006.

This meant an increase in the price from US\$150 per 1,000 m³ to the present level of US\$194. Earlier, under an informal deal with Russia, Belarus had been paying for gas at a lower rate. At the same time, also under the gas contract, Russia announced the liquidation of discounts in the prices of gas supplied to Belarus and their adjustment to the so-called European average price, starting from 2011. Furthermore Lukashenka, still hoping to maintain Russian preferences, agreed to enter the Customs Union with Russia and Kazakhstan as of 1 January 2010. Although the participation in this integrative structure enables the duty-free exports and sale of Belarusian goods on the Russian market, it still poses some threats to the Belarusian economy, related to the need to adjust to the higher customs duty rates in the case of imports from countries which do not belong to the Customs Union¹. Additionally, Minsk's key demand, the lifting of export duty on Russian oil, has still not been met. Moscow has stated that this will happen when Belarus has joined the Common Economic Space, which is still being created (by 1 January 2012 at the earliest). However,

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Belarus would have to surrender part of its economic sovereignty to Russia in the case of such integration. It must also be noted that when the first sections of the BTS-2 oil pipeline and the Nord Stream gas pipeline are put into operation, as is planned for the end of 2011, Belarus will lose in significance as a transit country for Russian fuels to the West, and at the same time Russia will have more opportunities to use energy blackmail against Belarus. Russia has also taken political actions towards Belarus. An unprecedented information campaign has been waged against

Lukashenka in the Russian media since this June. The NTV channel (controlled by Gazprom) showed a series of four documentaries in which the Belarusian leader was accused of ordering the murders of his political opponents, using anti-Russian rhetoric while benefiting from Russian economic subsidies for years, conducting illegal financial operations, and benefiting from smuggling. It was also suggested in the films that he has a mental illness. Similar allegations have also been made in programmes on other major Russian TV stations. The action as a whole seems to be a coordinated campaign ordered directly by the Kremlin. President Dmitri Medvedev and the Russian State Duma joined this information war in October by criticising the Belarusian leader's policy in quite strong language.

The goals of the Russian campaign

Although several Russian-Belarusian conflicts have taken place over the past few years, mainly over fuel prices, the Kremlin has never used such harsh rhetoric towards Minsk before. It seems that Moscow is aiming to achieve several goals this way. First of all, the Kremlin wants to take over strategic assets in Belarus (including refineries in Mazyr and Navapolatsk, control of Beltransgaz as well as chemical, machine-building and metallurgical plants), and thus to gain control over a greater part of the Belarusian economy, which would also ensure it political control of the country. A loyal and subjugated Belarus is necessary for Russia to build a deeper integration structure, the Common Economic Space, on the foundations of the Customs Union. The Kremlin is also probably demonstrating its dissatisfaction with Minsk's failure to fulfil its promise to recognise the independence of Abkhazia and South Ossetia, which is a matter of prestige and reputation for Moscow. To make its pressure more effective, Russia has intensified its actions in the context of presidential elections in Belarus (to be held on 19 December).

¹ For more, see I. Wiśniewska, "The customs union: Russia's political project," EastWeek, 7 July 2010.

The Russian information campaign is also addressed to the Belarusian *nomenklatura*, among whom Russia seems to have been trying to build up a pro-Russian faction for some time. The Kremlin expects that by demonstrating the withdrawal of its support for Lukashenka, it will cause the emergence of an opposition group in the short term within the Belarusian political elite on whom Moscow could base its further policy towards Belarus. So far the Belarusian leader has been able to control the *nomenklatura* effectively, by using such measures as the preventive pacification of any signs of dissatisfaction from some of its members. However, it is uncertain whether the Belarusian elite will remain loyal to Lukashenka, as the conflict between him and Russia is intensifying and the economic situation in their country is deteriorating.

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It is also worth noting the fact that the films shown on Russian television were targeted only against Lukashenka and his son Viktor, and did not criticise any other representative of the Belarusian ruling class. Last but not least, the changes in the Russian policy and the media campaign are not targeted against Belarusian society. Russia is consciously trying to avoid the emergence of anti-Russian sentiments in Belarus, such as could arise, for example, as a result of the imposition of economic sanctions.

The media campaign is also addressed to the West. By discrediting Lukashenka, Russia is trying to cut off Belarus from co-operation and political support from the West. Thus Russia wants to limit Minsk's room for manoeuvre on the international arena, and prove that it is destined to co-operation with Russia on the conditions dictated by Russia.

The state of the Belarusian economy is weakening

The continuing reduction in Russian preferences has laid bare the weakness of the outdated Belarusian economic model, one of whose main sources of stability and development were the lower prices of fuels supplied from Russia. Some of these negative trends have clearly strengthened since the beginning of this year, and within one or two years may cause an economic breakdown in Belarus.

The new conditions for Russian oil supply and processing have had a strong negative effect on the condition of the strategic petrochemical industry, which generated around 10% of Belarus' budget revenues in the preceding years. Russian oil imports yielded lower profits, as a consequence of which oil supplies between January and June 2010 fell by almost 50%, and refinery production by 30%. It was only possible to maintain a minimal profitability level in refinery production by mixing the full-rate oil with the duty-free contingent (the latter theoretically meant for internal use in Belarus).

The situation is much worse in the chemical industry. Unlike refineries, chemical plants have not been granted any duty-free contingent for Russian oil products or the semi-finished products necessary in their production cycles. The products were also covered with a full-rate customs duty at the beginning of 2010. The plants' financial condition has significantly deteriorated as a result. In effect, profitability in the first quarter of 2010 in the petrochemical industry as a whole fell from 9.5% to 0.9% year-on-year. If Russia further reduces or liquidates the duty-free oil contingents, and (as it initially announced) raises the rate of the customs duty on oil products, this sector may become totally unprofitable.

The continuing increase in gas prices is an equally serious problem for Belarus. According to the gas contract of December 2006, the price of gas supplied to Belarus for the first time in 2011 is to reach the same level as that offered to Western recipients (which is calculated on the basis of the so-called average European gas price) minus transit fees and export duty. According to Gazprom's calculations, the price would rise from the present US\$194 to a level between US\$220 and US\$250 for 1,000 m³ in 2011. Since the outdated Belarusian industrial infrastructure is highly energy-consuming, and gas has the predominant share in Belarus' energy balance (approximately 80%), each gas price rise has a detrimental effect on a significant number of enterprises.

Another threat to the country's economic stability is its significant negative trade balance. Between January and August, income from exports reached as little as around 30% of the level planned for this year. As a result, the foreign currency influx to the Belarusian economy is falling. At the same time, demand for foreign currencies is increasing among enterprises due to the rising costs of servicing their foreign debt and the higher costs of raw material imports. In effect, between January and August 2010, foreign currency demand among businesses exceeded its supply by over US\$3.4 billion. For this reason, the Belarusian central bank has to make frequent interventions on the market. This has slowed the growth in foreign currency reserves, which despite the significant loans the government has taken are still clearly below a level which guarantees financial security (as of 1 October, they stood at approximately US\$5.9 billion), and has forced the govern-

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ment to incur higher debts. According to the latest data, the Belarusian public debt is US\$9.5 billion, and the total foreign debt of Belarus is US\$23.1 billion, which is 45.5% of the country's GDP and will be rising in the near future. The debt level is not critical as yet. However, the fact that Belarus will have to pay off as much as US\$8 billion to its creditors in the next five years (the peak of repayments will fall in 2013–2014) makes the situation worse. The foreign debt service itself is a heavy burden, as it will cost US\$695 million in 2011 alone. As a consequence, Belarus will gradually fall into a debt spiral, which means it will take subsequent loans to repay those taken before. An additional burden for the state's finances is the public sector pay rises resulting from the populist moves made by the government before the presidential elections.

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Lukashenka's room for manoeuvre is shrinking

The increasing pressure from the Kremlin and the worsening economic situation are gradually lessening Lukashenka's room for manoeuvre. Therefore, it cannot be ruled out that in the next few years, a 'point of no return' will be reached when the Belarusian regime will have to give up its previous 'dodging' policy, which consisted in avoiding essential economic reforms and simultaneously resisting Russian demands. At the same time, the search for financial and raw-material support outside Europe, which has been so widely publicised by the Belarusian government, has failed to provide any real alternative to relations with Russia as yet. The multi-billion Chinese loans are linked to concrete investment projects, and are granted on condition that Chinese technologies, equipment and workforce are employed. For this reason, they may be helpful in the implementation of several investment projects, but cannot resolve the country's key macroeconomic problems. In turn, the supplies of Venezuelan oil by sea via Ukrainian and Baltic ports which have been carried out since this April are still a political demonstration of independence from Moscow, rather than a viable alternative to Russian supplies².

² According to the Argus agency's calculations and officially unconfirmed statistical data, a tonne of Venezuelan oil costs approximately US\$95 USD more than Russian oil with the full-rate export duty imposed.

However, it seems that despite these growing threats, Lukashenka will continue the previous policy and support the existing system, perhaps out of fear of losing some or all of his authority. In practice, this means increasing the foreign debt to maintain foreign currency reserves and pay for current expenses. The Belarusian regime has readily applied such solutions so far. Under Lukashenka's decree of May 2010, the Belarusian government was authorised to issue five-year Eurobonds in 2010–2011 for a total sum of US\$2 billion. An issue covering half of the planned amount was carried out this July and August. Additionally, in October the president ordered the placing of bonds worth approximately US\$0.5 billion on the Russian market. The government may also sell minority stakes in selected companies so as not to lose control of them. One example of such a transaction is the recently announced sale of a 25% stake in the Belarusian Potassium Company to Chinese investors, which may yield several billion dollars.

Lukashenka faces a dilemma over his choice of strategy

The temporary survival tactic will not resolve the key problems in the Belarusian economy, and will only delay the moment when the difficult decision has to be taken by one or two years. After that period, Belarus, which will have lost its creditworthiness, will have to make a strategic choice between the fulfilment of Russian demands and the need to modify its economic model. Meeting the Kremlin's demands would first of all mean the sale of majority stakes in the key Belarusian companies. In exchange for that, Minsk could regain preferential oil and gas supply conditions, and obtain guarantees for broad access to the Russian outlet for Belarusian goods. On the other hand, relinquishing control of the country's most important industrial plants would deprive the Belarusian government of a greater part of its revenues, and would significantly politically limit the country's sovereignty, thus sealing its adherence to the Russian zone of influence. Although Lukashenka will keep the formal attributes of the presidency, in practice

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he will have to respect Russian interests to a greater extent than before, and his authority will only be nominal. However, the realisation of this scenario would not mean a total lack of economic reforms; regardless of Moscow's preferences, Minsk will have to look for ways of making savings, reduce social welfare and restructure individual branches of the economy.

If Lukashenka decides to carry out reforms, he will have to completely discard the previous economic policy. In this case, the present economic model will be transformed to a lesser or greater extent. The regulations for doing business for domestic entities will be liberalised, at least partly. Facilitations for foreign investors will also be introduced. The privatisation of Belarusian enterprises will start. It cannot be ruled out that the initiated economic transformation will open up new opportunities for receiving loan support (at a level of several billion dollars annually) from international financial institutions such as the International Monetary Fund and the World Bank, which will – at least partly – allow the high costs of these reforms to be covered. At the same time, an increasing influx of foreign investments and the improving efficiency of the economy resulting from the reforms may over time bring revenues to the state budget, and enable the repayment of the incurred loans in the longer term. Another aspect of such reforms could be the increase in the share of the services sector in Belarus' GDP and the reduction of the heavy industry sector's share, which predominates at the moment. The modernisation of the energy-consuming and outdated industrial infrastructure appears equally important.

At the same time, it seems rather unlikely that choosing this scenario will entail a complete and comprehensive economic transformation. Reforms will be carried out gradually and to a limited extent, because genuine economic liberalisation in Belarus must entail relinquishing some or all control of at least some sectors by the government, which it sees as a serious threat to the system's stability. Furthermore, even a partial economic restructuring will upset the long-lived (unwritten) social contract between the regime and the public, which has guaranteed the citizens stability of employment and social welfare among other benefits.

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Besides, putting strategic entities up for sale in open tenders will mean Russian investors having access to them, because only they are able to ensure cheap fuel supplies and an outlet for the goods manufactured by the plants (tractors, trucks, buses and harvesters). Therefore, the most likely solution in this case seems to be the restructuring of those entities, while still keeping them under state control.

Forecast

The Kremlin's policy will be a key factor which will determine Minsk's moves. Alyaksandr Lukashenka will have to choose a scenario for further development of his country while coming under increasing pressure from Russia, and everything seems to indicate that the Kremlin is determined to achieve its goals in Belarus. This may bring about a crisis over oil and/or gas supplies in late 2010 or early 2011. In turn, the worsening economic situation may give rise to anti-Lukashenka sentiments in Belarusian society and among part of the political elite. In an extreme version, it may not be ruled out that Russian activity will cause Lukashenka's removal from power.

At the moment, it is difficult to forecast which strategic choice the present Belarusian government will make, especially that both the fulfilment of Russia's demands and the economic transformation entail the need to modify the politico-economic system Lukashenka has created. However, it cannot be ruled out that Lukashenka's fear of increasingly tough actions by the Kremlin will make him launch economic reforms. This is the only way in which Belarus may become independent of Russian preferences, and thus maintain its previous level of sovereignty.



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