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Will Belarus fully benefit from the Eurasian Economic Union?

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Introduction

On January 1, 2015, the Eurasian Economic Union (EEU) of Belarus, Russia, Kazakhstan, and Armenia was officially launched. Built on the vague and short free-trade experience of the Customs Union of Belarus, Russia, and Kazakhstan (only in operation since July 2011), the future of the EEU is by no means assured. In particular, the EEU seems to lack two key preconditions of economic integration, namely economic policy convergence and institutional support.

The politicians of the EEU countries claim there is an "agreed macroeconomic policy of the member-states of the Common Economic Space[1]," but in fact this is far from reality. Prices in each member country face different trends (CPI y-o-y average is 8.8%[2]) while monetary policy is not harmonized; exchange rates remain under government control in Belarus and Kazakhstan, while prices for some goods and services in mutual trade are often fixed in US dollars (energy resources, food, transportation services); and a common fiscal policy is still under construction but far from implementation. One should also recall the latest egregious example of the macroeconomic divergence of the four countries: Belarus, Kazakhstan, and Armenia have not joined the Russian trade embargo against the EU, USA, and a host of other Western economies. As a result, open borders between the Eurasian Union states during economic shocks might stimulate further macroeconomic imbalances, as Belarus and Russia witnessed in 2011 and 2014.

In addition to the lack of coordination at the macroeconomic level, the EEU also lacks institutional support at the supra-national level, which became obvious during the November-December trade conflict between Belarus and Russia. The supranational body of the Union, the Eurasian Economic Commission (EEC), was unable to lift restrictions related to Belarusian meat products imposed by Rosselkhoznadzor (the chief Russian sanitay and phyto-sanitary inspection body) and failed to reopen transit of embargoed food through Russia to Kazakhstan. This impotence in a key trade dispute can be traced back to the institutional design of the EEC, as rulings of the Eurasian Economic Commission, as well as the EEU Court, are not binding upon member states. Indeed, key decisions within the EEU are made not by the EEC by the presidents of the member states at the meetings of Supreme Eurasian Economic Council, the top supranational authority of the EEU. This structure only reinforces the political background of EEU rather than its status as a community of like-minded nations, emphasizing the mixture of geopolitical ambitions of Russia, the need for cheap energy and huge export market for Belarus, access to Russian oil and gas infrastructure by Kazakhstan, and the geopolitical uncertainty of Armenia vis a vis Azerbaijan.

Within this current macroeconomic and institutional framework, we believe that Belarus will not be able to benefit economically from the Eurasian Economic Union. To see why, let us consider current trends in trade, labor, and capital flows between Belarus and Russia. We assume here that the aim of EEU is to create a common market of goods, services, labor, and capital under a reciprocal and common macroeconomic policy.

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[1] The Common Economic Space was a common market of the Customs Union countries (Belarus, Russia, and Kazakhstan), in place since January 1, 2012. It was replaced by Eurasian Economic Union on January 1, 2015.

[2] As of October 2014, based on the data of Belarusian Statistical Committee (www.belstat.gov.by).

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Trade

Belarusian exports stagnated in 2012-2014 due to an increasingly undiversified export structure, a crawling appreciation of the real exchange rate, diminishing oil prices, and increased competition due to Russian WTO membership. Traditionally, Russia has been the main trading partner of Belarus, and accounts for roughly 50% of Belarusian exports and imports. However, despite the common market with Russia and Kazakhstan, Belarus' share in Russian imports diminished from 4.7% in 2011 to 3.8% in 2014[3]. In regards to the other Customs Union partner, the share of Belarus in Kazakhstan's imports remained almost unchanged during the same period, at a tiny 1.7% (up from 1.6% in 2011)[4].

While this performance has underwhelmed, the worst may be yet to come. In 2015, oil prices are expected to remain at low levels, taking the Russian rouble along with it. And even as Russian (and EEU) external tariffs will continue to decline according to their WTO accession schedule, Belarus' and Kazakhstan's tariff exemptions within the Customs Union have discontinued as of January 1, 2015. Taken together, this will put strong downward pressure on Belarusian exports, decreasing export competiveness.

Where Belarus will gain, and where it seems that the country is most concerned, is in access to below-market-price energy imports within the EEU. The annual average oil and gas subsidy from cheap energy imports from Russia for the period 2001–08 was estimated at 14.5% of Belarus' GDP, and even now it is close to 10% of GDP. While these underpriced energy imports have spurred economic growth, they have also exposed the country to increased commodity price volatility and political risks associated with the negotiation of energy trade agreements with Russia.

Capital

Problems related to capital flows and investment come out of the singular problem of the divergence of the financial systems of Belarus, Armenia, Russia, and Kazakhstan. Russia and Kazakhstan, two petrostates dependent on oil dollars, face the problem of capital outflow, while Belarusian authorities are concerned with promoting capital inflows.

These divergent interests lead to divergent macro-policy responses, prudential regulations, costs of capital, uneven securities market development, as well as a different approach to capital controls.

The capital inflows to Belarus have been mostly foreign debt, which has been growing rapidly from 25.1% of GDP in 2008 to 55.4% of GDP as of October 1, 2014. The stock of FDI in Belarus remains relatively low (31.5% of total foreign liabilities in Q4 2014, up from 28% in Q4, 2011), of which almost 75% is of Russian origin, from both Russia and Cyprus. This inability to attract FDI flow can be explained by ineffective capital allocation mechanism (massive state financial support and domination of state-owned banks fuels uncompetitive privileged access to capital for state-owned enterprises[5]) and the high cost of capital (the central bank overnight rate is currently 40%). Bearing in mind the projected negative scenario for Belarusian export, a devaluation of the Belarusian rouble is highly likely to happen in 2015 (it has already lost 35% of its value since December). Previous analyses have shown that devaluation in Belarus can lead to improvement of the trade balance, but at the cost of higher debt payments[6], substantial increase in domestic prices, and falling domestic output.

Labor

The relatively high Unit Labor Cost (ULC) in Belarus, a consequence of wage targeting policy and excess employment, creates additional inflationary pressure and discourages export competiveness. Since 2010 productivity growth has lagged real wage growth in Belarus: real ULC increased 22.8 percent over the last four years (Q2 2014 to Q1 2010). Given the excessive employment it's not unexpected that the total volume of unsold manufacturing goods exceeds 75% of monthly average production, and over 25% of manufacturing entities remain unprofitable. Taking this into account, free movement of labor within the EEU and remittances inflow (over 90% of labor migrants from Belarus go to Russia) might assist economic development.

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[3] Calculations from the data of Russian Federal Service of State Statistics: www.gks.ru.

[4] Calculations from the data of Kazakhstan Ministry of Economy, Statistical Committee: www.stat.gov.kz.

[5] Naūrodski, S., Valetka, U. Securities market in Belarus – still undisclosed potential, Baltic Rim Economies, 2014, № 1.

[6] In 2015 Belarus has to pay $4 bn to external creditors, while the total amount of the country's FX reserves accounts for less than $6 bn.

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However, research shows that remittances (about 3% of GDP according to estimates) do not support economic growth in Belarus: GDP responds negatively to the growth of remittances with a lag[7]. This may be explained by decreasing labor productivity due to brain drain effects. In addition, the stream of the excess labor force for temporary migration to Russia so far has resulted in a moral hazard effect: the government is unwilling to reform unemployment security system and education in the situation when both still do not serve labor market well, as there is an outlet for dissatisfied workers. The strains on the Belarusian labor market may be exacerbated by Russia's continuing dismal economic performance and anti-immigrant backlash, which is lowering the opportunities for economic migrants in the country. Due to the recession, Russian labour market has already lost some of its attractiveness and labor migrants are coming back. Even despite a miserable size of unemployment benefits[8] in Belarus, the number of registered unemployed increased by 26.8% in January 2015.

As a result of these conditions, current and future GDP growth and competitiveness are under threat because of a lower return of human capital. A politically painful adjustment of the labor share in GDP (which is traditionally higher in Belarus than in the rest of EEU countries) might also generate negative externalities for the Belarusian financial sector, as the associated fall in labor incomes reduces aggregate savings.

Conclusion.

Current trends in trade, labor, and capital flows between Belarus and other EEU countries leads us to conclude that the potential benefits for Belarus from EEU membership do not trigger economic growth, but rather sustain structural problems of Belarusian economy. The competitiveness of Belarusian economy is still directly linked to the continuing challenge of comprehensive structural reforms in the country. Those reforms include privatization, removing price distortions, strengthening competition, wage and pension system reform, and further financial liberalization. The EEU has not become the stimulus to speed up the process of reforms in Belarus, as there are doubts about institutional capacity and macroeconomic stability of the union. Capital mobility and financial regulation issues in the current version of the Treaty on the EEU are postponed until 2025, so it is difficult to count on additional incentives from an EEU common capital market to implement financial and labor market reforms in Belarus that could raise the returns to capital and improve competitiveness.

Belarus should seek more economic benefits from trade with the EU and the rest of the world. The magnitude of the Russian devaluation and the lasting oil price shock are showing how hazardous it is for Belarus to be in a customs union with two petrostates, with recent analyses indicating that the impact from Eurozone's and Asia's economies on Belarusian GDP are significantly higher than that from Russia[9]. Given this reality, free trade with both East and West would enable the country to balance these adverse shocks better.

Unfortunately, it remains to be seen whether the strictures of the EEU will allow for such a strategy. In the current economic situation there is still the chance that EEU membership will leave Belarus on its current sub-optimal trajectory, foreclosing any chance of garnering from increased EU trade ties. For example, Russia has recently enabled Belarusian enterprises to participate in the Russian import substitution programme. With an enticement such as this along already-established trade lines, and with Belarusian authorities poised to receive financial support from Russia, it weakens the position of those in Government who stand for deeper structural reforms. This in no way benefits Belarus and its economy. In essence, if Belarus follows the proverb as "an affectionate calf that gets to suck two cows," it may be trading off lower-risk in the short run for the far greater benefits of political and economic integration with Europe in the long run.

[7] Valetka, U., Development and Side Effects of Remittances in the CIS Countries: The Case of Belarus (October 23, 2013). Available at SSRN: http://ssrn.com/abstract=2430806.

[8] In 2012, Belarus spent only 0.004% of GDP on unemployment benefits, which compared to 0.39% in transition economies and 0.61% in the OECD. See more in Valetka, U. Labor market and social policy: a trap of contracted differentials, Belarusian Yearbook – 2013, 2014, http://nmnby.eu/yearbook/2013/en/page28.html.

[9] http://kef.research.by/webroot/delivery/files/KEF-2014_conference20141105r_Lipin.pdf.

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