

## A delicate balance between east and west

Relations with Russia are testy and overtures to the west tentative, says **Jan Cienski**, who wrote this report

Change is a dangerous thing for an autocrat, and Belarus's Alexander Lukashenko is being buffeted by demands for just that as he tries to steer his country through the economic crisis and strained ties with Russia without losing control.

At first glance, the president of a country that this year could see economic growth of about zero, should be sitting pretty, as zero is much better than the negative figures for neighbouring Russia and Ukraine.

For next year, the forecast by the International Monetary Fund is of a resumption of growth of about 1.8 per cent.

But Mr Lukashenko is no ordinary leader, and the measures he has taken to minimise the impact of the global crisis this year, and will have to take to get the economy growing robustly again, could undermine his rule.

The push to change course comes not from Belarus's 9.7m relatively quiet people, but from a series of external shocks that have disrupted the post-Soviet system created by Mr Lukashenko. There are few democratic rights but in exchange Belarusians were spared the turmoil that shook Russia and Ukraine after the collapse of the USSR.

The first jolt was from Moscow, which finally became exasperated with the president's on-off promises to unite his country with Russia.

Two years ago, Moscow demanded that Belarus pay the same prices as the rest of the world for oil and gas – gas prices have since tripled. This damaged Belarus's economic model, which was based on sourcing cheap energy from Russia and sending rugged but fairly inexpensive industrial equipment in the opposite direction, as well as refining Russian crude and selling it westwards.

Mr Lukashenko turned to the west, which had isolated him following accusations of a rigged 2006 presidential election. He let out his few remaining political prisoners, and undertook an economic liberalisation programme, which included reducing bureaucracy, ending the state imposition of retail prices for everything from cars to toothpaste, and promising to sell off some state companies.

The result was supposed to be a flood of western investment that would modernise the economy and allow factories such as the Minsk Tractor Works to find clients outside the former Soviet Union.



Tense comrades in arms: Russian president Dmitry Medvedev (left) and Alexander Lukashenko at joint military exercises in September

That tentative opening to the west was always shaky – a year ago the regime won every single parliamentary seat in elections that international observers called unfair – and it came just as the world was descending into economic crisis.

The outside world did step up to help Belarus, which ran into balance of payments problems due to its low level of currency reserves. The IMF lent \$3.6bn, while Russia and Venezuela stumped up additional help.

But as a price for taking IMF help, the country was forced to devalue by 20 per cent against the dollar, causing a run on the rouble in the first months of this year, and lowering per capita gross domestic product from \$6,230 to an estimated \$5,094 this year, according to Standard & Poor's, the rating agency.

The gloomy international outlook and reduced risk appetite has scared off investors. An angry Mr Lukashenko recently complained that there was only a single lowball bid for the state-owned BPS Bank, one of the country's four largest, from Russia's Sberbank. The deal has still not gone through.

"There has been very little progress on privatisation," says Irina Tochitskaya, deputy director of the IPM Research Centre, an economic think tank.

While selling off some assets would help the government reduce its debt – estimated to be 33 per cent of GDP this year – a change of ownership would also strike at the system created by the president.

Any new owners would be tempted to reduce over-employment, but that

'Repression now consists mainly of the threat of losing your job or place at university. People are completely dependent on the government'

would jeopardise the Soviet-style promise of full employment Mr Lukashenko makes to his people.

"We had no lay-offs, not a single person was let go," says Vasilii Timanovich, the personnel director at the Minsk Tractor Works, which saw sales to Russia fall by half this year. "We will never lay anyone off because our economy is socially oriented."

If any state companies did become private, it would also erode the current system whereby ideological commissars can have people fired if they dabble in opposition activities.

"Repression now consists mainly of the threat of losing your job or place at the university. People are completely dependent on the government," says Alexander Milinkevich, one of the leaders of the barely-tolerated opposition.

Stymied on privatisation, the government has pressed business to keep producing despite the slowdown, as a way of keeping unemployment at its current 1 per cent.

State-owned banks have been funneling low-interest loans to state industries, which have been running up enormous inventories, and to homeowners, and Mr Lukashenko has been buying tractors and heavy equipment for collective farms.

Belarus's economic fix is also creating geopolitical problems for its leader.

Although the autocratic style of the Kremlin is closer to his own way of governing, Mr Lukashenko and the elites that help him rule realise that any union with Russia would leave them at an enormous disadvantage compared with the much wealthier oligarchs from the east.

"We could end up as a Russian protectorate, then our European dreams would be over," says Mr Milinkevich. There is constant friction between Minsk and Moscow – recently there was a meat and milk war – but the president still makes eyes at Russia.

This autumn the two countries staged massive war games aimed at deterring a theoretical Nato attack. But Mr Lukashenko spoiled the comradely atmosphere by taking a verbal poke at Vladimir Putin, Russia's powerful prime minister, and by refusing to recognise the independence of Abkhazia and South Ossetia, two breakaway regions of Georgia.

Although Moscow keeps pressing the issue, Mr Lukashenko knows that giving in would damage his ties with the west. "There would be consequences," warns an EU diplomat stationed in Minsk.

But his currying of favour with the west also has limits. Mr Lukashenko wants cash and technology, while giving away as little power as possible.

"I don't see a connection between business reforms and politics," says Andrei Kobaykov, the deputy prime minister. "We'll change when it is convenient for our society."

The government's goal appears to be to change as little as possible, and hope that the rapid growth of previous years quickly returns, thus sparing it the danger of destabilising the system with too many reforms.

But certain changes may be permanent. Russia is unlikely to go back to subsidising Belarus's energy, and its markets are becoming more difficult for Belarusian companies.

Relying more on trade with the west also has its limits. Currently Belarus's biggest exports in that direction are oil and potash – and its factories produce few goods that are in demand in western Europe.

That means Mr Lukashenko's intricate balancing act is far from over.

## Soviet model may face trouble despite weathering the crisis

### ECONOMY

Over-production and state aid have held off recession but could lead to problems ahead

Belarus has only been dealt a passing blow by the global economic crisis, but its method of fighting recession – pumping credits to state-owned industries so they continue producing despite falling sales – has stored up big problems for next year. While its ex-Soviet neighbours Ukraine and Russia suffer severe contractions this year, Natalia Koliadina, the International Monetary Fund's representative in Belarus, estimates its economy may end the year with zero economic growth or slightly above. Last year it grew 10 per cent.

While some other analysts are gloomier – foreseeing a contraction of as much as 5 per cent – Belarus still remains a star performer in the region.

A big reason for its relative success is the country's hand-steered method of economic management, which has more in common with Soviet-style planning than free markets.

Alexander Lukashenko, the authoritarian president, has decreed that production should

fall to no more than 20 per cent below pre-crisis levels.

This has prompted the state-owned companies that make up three-quarters of the economy to keep churning out trucks, tractors and other equipment despite sales to Russia – Belarus's main export market – falling by half.

"We work like we've always worked, as a state-owned company," says Mikalai Dubovets, the deputy marketing director of the Minsk Tractor Works, the largest tractor builder in the former USSR.

With credit growth at about 40 per cent year-on-year, state banks are also lending to households to keep the construction sector afloat. The loans are heavily subsidised – 5 per cent in the city and 1 per cent in the countryside – at a time when inflation is 12.5 per cent.

"Domestic growth has basically been financed by banks," says Dzmityr Kruk, an economist at the IPM Research Centre, a think tank.

This level of lending could potentially create trouble for the banking system. Although the government claims that non-performing loans are at about 4 per cent, Standard & Poor's, the rating agency, sees the possibility that problem loans could jump to 35-50 per cent of the portfolio in the event of recession over the next two years.

"The liquidity of the banking system has been deteriorating," says Ms Koliadina.

A creaking banking system is just one of a host of troubles facing Belarus as its economic model comes under strain.

The country has a deserved reputation as the least reformed part of the former USSR – but the Soviet-style system created by Mr Lukashenko actually worked for many years, thanks in large part to cheap energy from Russia.

"The government still believes in what we call real socialism," says Herbert Stepic, chief executive of Raiffeisen International, the subsidiary of the Austrian bank RZB and which owns Pri-

orbank, the third largest bank in Belarus.

The first shock came in 2007, when Russia decided it no longer wanted to subsidise its neighbour, which was showing decided reluctance about following through on earlier pledges to unite with it. Gas prices have tripled since then, to about \$150 per 1000cu m, making it increasingly difficult for Belarus's heavy industry to compete.

That prompted Mr Lukashenko to begin a tentative opening to the west.

"Our further development means we need new technology and new methods of management which are tied to privatisation," says Andrei Kobaykov, the deputy prime minister.

The country undertook a series of economic and regula-

The government's conservative estimate for next year foresees GDP growth of 2-3 per cent, while the IMF expects 1.8 per cent

tory reforms in 2007-2008. The most important included the introduction of a 12 per cent flat-rate income tax, increasing the permitted share of foreign ownership in banks from 25 to 50 per cent, and ending the "golden share" principle under which the government could take over businesses that were or had been owned by the state if it was felt they were in economic danger.

The changes created a rush of interest in the country, and there were a few privatisations, including the sale of a brewery and a mobile phone operator, as well as of 50 per cent of the gas transmission network to Russia's Gazprom. But in recent months sales have ground to a halt.

There have been some foreign investments, including companies interested in creating a logistics centre in Minsk for the

shipment of goods from the EU to Russia, but as was the case with privatisation, there is more interest than money.

"Belarus is not high on the radar screen of investors," says Valdas Vitkauskas, head of the Minsk office of the European Bank for Reconstruction and Development.

The reason is the global economic crisis, which hit Belarus in the fourth quarter of last year.

As exports fell by about half in the first six months of the year, the country ran into severe external funding difficulties. Its sales of machinery to Russia dropped, as did those of refined Russian crude to western Europe, which accounted for 25 per cent of exports. With foreign currency reserves dropping to \$3.7bn at the end of last year, the country was rescued by a \$3.6bn IMF loan, as well as \$1.5bn from Russia and Venezuela.

The lack of new external funding will be an increasing problem for the government next year. Russia has withheld payment of a previously promised \$500m stabilisation loan. It will also be more difficult to dip into the public purse.

As part of its commitment to the IMF, Belarus agreed to balance its budget this year – a goal it is unlikely to meet, with a deficit in 2009 expected to be 2 per cent of gross domestic product.

Although debt as a percentage of GDP is still relatively low – only expected to reach 33 per cent this year – it jumped from 25 per cent a year ago, with the cost of pumping aid worth about 7 per cent of GDP into the state sector.

The government's conservative estimate for next year foresees GDP growth of 2-3 per cent, while the IMF expects 1.8 per cent. Any recovery is unlikely to be smooth.

"The country did well during the crisis, but it has historical structural problems which will make it difficult to recover," says Mr Stepic.

### BELARUS

#### Constitution

Official name  
Republic of Belarus

**Legal system**  
The constitution adopted in March 1994 was amended by referendum in November 1996 to increase presidential power and set up a bicameral parliament

**National legislature**  
Bicameral parliament (National Assembly): upper house, Council of the Republic, with 64 members; lower chamber, House of Representatives, with 110 members.

**National elections**  
September 28 2008 (legislative); March 19 2006 (presidential); the next legislative election is due to be held by 2012, and the next presidential election in 2011

**National government**  
The president appoints the Council of Ministers and has extensive executive powers

**Head of state**  
President, currently Alexander Lukashenko, elected to a third consecutive term in March 2006 with 83% of the popular vote

**Main political parties**  
The two main parties supporting Mr Lukashenko are the Communist Party of Belarus (KPB) and its ally, the Agrarian party; the right-wing opposition consists of the United Civic Party (UCP) and the Belarusian Popular Front Revival (BPF), which are allied with the Party of Communists of Belarus (PKB)

#### Economic summary

	2008	2009 Estimate	2010 Forecast
Total GDP (Rbs bn)	128,829	140,035	157,312
Total GDP (\$bn)	60	49	53
Real GDP growth (annual % change)	10.0	-1.2	1.8
GDP per head \$ (PPP)	12,313	12,486	13,037
Inflation (annual % change in CPI)*	14.8	13.0	8.3
Current account balance (\$bn)	-5.0	-4.7	-3.7
Merchandise exports (\$bn)	33.0	n.a	n.a
Merchandise imports (\$bn)	39.2	n.a	n.a
Trade balance (\$bn)	-5.8	n.a	n.a

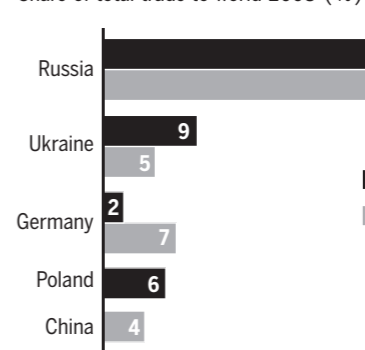
#### Sovereign credit rating

Standard and Poor's: <b>B+</b>	Moody's: <b>B1</b>
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#### Main trading partners

Share of total trade to world 2008 (%)



Area: **207,600 sq km**

Languages: **Belarusian and Russian**

Currencies: **Belarusian rouble (Rbs)**

Exchange rate:

2008 average (per \$) **Rbs 2,147**

Latest figure (per \$) **Rbs 2,715**

Population (end-2007) **9.69m**

Capital: Minsk **1,729,000**

Grodno **480,000**

Mogilev **369,000**

Vitebsk **350,000**

Grodno **321,000**

Brest **320,000**

\* EU harmonised

Sources: EIU; IMF; Thomson Reuters Datastream

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# Tractors plough a lonely furrow

HEAVY INDUSTRY

Modernisation and economic problems in Russia and Ukraine have hit markets

Think Finland and a snappy Nokia phone may come to mind, while Switzerland is linked to chocolates and banks. In the case of Belarus, the association is heavy machinery – rugged trucks and tractors.

That held true back in the times of the USSR, and it still does today: the country supplies almost 90 per cent of the tractors used in the former Soviet Union.

While Belarus does have a well-regarded software industry – one of its leading exports to western Europe after potash and refined crude – it has built its economy on heavy industry.

That reliance has proven very dangerous. Even before the economic crisis hit, Belarusian companies were having a harder time selling their hardy equipment to their main customers in Russia.

“As Russian industry has grown it has shifted to more modern and innovative goods, which makes it difficult for Belarusian companies to compete,” says Pavel Daneyko, director of the Belarusian Economic Research and Outreach Centre, a policy think tank.

The crisis has made things much worse, as Russia and Ukraine, two of Belarus's main customers, have spun into deep recessions.

In the first half of this year, industrial output overall was down by only 4.6 per cent on an annual basis, but the machine-building and metal-working industry saw a drop of 28.6 per cent.

The effects have been felt in places such as Zhodzina, a town of 60,000 about 50km east of Minsk that is the

site of the Belaz factory, making heavy trucks destined mainly for the mining industry.

With about 58 per cent of its production aimed at Russia, the 50 per cent fall in sales to its neighbour this year has had a dramatic impact.

In the first six months of 2009, Belaz reported a 39 per cent drop in production, which was not enough to keep enormous numbers of unsold trucks from accumulating. At one point the factory had seven times its normal monthly production in stock.

That picture was common across the state-owned heavy machinery sector, as the government mandated continued production, fuelled by cheap credits from banks (also state owned) in order to keep the economy working and stop unemployment from rising.

Even now, after a determined effort to find markets beyond Russia, the factory's parking areas are jammed with enormous bright yellow trucks.

“We are trying to find new markets with our cheaper prices,” says Vladimir Rudkovski, Belaz's marketing director.

The predicament is similar at Minsk Tractor, whose enormous “Lenin” factory in the capital is one of Bela-

**‘If the state withdrew from these companies, they would go bankrupt’**

rus's largest exporters.

A statue of the founder of the Soviet state stands overlooking a line-up of some of the goods made, ranging from a tiny lawn tractor to a double-wheeled behemoth. The factory produced 68,000 tractors last year, of which 20,000 went to Russia.

This year, sales to Russia



Stalled engines: sales of tractors from the Minsk factory to Russia, its main market, have fallen by half this year

Jan Cienski

have fallen by half, and overall production has fallen by about a fifth.

Faced with a gradual constriction of their biggest buyer, Belarusian heavy industry is looking for new markets abroad, often setting up joint production facilities to help win contracts.

Venezuela, whose president Hugo Chavez is an ally of Alexander Lukashenko, Belarus president, is to host assembly plants for both Minsk Tractor and Belaz.

Delegations from China, India, Iran, Pakistan, Brazil and other emerging nations are making trips to Belarus to kick the tyres of its trucks and tractors.

Although heavy equipment seems like the quintessential Soviet product, and both factories say that their main competitive advantage is cheaper prices – the country's heavy industry has had to upgrade and invest to remain within

hailing distance of international rivals.

Mikalai Dubovets, marketing director for the tractor works, says his factory is planning about \$600m in investments.

At Belaz, the company has invested about \$100m since 2000 to rebuild its production line, and is planning on spending another \$120m by 2012.

Finding that kind of money during the crisis is increasingly difficult, especially as the cash-strapped government is expected to run a deficit of about 2 per cent of gross domestic product this year.

“Without investors, we can't move forward,” says Mr Dubovets.

The government has embarked on a privatisation programme, but appears to be more interested in selling off financial institutions than the factories that are the government's pride.

In Soviet style, Mr Lukashenko, makes fre-

quent trips to truck and ball-bearing factories to pronounce on the state of the economy.

“If the state withdrew from these companies, they would go bankrupt,” says Georgy Gryts, deputy head of the government investment agency.

Although he says the country is looking for some outside investors to help state-owned companies, the

deal is unlikely to be very attractive. The factories have no intention of reducing their overmanned staff, or slashing the social benefits, kindergartens, and clubs they provide for workers.

“A lot of investors may say they don't like that, but we say, ‘Comrades, we need a guarantee that these conditions will be continued,’” says Mr Gryts.

## Coke fizzles on the investment trail

The dust had barely settled from the chaotic collapse of the Soviet Union in 1992, when Coca-Cola was setting up shop in Belarus, where it remains one of the country's most significant foreign investors.

That a consumer goods company, which has invested \$100m in the country since it arrived in 1994, is still so prominent in foreign direct investment (FDI) rankings is a sign that the country's recent outreach to attract foreign investment has not been a roaring success.

The most striking characteristics when Coke arrived were the stultifying bureaucracy and impenetrable regulations – these have remained hallmarks until recent reforms started by the government two years ago.

“It was an absolutely unfamiliar environment for the company,” says Alexander Denisov, the head of Coca-Cola in Belarus, an offshoot of the Greek-based operations of Coca-Cola Hellenic. “We were one of the first foreign investors here and the government was not familiar with how to deal with us.”

Despite the reams of paperwork, the beverage company managed to build an American-style bottling plant in only two years.

However, simply bottling Coke and other soft drinks was not enough. The product had to be advertised and distributed – and neither activity really existed in Belarus at the time.

Coca-Cola ended up being one of the first companies to run advertisements in the country, and also had to create a distribution network to service the retail sector – which was more than 75 per cent state-owned.

Although Belarus has the reputation of being a state preserved in aspic, Mr Denisov, a glowing fridge filled with Coke products next to his desk, has seen gradual changes over the past 15 years. Now there are local and foreign advertising agencies to



The attractions of a brand

make Coke's ads. As well, the retail sector is now almost entirely private, with the few remaining state-owned shops to be found only in remote rural regions.

As Belarusians have become wealthier, they have become less concerned with price and more with brand. The company, which controls about a quarter of the country's non-alcoholic drinks market, has even moved into the water and energy drinks segments characteristic of more developed countries.

Coca-Cola now bottles about 100m litres of drinks a year, double the level of five years ago, and Mr Denisov is planning additional investments despite the economic crisis.

The crisis has been relatively mild for the soft drinks market, with sales in Belarus falling by about 4 per cent, mostly due to lower club and restaurant sales. The falls have been much steeper in neighbouring Ukraine and Russia, where economic contraction has been more severe, says Mr Denisov.

“Because of our controlled economy, we are going through the crisis in a less painful way,” he says.

Mr Denisov says he has seen a dramatic speeding up of reforms as Belarus tries to attract foreign investors to lessen its dependence on Russia. “Over 15 years, I have never seen the kinds of changes I have seen over the past year,” he says.

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# Russian high-rollers beat a path to Minsk after gambling ban

CASINOS

Border restrictions enacted in July are driving forces behind industry growth

Belarus may not have been a prime destination for foreign investors over the past year, but there has been an unexpected source of capital from Russia: casino owners fleeing gambling restrictions imposed by the Russian government.

On July 1, Russia enacted a ban on casino gambling, with police sweeping through Moscow and St Petersburg shutting down the gambling halls and casinos that had become a multi-billion dollar industry over the past decade.

As it became clear that the Kremlin would go through with its ban – casinos are to move to four remote regions – casino operators began casting around for a likely refuge and settled on Minsk, the Belarusian capital.

“As soon as we heard about it, we began making plans to open in other countries,” says Michael Boettcher, president of Storm International, until this summer the largest casino operator in Russia. He called the new Russian regulations “a farce”.

The company's first beachhead is the Shangri La, an immense sea of coloured lights in downtown Minsk.

Outside, four dark limousines with Russian licence



Safe bet: the state has welcomed investors

PA

plates – the drive from Moscow is only about eight hours – stand by the casino entrance, their burly chauffeurs leaning against their cars.

Anyone wanting to gain entrance has to show a significant amount of money before the doors are opened – screening out poorer punters.

Inside it is a lot more demure than the exterior would suggest.

The discreet click of billiard balls and the whisper of cards landing on felt are the only sounds, as the few high rollers sit by card tables where the minimum bet is \$200.

Geared towards a very wealthy clientele, some of the rooms can even be closed off so that a single gambler can place his bets away from prying eyes.

“They prefer playing on their own, they don't like a crowd at the table,” says

Sheryl Braam, the casino manager.

The casino opened this summer with only four tables, but within two months had expanded to occupy a whole building.

While underground gambling dens have quickly sprung up in Russia to take

**‘That is a really attractive segment. We have a different policy from Russia in this regard’**

the place of the formerly legal casinos, gambling now carries a risk that not everyone wants to bear.

“I don't think anyone wants to see the inside of a Russian prison,” says Ms Braam.

So far the clientele at the

Shangri La is almost exclusively Russian.

“I think we had our first Belarusian customer last week,” says Mr Boettcher. “Minsk is a pilot for us. If it works, we'll see about expanding.” The company also has casinos in Georgia, Armenia and Central Asia.

Storm is not the only company to look to Minsk, which has a large number of casinos, ranging from the up-market ones such as the Shangri La, to rowdier places filled with slot machines and leather-jacketed youth.

The segment is growing so quickly that an airline flying small aircraft between Moscow and a secondary airport near the centre of Minsk has already sprung up. In late October, a business jet flying gambling clients from Moscow to Minsk crashed near the Belarusian capital, killing all five aboard.

For Russian visitors, Minsk is a familiar place. Everyone speaks Russian; the safe and quiet streets are still named after heroes of the past such as Karl Marx, while a statue of Lenin stands on the main square of the city.

So far the government has been quite welcoming of its new investors, and the industry is consulting with officials to ensure that the regulatory structure is friendly.

“That is a really attractive segment. We have a different policy from Russia in this regard,” says Georgy Gryts, deputy head of the Belarus government investment agency.



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