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# The Foreign Exchange Crisis in Belarus: Causes and Effects

## By Dr. Leonid Zlotnikov

**Executive Summary**

*The foreign exchange crisis and the currency devaluation that followed have resulted in a rapid deterioration of living standards in Belarus. The course President Lukashenka takes in the economic sphere in response to the crisis will likely determine the political future of the country.*

In late May, Belarus undertook a steep devaluation of its currency, made necessary by the low efficiency of its non-restructured national economy. The Belarusian ruble's (BYR) new exchange rate was administratively set below its market value. The devaluation has since caused impediments to doing business, a lack of foreign cash for sale to households and consequently, a growing public discontent with President Alyaksandr Lukashenka's economic policies.

The current shortage of foreign currency inside Belarus results from multiple factors, particularly the cut in long-standing Russian energy subsidies and the lack of systemic economic reforms. Moreover, the devaluation of the Belarusian ruble has accelerated inflationary pressures inside the economy, resulting in falling real wages and rapidly shrinking individual purchasing power. Consequently, as public dissatisfaction over President Lukashenka's economic policies grows increasingly widespread and vocal, the ability of the country to weather the crisis will depend on whether the regime pursues genuine reform and moves toward market liberalization or upholds the command economy. The course taken in the economic sphere will likely determine the political future of Belarus.

**Squandered Subsidies**

One of the predominant features of the Belarusian economy is the persistence of a large state-owned sector. Private property protection laws are virtually non-existent. The structure and management of the agricultural sector have remained almost intact since the Soviet era, with land owned by the state. And similar to state-owned enterprises, most private companies (excluding small-scale ventures) must abide by government-dictated growth rates. As a result, Belarus is ranked 155th on the most recent *Wall Street Journal*-Heritage Foundation's Index of Economic Freedom, placing it among some of the world's most oppressive economic environments.

Until recently, Belarus was able to maintain this economic structure thanks to subsidies from Russia, mainly in the form of below-market energy shipments, which animated the economy. During 2001-2006, for example, Belarus' annual imports of subsidized Russian oil increased from 12 million to 22 million tons. Roughly 6.5 million tons of the oil was consumed domestically, while the remainder was processed at Belarusian refineries and exported. As the oil trade expanded, foreign sales of oil products rose from 17 to 38.5 percent of Belarus' total exports. This was a lucrative business. As a result of

Dr. Leonid Zlotnikov is a Belarusian economist.

foreign trade transactions with oil and petroleum products (where the final profit derived from the revenue from exported oil products minus the cost of the imported Russian oil), Belarus not only consumed six million tons of Russian oil free of charge, but earned additional income in the amount of $1.2 billion in 2006.

At their peak in 2006, Russian subsidies on oil and gas accounted for 20 percent of Belarus' total GDP ($7.7 billion). But that year Moscow reminded Minsk that it is expected to pay export duties for exported petroleum products produced from Russian oil (in compliance with the Belarus-Russia Customs Union Treaty of 1995, a clause which Belarus had failed to execute). After a rowdy debate, Russia forced Belarus to pay the duties. Moscow then gradually increased the fees charged on the re-sale of its oil products from 65 percent in 2007 to 100 percent in 2011. By 2010, the value of Russian energy subsidies had dropped to 6.5 percent of GDP ($3.5 billion). And by the end of 2011, it will have fallen by an additional $800 – $900 million. Not surprisingly, by the first quarter of 2011, the share of oil and petroleum products in Belarus' total exports decreased to 27.3 percent. In the end, the infusions of economic subsidies from Russia were squandered without any benefit for the modernization of the Belarusian economy.

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**Consumption in Excess of Capacity**

As Russian subsidies began to fall in 2006, Belarus built up a lasting and increasingly negative balance of trade. Essentially, the country was importing more than it could export. And it is this persistent trade deficit that has been a major cause of Belarus' current currency crisis. In principle, the gap in Belarus' trade balance could be bridged by increasing the government's sovereign debt and attracting new Foreign Direct Investment (FDI). Yet, the latter has resulted in higher investment income payments to non-residents, prompting further deterioration of the current account balance as money flows out of the country.[1] This outflow of foreign currency is therefore reflected in the country's negative current account balance.

As seen in *Table 1*, the depletion of foreign currency inside Belarus reached an alarming level by 2010, leading the government to spend its own currency and gold reserves to maintain the balance. During the first quarter of 2011, these reserves had fallen from $5.04 billion to $3.76 billion, despite an $800 million loan secured through the Eurobond market in January. By April, the country's foreign currency and gold reserves were only adequate to cover the equivalent of a month's worth of imports.

As the financial situation in the country deteriorates, it has intensified tensions over the repayment of foreign loans. Corporate and commercial banking short-term loans comprise 45 percent of the country's total debt (see *Table 2*). However, Belarus' external borrowing capacity has shrunk considerably relative to previous years. Usually, the inflow of currency from foreign

[1] A similar effect was produced by the payment of export duties on petroleum products to Russia ($0.4 billion in the first quarter of 2011). See Table 1.

**Table 1: Current account indicators (in $ billions)**

| Year | 2004 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 Q1 |
|---|---|---|---|---|---|---|---|
| **Financial account deficit** | **0.23** | **2.25** | **5.59** | **3.67** | **6.95** | **7.7** | **1.86** |
| Trade account deficit | -1 | -1.5 | -2.9 | -4.6 | -5.55 | -7.42 | -2.35 |
| Deficit of investment earnings account | -0.001 | -0.13 | -0.41 | -0.95 | -1.1 | -1.33 | -0.99 |
| Transfers account deficit | 0.29 | 0.18 | 0.19 | 0.19 | 0.26 | 0.27 | -0.34 |
| **Total current account deficit** (2)+(3)+(4) | **-0.71** | **-1.45** | **-3.12** | **-5.36** | **-6.39** | **-8.49** | **-3.68** |

investment works to counteract these pressures. But in the first quarter of 2011, the country managed to raise only one percent of the total FDI projected for the year. Meanwhile, the lack of privatization of state assets has further limited the government's ability to raise revenue.

In addition to the widening current account deficit, excessive loans to businesses and an unreasonably high increase in personal income have helped accelerate the crisis. As net money issuance by the Central Bank approached $6 billion (10 percent of GDP) in 2010, Belarus' commercial banks increased lending to businesses by 40 percent. Consequently, unsecured monetization of deficits became the only source of credit resources, which further increased the demand for foreign exchange inside the country. As of January 1, 2011, commercial banks were exchanging their holdings (of roughly $3.7 billion) for inflated Belarusian rubles provided by the Central Bank, effectively making these assets part of Belarus' foreign currency and gold reserves. The International Monetary Fund (IMF) has warned about the inadmissibility of such practices in the future, but to no avail.

Significantly, the country's political cycle intensified pressure on hard currency reserves by prompting a substantial rise in wages and pensions. These increases are believed to have accelerated the crisis. In an effort to secure popular support ahead of the December 2010 presidential election, Lukashenka raised the wages of public sector workers by 25 percent (up to an equivalent of $500). Since productivity levels did not warrant an increase, the cost would have to be borne by state reserves. Simultaneously, higher inflation expectations among the public increased private foreign currency purchases by almost $1 billion (1.8 percent of GDP).[2]

## Devaluation: A Road to Calvary?

In the beginning of 2011, the Belarus Central Bank attempted to mitigate public demand for foreign currency by limiting the access of private actors, and especially small- and medium-sized enterprises (SMEs), to available cash. Among

[2] Given that the government did not devalue the Belarusian ruble in the beginning of 2011, purchases by private households were effectively halted until March 2011.

**Table 2: Trends of external debt indicators (in $ billions)**

| Year | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 Q1 | 2011 April |
|---|---|---|---|---|---|---|---|---|
| Credits inflow | 2.35 | 5.27 | 9.39 | 8.61 | 12.26 | 11.01 | 4.26 | |
| Credits re-payment (without interest payments) | 2.16 | 3.56 | 3.73 | 5.96 | 5.35 | 4.56 | 1.04 | |
| External debt, increment | 0.19 | 1.71 | 5.66 | 2.65 | 6.91 | 6.45 | 3.22 | |
| External debt, total | 4.94 | 5.13 | 6.84 | 12.5 | 15.15 | 22.06 | 28.5 | 31.7 |

others, imports supported by foreign exchange from Belarusian banks were restricted. Businesses were only allowed to sustain the flow of imported goods by either using their own currency reserves or through loans from foreign banks. Accordingly, demand for foreign currency on the part of entrepreneurs soared at the country's exchange offices, and public demand for foreign cash increased by $0.5 billion.

By early March 2011, devaluation expectations had become stronger and increasingly vocal. However, President Lukashenka insisted that foreign currency reserves would be sufficient to meet household demand. He repeatedly denied that devaluation would be necessary or even considered an option. The Belarusian ruble exchange rate was maintained within two percent of its fixed value. An IMF proposal made in early March to expand the range to eight percent was rejected. As devaluation expectations mounted, the regime announced that previous restrictions on foreign exchange trading would be lifted as of April 1, 2011. Ultimately, however, this proved unfeasible.

### Black Tuesday

As the Belarus Central Bank attempted to sustain the value of domestic currency, it faced the continued depletion of foreign exchange and gold reserves. Alarmed by the rate of this drawdown, the Central Bank was forced to freeze sales of foreign currency to private actors on March 22, 2011. At the same time, the Central Bank stopped selling foreign currency to the commercial banks. They were advised to provide the domestic market with foreign cash from their own reserves or alternatively, to purchase it from individuals. Not surprisingly, within 24 hours all foreign cash had disappeared from the country's exchange offices.

Contrary to these supply and demand forces, however, the official exchange rate remained unchanged. The official rate was used by banks trading foreign currency to individuals, and by businesses, which had to sell 30 percent of their foreign exchange revenues to the Central Bank. It was also used for "crucially important" imports — such as energy and pharmaceuticals — as well as for the repayment of corporate foreign debts. Additionally, the over-the-counter exchange rate was expanded from two to 10 percent. In practice, this approach to the country's depleting supply of foreign currency created a myriad of simultaneous exchange rates for the Belarusian ruble. Meanwhile, a policy of 'no devaluation' was officially maintained. Commercial banks were able to overcome the imposed restrictions through a series of conversion transactions, but the availability of foreign currency was not nearly sufficient to cover the needs of the business sector or the demands of individuals.

### The Failure of Partial Devaluation

In the end, the pressure of the rapidly deteriorating currency crisis proved too much, and the Central Bank devalued the Belarusian ruble by 56.3 percent on May 24. The official exchange rate was subsequently set at BYR 4,930 per U.S. dollar. Yet this partial devaluation failed to achieve its main objective, a uniform exchange rate for all segments of the domestic market. The gray market rate in particular remained much higher, at a level of BYR 6,000-8,000 per U.S. dollar. In addition, new restrictions were imposed on the over-the-counter market rate as banks were not allowed to exceed the official rate by more than two percent. Significantly, the state of the foreign exchange market in Belarus has remained largely unchanged following the devaluation, as hard currency is virtually unavailable. And though commercial banks continue to look for opportunities to conduct transactions at the real market exchange rate, doing so has become increasingly difficult.

### Deteriorating Living Standards

One of the immediate outcomes of the currency devaluation has been to accelerate the growth of inflationary pressures on the economy. In the first half of 2011, consumer prices increased by 35.5 percent. Despite President Lukashenka's attempts to squelch the mounting agitation and claim that the crisis was under control, public confidence was undermined and private individuals began withdrawing bank deposits en masse. By the end of May, foreign currency deposits were reduced by 21 percent and Belarusian ruble deposits by almost 16 percent.

At the same time, official statistics seem to indicate that the Belarusian economy has grown considerably over the first half of 2011 – with a 12.5 percent increase in GDP and a 23 percent increase in wages. However, such figures do not present an accurate picture of the current state of the Belarusian economy. As these figures compare growth rates against the same period in 2010, they fail to consider the impact of the 35.5 percent increase in inflation since. In fact, real wages have effectively decreased from an average monthly salary of $500 in January 2011 (following the pre-election increase in state wages) to $300 at the current official exchange rate. This figure drops to $200-250 when calculated at the actual market rate. Nevertheless, the government has persistently presented a picture of the economy that is vastly different from the experiences of average households and has refused to develop any plans for stabilizing the situation.

**THE CURRENCY DEVALUATION ACCELERATED THE GROWTH OF INFLATIONARY PRESSURES ON THE ECONOMY.**

As real incomes have rapidly declined, public discontent has grown increasingly vocal and become widespread. Even the Belarus Trade Unions Federation (FPB), traditionally loyal to the regime, has taken a firm position. "The government has already lost the informational and economic war and the situation can be improved only through real action, not by promises alone. Public trust in the government will last till mid-August," one of FPB's chairmen, Nicolay Belanovsky, said.[3]

In response to the deteriorating economic climate, the government published an action plan

[3] Olga Grineviskaya, "Official Trade Unions Ready to Hold Out until August," Narodnaya Volya, June 3, 2011.

for overcoming the crisis in late May. This strategy included provisions for social support and some cost reductions of public programs. It promised to increase housing and utilities tariffs, allow consumer prices to reach the (dollar equivalent) level of neighboring countries and reduce the budget deficit from three to 1.5 percent. However, the plan does not stipulate any measures for restructuring the economy, privatizing state-owned companies or establishing a single exchange rate. Given that President Lukashenka has already declared that he will not reduce the costs of some of the most important public programs, this limited plan might prove difficult to implement.

> Without economic reforms, Belarus will continue to experience a gradual devaluation of the ruble and a deterioration of living standards.

**Belarus at a Crossroad**

The current economic crisis points to two possible future scenarios, one which has the government working to hold the command economy in place; and a second, less likely path that moves Belarus toward market liberalization.

*Scenario I: Sustaining the command economy*

One potential outcome from the crisis will result in a sustained effort by the government to maintain the command economy. Under this scenario, the recent devaluation of the Belarusian ruble would ease some pressure on the state by improving export efficiency and reducing the foreign trade deficit in the coming months. But instead of achieving this goal through improved production efficiency or foreign investment, these gains would instead be won through a reduction in individual incomes, primarily of those who are in the import goods manufacturing sector. Simultaneously, the government would mainly use foreign imports to fund ambitious investment programs in, among others, cattle-breeding ($20-25 billion within the next five years). The payback period for such programs is almost 16 years, and thus a substantial portion of current imports (up to $2 billion annually) would be spent exclusively on implementing programs that do not provide any revenues from an increase in exports over the next couple of years. Such top-down, industry-specific modernization—along with intensive housing construction—has already shown to provide an inefficient return on the expended imports. If the current economic model and its authoritarian administration are maintained, however, it is unlikely that foreign loans and FDI will be available to ease the pressures for foreign currency. As the regime's short-term loans come due next year ($14 billion as of April 1, 2011), resources currently slated for the country's economic modernization would be virtually non-existent, since they will have to be redirected to pay creditors.

*Scenario II: Moving toward market liberalization*

This alternative would see the regime pursue a new strategy of market liberalization, addressing the currency shortage through the privatization of state assets. Meanwhile, households and businesses would be able to use their deposits in the market, thereby bolstering domestic economic growth. Similar to what happened in China, an open economy and competitive labor costs would stimulate the inflow of FDI into Belarus, facilitating the adoption of state-of-the-art technologies from abroad. Likewise, SMEs could more effectively and efficiently utilize available economic resources if they were allowed to operate in an economic environment that was friendlier toward entrepreneurship. The confluence of these policies, all geared toward increased liberalization, would ultimately lead to the gradual modernization and strengthening of the Belarusian economy.

**Conclusion**

Without economic reforms, Belarus will continue experiencing a gradual devaluation of the ruble and a deterioration of living standards. The broader trend of public discontent and frustration with worsening living standards is unlikely to change if the crisis continues. Since the political repercussions of the economic liberalization scenario would probably prove detrimental for the regime, it is likely that President Lukashenka will continue to exert all available means for sustaining the command economy scenario.