

## The impact of the conflict in Ukraine on the Belarusian economy

The conflict in Ukraine has significant indirect effects on the Belarusian economy. The country's exports suffer significantly from a stagnation of its most important trade partner (Russia) and a strong recession of its second most important trade partner (Ukraine). In addition, Western sanctions against Russia affect the financial flows and hence the financial environment in Belarus. While certain sectors, e.g. food exports to Russia, may develop positively, overall significant negative effects on Belarus are expected from the conflict in Ukraine. Such developments clearly illustrate the risks that arise when the economy of one country (Belarus) strongly depends only on a single other country (Russia). Belarus should learn its lesson from this situation and promote a diversification of its external economic relations. An IMF programme could diversify and stabilise the financial flows while joining the WTO would allow diversifying and stabilising trade. Also, close cooperation with international financial institutions would help to conduct structural reforms, e.g. with the help of pre-privatisation.

### Current environment dominated by external shocks

From an economic and geopolitical point of view, Belarus is located in a currently very tense region. It is possible to identify four areas in which shocks realize, which heavily affect the Belarusian economy.

Economic situation in Russia: A strong downturn is currently observed in the Russian economy, which will stagnate this year (IMF forecast: 0.2% real GDP growth). The trend will not significantly change in 2015 with growth rates of 0.5%. The current decline of oil prices serves as an additional adverse factor.

Economic situation in Ukraine: According to forecasts, GDP will decrease by 6.5% this year. In the best case scenario, the IMF predicts weak growth of 1% in 2015; yet a further decrease is possible as well.

Western sanctions against Russia: These affect multiple areas, whereby the sanctions in the financial sector have the strongest effect.

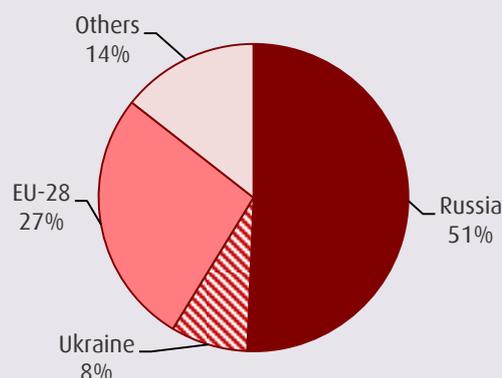
Counter-sanctions by Russia: As a reaction to Western sanctions, Russia has introduced trade restrictions as well, particularly for imports of food products.

The expected effects of these shocks on Belarus are described below. Before we assess these effects, we first analyse the external economic ties of Belarus.

### External economic ties of Belarus

Basically, external economic ties can be separated into trade and capital flows. In terms of trade flows, Belarus is a very open country; the degree of openness (ratio of foreign trade to GDP) amounts to 112% and is thus very high.

#### Goods trade by regions, 2013



Source: UN Comtrade; goods trade: export + import

Striking is the high share of Russia in the foreign trade of Belarus, which exceeds 50%. Ukraine also plays a significant role with 8%. On a per-country basis (when EU countries are considered separately) Ukraine is the second most important trade partner of Belarus after Russia. Aside from goods trade, trade in services also plays an important role for Belarus. It is an important transit country for Russian oil and gas to the EU, and for transit of goods between both trading partners.

Also in terms of capital flows Russia plays a prominent role. 59% of the FDI stock originates from Russia; the investors are often Russian state enterprises. The banking sector is also heavily influenced by Russia. While Belarusian state banks dominate (market share of ca. 65%), Russian state banks hold a significant share of 25%. The rest of the market is shared among private banks.

Furthermore, it should be pointed out that Belarus receives substantial subsidies from Russia through multiple channels (e.g. reduced oil and gas prices, credits with attractive financial conditions). According to estimates, they amount to ca. USD 7.7 bn per year, which is more than 10% of GDP. In return, Belarus is a member of the Customs Union. In conclusion, Belarus is weakly diversified in terms of external economic ties and is dependent on Russia to a large degree.

### Implications of the conflict in Ukraine for Belarus

In terms of foreign trade, many people focus on the expansion of food production and its increased exports to Russia. In fact, these have increased according to recent statistics. The question is, however, whether this is a long-term trend which will also be accepted by Russia. The effects of such an increase in exports on the inflation rate in Belarus (currently almost 20%) should also be considered. In the machine-building sector, where Russia is the most important market, the developments look very problematic. On the one side, gloomy economic forecasts suppress investment, on the other side already effective financial sanctions increase interest rates; both effects lower the import of relevant equipment and machinery in Russia. Additionally, the crisis in Ukraine affects the Belarusian export of goods – Ukrainian imports decreased by over 25% in comparison to the previous year. In addition, Belarus experienced a loss in competitiveness: The Belarusian Ruble appreciated by 34% against the Russian Ruble and by 22% against the Ukrainian Hryvnia since the middle of the year.

Regarding capital flows, it can be assumed that financial sanctions against certain Russian banks restrict their possibilities of refinancing or increase its costs, which also affects their Belarusian subsidiaries.

To sum up, the developments have to be regarded as overall negative. Furthermore, the central question is whether the Russian subsidies will – in the described environment – still continue to flow to Belarus as before, or whether there will be limitations of the readiness and/or ability from the side of Russia in this regard.

### Strategies to limit the negative effects

The Belarusian policymakers should consider how the expected negative economic effects could be mitigated. Since the dependence on Russia is the starting point, relevant considerations should start here. A strategy should consist of several components:

Macroeconomic stabilisation: The situation is still difficult, as high external deficits, low FX reserves, and the pressure on the exchange rate demonstrate. An IMF stabilisation programme is advisable as an anchor in this environment, to ensure cheap financing of the external deficits on the one hand, and above all to achieve a reduction of these deficits via policy corrections.

Trade policy: One key message lies in the diversification of foreign trade in terms of trade partners. The aspired WTO membership can offer new possibilities in this respect. Belarus should also investigate whether the Free Trade Agreements (DCFTA) of Ukraine, Moldova and Georgia with the

EU offer new opportunities to access the EU market, e.g. through joint ventures.

Structural reforms: A diversification in the financial and banking sector is certainly not easy to accomplish. One approach would be to use the instrument of pre-privatisation, in which international financial institutions take minority stakes in state banks. This would help to diversify the sector, generate fresh capital for the banks' development, and hence enhance the stability of the financial sector.

### Conclusion

Strong economic ties with Russia imply certain downside risks for the Belarusian economy in the current environment; a rethinking is therefore necessary. A combination of macroeconomic stabilisation, as well as trade policy and structural reforms seems a reasonable approach to limit the negative effects on the economy.

Such credible reform efforts should be supported by Germany and the EU. This would help to diversify Belarus and make it more resilient towards negative economic shocks.

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### German Economic Team Belarus (GET Belarus)

GET Belarus conducts a dialogue on economic policy issues with the Belarusian government, civil society, and international organizations since 2003. It provides information and analytical support to institutions involved in the process of formation and implementation of economic policy. It is funded by the Federal Ministry of Economic Affairs and Energy (BMWi) within the framework of the successor of the TRANSFORM programme of the German government.

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