Banking in Belarus – On a Trajectory of its Own?

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This study analyzes the functions and development of the Belarusian banking system in recent years, with a special focus on the current situation, which is characterized by a sharp deterioration of the country's terms of trade in early 2007. Since the mid-1990s, the "Belarusian economic model" has consisted of a mixture of market elements with rigorous state interventionism and outright remnants of the centrally planned economy. About three-quarters of the country's economy and four-fifths of its banking sector remain state owned. Thanks to a surprisingly favorable industrial legacy and to very advantageous terms of trade including outside subsidies in recent years, the "model" has delivered impressive growth and has slashed poverty. Credit institutions – particularly the largest ones – serve as instruments to carry out directed lending to finance fixed investment projects in various areas targeted by the state. From time to time, the authorities step in and bail out the most troubled players. The only major foreign acquisition in the sector to date was the purchase of Priorbank (the fourth-largest credit institution) by Raiffeisen Zentralbank Österreich AG (of Austria) in 2002. Most recently (since 2004) Belarusian banks appear to have joined, to some degree, the credit boom reigning in all of the country's neighbors. The external shock of early 2007 (Russia's sharp increase of energy prices) threatens to erode the quality of credits and to put pressure on the Belarusian ruble, thereby undermining the stability of the sector. The authorities have so far reacted by soliciting external financial assistance and by trying to attract FDI by selling some key enterprises – including some medium-sized banks – to foreigners, mostly Russians.

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1 Introduction

Surrounded by countries with strongly expanding or booming banking sectors and situated on the borders of the European Union and the Russian Federation, Belarus, its economy and banking system clearly arouse interest. This interest is heightened by the fact that Belarus has so far been following an economic strategy and carrying out economic policies that strongly differ from those of all of its neighbors. To the lasting surprise of many, the "Belarusian economic model" so far seems to have been quite successful – in terms of raising the economic well-being of the population, achieving near full employment and reducing poverty to the lowest level in the Commonwealth of Independent States (CIS). The banking sector appears to have played a particular role in the implementation of the model, a role that may have brought credit institutions some advantages but that also saddled them with heavy economic burdens and opportunity costs.

The purpose of this study is to analyze the functions and development of the Belarusian banking system in recent years, with a special focus on

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the current situation, which is characterized by a sharp deterioration of the country's terms of trade in early 2007 and consequent uncertainties. As far as possible, the evolution of legal foundations and banking supervision, banks' major sources of assets, liabilities, earnings and related changes, banking crises, recapitalizations, state interventions and control, renationalizations, the role of foreign-owned banks and FDI will be discussed. The study is organized as follows: Section 2 attempts to shed some light on the country-specific economic framework in Belarus and on the driving forces of Belarusian growth. Section 3 focuses on the Belarusian banking system, its role and its development since the turn of the millennium. Section 4 gives a brief account of the January 2007 energy deal with Russia and highlights the impact it has had so far (August 2007) on the Belarusian economy and banking sector. Initial economic policy reactions of the authorities are also outlined. Section 5 gives a short and medium-term outlook of likely future developments in the economic and banking sphere.

2 Some Elements of the "Belarusian Economic Model" and Driving Forces of Expansion

Under the Soviet system, Belarus had been the "industrial assembly plant" of the USSR, affording the population of the resource-poor republic a relatively high standard of living. As an independent state, Belarus initially embarked on the road of reform, like other CIS members. But in the mid-1990s, a change of political regime triggered an about-face, featuring an increasingly authoritarian state once again reinforcing its power over the economy. From a reluctant reformer Belarus became a retractor of reforms. This made itself felt in an explosion of regulations, the proliferation of price controls, relicensing campaigns of economic entities, the stalling and rollback of privatization, and the multiplication of compulsory state orders. Even where privatization was not rolled back, the introduction of a generously interpreted "golden share" rule guaranteed the state substantial influence in former state-owned enterprises and banks, including those that had been 100% privatized. Thereby, elements of central planning were reintroduced into the Belarusian economy (Barisitz, 2007, p. 64).

This policy "model" – combining a hybrid economy with authoritarian rule – has remained largely unchanged and has seen some impressive growth in recent years. Annual average GDP growth from 2001 to 2006 according to official statistics came to 7.8% (table 1); according to IMF estimates it was about 6%.[2] But the nature and quality of this growth are highly questionable, given that it appears to have been forced to a considerable degree by the authorities (Lallemand, 2006, p. 71). The country has benefited from substantial energy price subsidies coming from Russia and from favorable barter deals with its big neighbor to the East.

Looking more closely, the main drivers of Belarusian growth can be identified as the following (Bakanova and Freinkman, 2006, pp. 224–226; IMF, 2006, pp. 5–9):

[2] *In the assessment of the IMF, Belarusian annual GDP growth measured according to international standards would be about 1 to 2 percentage points lower than published by the authorities (IMF, 2004, p. 5).*

Internal factors

– Belarus inherited several unique USSR economic assets in the manufacturing sector (e.g. in the automobile and tractor industries)[3] which proved to be more competitive on the Russian market than other former USSR industries. Moreover, Belarus inherited significant capacities in oil refining and chemical industries (including fertilizers), which confirmed their competitiveness on European and world markets.
– In contrast to many large manufacturing plants in Russia and other CIS countries, enterprises in Belarus tended to lose a smaller share of their original productive capacity during the period of early transition. This was due to lower incidence of asset stripping and capital flight in Belarus, because of slow privatization and the reinforcement of administrative controls.
– In recent years, the monetary and fiscal authorities were successful in achieving a degree of macrostabilization (including exchange rate stability vis-à-vis the U.S. dollar and the Russian ruble), which strengthened confidence and supported remonetization and dedollarization.

External factors

– Since the Soviet collapse, the Belarusian economy has benefited from privileged access to underpriced Russian energy deliveries. Due to continuing special political relations with Russia, this access has been maintained even in comparison to other CIS countries, many of whom have had to sustain hefty price increases in recent years. While privileged relations and access persist until today, Belarus itself has most recently (early 2007) had to accept a sizable reduction of price subsidies.[4]
– In addition to this framework of low energy input prices, Belarus has in recent years benefited from an environment of strongly rising and very high world market oil and commodity prices. This situation has enabled it to attract huge windfall trade gains that have then been redistributed through various channels, in which the budget and state-owned banks play a major role.
– Since the turn of the millennium, Belarus has profited from the acceleration of growth in its major trading partner, Russia, as well as in other partner countries.

Over the course of time, the internal factors – except the successful macroeconomic management in recent years – have become less important, while the external factors, notably the widening gap between continually underpriced energy purchases from Russia and booming energy product export prices on European and world markets, have gained importance in explaining Belarus' growth performance. However, in recent years Belarusian growth, while impressive, has no longer been excep-

[3] *According to information provided by the recently established National Investment Agency, Belarus boasts 30% of world output of heavy trucks and 6% of global tractor production.*

[4] *While the gas prices that Gazprom charged Western European countries remained at the average level of USD 250 per 1,000m^3 in 2006 and 2007, the gas price charged to Belarus rose from USD 46 to USD 100 per 1,000m^3 in early 2007 (Astrov and Christie, 2007, p. 13).*

tional in the regional context and compared to other CIS countries. Moreover, a substantial share of industrial production is reported to pile up in warehouses and go unsold (Lallemand, 2006, p. 73). The price gap between energy imports and energy-intensive exports is estimated to have yielded trading gains of about 12% of GDP (or around EUR 3 billion) for Belarus in 2005 (IMF, 2006, p. 5) and has probably produced gains of about the same dimension in 2006.

These large gains have been redistributed through various budgetary and nonbudgetary channels, boosting domestic demand, particularly household consumption and investment. About a quarter of the terms-of-trade gains enter the budget in the form of taxes on the consumption and export of imported energy, as well as the profits of energy companies. This fiscal windfall feeds budgetary subsidies to state-owned firms and banks, and supports budgetary investment. The remaining gains are redistributed through two main channels: First, economy-wide mandated wage adjustments, which, while contributing to raising household demand, cut into companies' earnings and may compromise their competitiveness. Second, redistribution takes place through large-scale recommended (directed) bank lending funded by increasing deposits that reflect higher enterprise profits (mostly those of exporters) and rising household income. Recommended lending is used to finance state-targeted fixed investment, which raises questions about the viability of the produced capital stock. Finally, redistribution is also carried out by holding domestic energy prices below full cost recovery levels (IMF, 2006, p. 6).

Sustainability of Belarusian growth depends on the durability of its driving forces. Given the predominance of state-directed capital formation and the low level of private and foreign direct investment, and given the fact that domestic and foreign competition has strengthened on the key Russian market in recent years, the competitive position of Belarusian manufacturing enterprises, including its flagship companies, has deteriorated or is under pressure. On the other hand, the competitiveness of Belarusian oil processing and chemical industries continues to be bolstered by the energy price gap, which has, however, been painfully cut by the deal with Russia in early 2007 and will probably erode further in the coming years (see also subsection 3.3 and section 4). This may be the most serious threat to the sustainability of the "Belarusian model." The threat is compounded by economic rigidities and backwardness that have accumulated as a result of the chronically low level of FDI coming into the country, which sets Belarus apart from all of its neighbors and heightens the vulnerability of the macroeconomic gains achieved recently.[5]

[5] *According to official sources, Belarus spends two to three times more raw materials and energy resources per unit of output than Western industrialized countries (Ministry of Foreign Affairs and Ministry of Economy of Republic of Belarus, 2007, p. 2).*

Table 1

Belarus: Macroeconomic Indicators (2000 to 2006)

	2000	2001	2002	2003	2004	2005	2006[1]
GDP growth (real, %)	5.8	4.7	5.1	6.9	11.4	9.3	9.9
CPI inflation (year-end, %)	107.5	46.2	34.8	25.4	14.4	8.0	6.6
Change of annual average exchange rate (BYR/EUR, %)[2]	–150.5	–72.1	–34.0	–37.7	–14.4	+0.1	–0.4
Change of annual average exchange rate (BYR/USD, %)[2]	–216.9	–58.5	–28.8	–14.5	–5.3	+0.3	+0.4
General government balance (% of GDP)	–0.1	–1.9	–2.1	–1.7	0.0	–0.7	0.5
Current account balance (% of GDP)	–3.2	–3.3	–2.2	–2.4	–5.2	1.7	–4.1
Foreign direct investment (net, % of GDP)	1.1	0.8	3.1	0.9	0.7	1.0	1.0
Gross reserves (excluding gold, % of GDP)	3.3	3.1	2.8	2.6	3.0	3.8	2.9
Gross foreign debt (% of GDP)	12.1	20.3	22.3	23.1	21.5	17.2	18.6

Source: NBRB, EBRD, IMF.

Note: Annual average exchange rates in 2006: BYR/EUR: 2,691.9, BYR/USD: 2,144.6.

[1] Preliminary data.

[2] A minus sign corresponds to depreciation, a plus sign to appreciation.

3 The Belarusian Banking System – Its Functions and Development

3.1 Reemergence of a State-Centered Banking System in the 1990s

As opposed to the situation in other Central, Eastern and Southeastern European (CESEE) countries, the Belarusian banking system has remained majority state-owned. Due to initial privatization and the appearance of privately-owned banks, up to the mid-1990s the share of state-owned banks in total banking assets had declined to around 55% and the total number of banks had surpassed 40. However, subsequent recentralization of state authority coupled with renationalizations and preferential treatment of state-owned credit institutions contributed to the resurgence of the latter: State-owned banks' share in total assets grew to about two-thirds in 2000 and continued to grow (table 2).

Five major state-owned banks constitute the descendants of the former Soviet specialized credit institutions on the territory of the republic, and one-and-a-half decades after the collapse of the USSR, they still dominate Belarusian banking. These five banks are: Belarusbank (formerly called Sberbank of Belarus, renamed in 1995 after merging with a much smaller credit institution; specialization on household deposits, financing of budgetary programs and housing loans), Belagroprombank (focused on the supply of credits to agriculture), Belpromstroibank (provides loans to industry), Belinvestbank (formed in September 2001 by the merger of the former Belbiznesbank with Belorusskiy Bank Razvitiya, supplies loans to light industry and trade) and Belvneshekonombank (specialized in foreign trade). Particularly the first two (Belarusbank and Belagroprombank), which are also the largest (table 3), are still predominantly considered to be nonprofit enterprises with social obligations to contribute to the development of the national economy.

While legislation in the early 1990s had suggested a degree of (formal) independence for the central bank, Natsionalny Bank Respubliki Belarus (NBRB), a presidential decree of 1998 effectively rescinded this independence by vesting the president of the republic with the authority to remove the chairperson of the NBRB and to suspend or revoke any decisions of the NBRB (Barisitz, 2000, p. 88). In the mid-1990s, obligatory state orders and directed credits allocated by state-owned banks according to the authorities' instructions proliferated and increasingly emerged as dominant components of the economic system. In 1995 the central bank established the Fund for the Insurance of Deposits of Natural Persons.[6] After reaching a trough, bank lending increased again in the second half of the 1990s, particularly loans to agriculture and housing construction. Given that necessary funds related to these quasi-fiscal duties had to be taken from deposits and were not always supplemented by the authorities, and given that directed credits frequently turned nonperforming, banks' financial situation deteriorated over the years and loan portfolios became impaired. Although the authorities have intervened from time to time and injected new capital into some of the most troubled credit institutions and continue to do so, the sector has remained insufficiently capitalized – and thus captive to the state. This pattern of activities and state of affairs basically persists today.

The Russian crisis of August 1998 and the devaluation of the Russian ruble caused Belarusian exports to its eastern neighbor to plummet and temporarily jeopardized Russian economic support. The authorities in Minsk reacted by sharply devaluing the Belarusian ruble in turn[7] and by stepping up administrative guidance of the economy. While this helped counter contractionary tendencies and (partly) restored Belarusian competitiveness, the controls could not prevent a spiraling of inflation. The macroeconomic difficulties caused many loans, particularly foreign currency-denominated ones, to become nonperforming. In early 1999, three major credit institutions, accounting for almost 60% of the sector's assets, became technically bankrupt or found themselves at the brink of insolvency. After a World Bank mission had judged the Belarusian banking system to be extremely fragile and at the edge of systemic disruption, the NBRB started in mid-1999 to implement recapitalization plans for some of the biggest insolvent banks. Some other banks were put into conservatorship, one institution was liquidated. By December 2000, the total number of banks had fallen to 31 (table 2).

[6] *All accounts of natural persons up to a limit of USD 1,000 per person are guaranteed.*

[7] *The Belarusian exchange rate regime has traditionally been a managed float which featured multiple exchange rates in the past. After exchange rate unification in 2000, the NBRB committed to a dual "adjustable peg" – to the U.S. dollar as well as to the Russian ruble. De facto, this difficult task has been dealt with by observing a relatively narrow crawling band to the American currency while resorting to a wide one with regard to the Russian currency. In mid-August 2007, the authorities announced that as from early 2008, the sole peg of the Belarusian currency would be the U.S. dollar (see below).*

Table 2

Belarus: Banking Sector-Related Indicators (2000 to 2006)

	2000	2001	2002	2003	2004	2005	2006[1]
Number of banks (of which foreign-owned, year-end)	31 (6)	29 (9)	28 (12)	30 (17)	32 (19)	30 (18)	30 (18)
Broad money (M3, year-end, % of GDP)	17.7	15.2	15.1	16.9	17.8	19.3	22.1
Degree of financial intermediation (bank assets/GDP, %)	27.5	25.5	25.7	28.9	30.8	32.2	37.9
Share of state-owned banks in total banking assets (%)	66.0	53.2	61.9	61.6	70.2	75.2	79.0
Share of foreign-owned banks in total banking assets (%)	4.3	7.5	8.1	20.4	19.9	16.2	14.7
Share of domestic privately-owned banks in banking assets (%)	29.7	39.3	30.0	18.0	9.9	8.6	6.3
Deposit rate (average, one-year deposits, % p.a.)	37.6	34.2	26.9	17.4	12.7	9.2	7.7
Lending rate (average, one year loans, % p.a.)	67.7	47.0	36.9	24.0	16.9	11.4	8.8
Deposits (volume of deposits/GDP, %, year-end)	14.3	11.9	12.1	13.6	14.9	16.0	18.4
Credit (credit volume/GDP, %, year-end)	18.6	15.9	14.0	15.3	18.4	19.6	24.8
Share of nonperforming loans in total loans (year-end, %)	15.2	11.9	8.3	3.7	2.8	1.9	1.2
Return on equity (ROE, %)	8.3	5.6	6.5	8.4	7.8	6.8	9.6
Return on assets (ROA, %)	1.1	0.8	1.0	1.6	1.5	1.3	1.7
Capital adequacy (capital/risk-weighted assets, %)	24.4	20.7	24.2	26.0	25.2	26.7	24.4

Source: NBRB, EBRD, IMF, Raiffeisen Zentralbank.

[1] Preliminary data.

Memorandum item: Euro area (2004, %): banking assets/GDP: 202, deposits/GDP: 89.9, loans/GDP: 110.6, foreign-owned banks/total banking assets: 21.7.

3.2 Entrenchment in a Favorable, but Vulnerable, Environment since the Turn of the Millennium

3.2.1 Crisis-Induced Reforms and Backsliding

Following the plunge of the Belarusian ruble and the skyrocketing of inflation in the wake of the Russian crisis, the NBRB managed to steadily reduce consumer price inflation (the CPI) from 108% in 2000 to 7% in 2006 (year on year). Macroeconomic tightening, but also the strengthening of price controls, and growing money demand, contributed to this achievement. A new Banking Code was adopted in 2000, strengthening the framework for prudential regulations, and in particular streamlining rules for provisioning. The Banking Code also confirmed a special state guarantee of the full amount of natural persons' deposits with majority state-owned credit institutions – which reflects a competitive advantage over rival banks that only benefit from the above-mentioned limited deposit insurance coverage. In the difficult situation immediately after the Russian crisis, the authorities showed increased interest in reaching an arrangement with the IMF. The authorities unified the hitherto multiple exchange rates in September 2000 and tightened fiscal policies. An IMF staff-monitored program, which was to lay a track record to precede a possible Stand-By Arrangement, was agreed upon and carried out in April–September 2001. It brought important progress in monetary tightening, price liberalization and deregulation, and it even suspended directed credits.

But, given some intermittent fiscal slippage and the policy of strong economy-wide wage adjustments, expounded by the president in 2001, the program veered off track and was not renewed. Some backsliding ensued: price controls proliferated again, and directed credits reemerged on a large scale. No serious enterprise privatization initiatives have materialized in recent years, apart from the sale of the government's stake in the oil refinery Slavneft to a Russian investor in 2002. About three-quarters of GDP continues to be produced in state-owned enterprises. While some key firms continue to deliver good results, also on export markets, a large part of the real sector suffers from inefficient and energy-intensive production methods, low technological levels and considerable wear-and-tear and aging of capital stock. FDI continues to be very modest and is negligible from countries other than Russia. Ambitious wage targets, a lack of restructuring and the fact that about half of industry and two-thirds of agriculture registered losses in 2004 call into question the quality of banking assets.

3.2.2 Rent-Based Structural Conservatism and Incipient Change

The Belarusian banking sector has been one of the major instruments of redistribution of the energy windfall rents that gradually accumulated as a result of the improvement of the terms of trade since the turn of the millennium. Still, given the combination of coercion and high risk exposure and experience (see above), the sector remains underdeveloped and fragile. Total assets came to 38% of GDP at end-2006. At this point, there were 30 banks, 18 of which were majority foreign-owned (mainly by Russian investors). But, with one exception, foreign-owned banks have remained relatively small. The exception is Priorbank, a credit institution founded in 1989[8] and the fourth-largest Belarusian bank as of end-2006. Following a presidential decree of May 2002 that approved plans to sell state shares in all banks excluding the four largest state-owned ones, 61% of Priorbank was purchased by RZB (of Austria) in December 2002. That was the only important bank privatization to date (table 3).

Priorbank and the four large state-owned banks – the savings institution Belarusbank (by far the largest credit institution of the country), Belagroprombank (the second-largest), Belpromstroibank and Belinvestbank – as well as Belvneshekonombank (in which the state's share was reduced to less than 50% of capital) are "authorized banks," which means that they are officially authorized to and required to carry out state programs (Minuk et al., 2005, pp. 197–198). The latter feature campaigns to finance housing construction, collective farming, heavy industrial concerns and other "priority" activities. Given the commanding size of Belarusbank (with over 40% of total banking assets and 60% of total household deposits), the sector is very highly concentrated. State-owned credit institutions' share in total banking assets slightly declined from 66% at end-2000 to 62% at end-2003, before strongly expanding to 79% at end-2006. Foreign-owned banks' share grew from 4% in 2000 to 20% in

[8] *Priorbank had been established by Belpromstroibank and a number of enterprises.*

2003, before receding to 15% in 2006 (table 2). Accordingly, domestically-owned private banks were reduced to a small share.

Until recently, the four large state-owned credit institutions did not stray far from the specific business sectors they were assigned to service in Soviet times. After the liquidity and solvency crisis of 1999 had required exceptionally big emergency injections of funds in the framework of a recapitalization program involving a number of large credit institutions, the situation calmed down again and familiar practices seem to have resumed. Like in previous years, state-owned banks have often been compelled to lend without adequately measuring and pricing risk. Unwarranted visits and inspections of credit institutions by the tax police, other control bodies and state organs remain integral components of the banking landscape.

Since 2003, the president of the republic and the government have "recommended" quantitative lending targets to state-owned banks for favored projects, regions and branches. The authorities have strongly influenced banks' interest rate decisions by "proposing" rate caps on lending to large firms or squarely "suggesting" appropriate deposit and loan rates. In 2004, banks were "requested" to restructure overdue loans to food processing companies and to come up with money to cover accumulating wage and energy arrears. This de facto continuation of directed lending practices painfully cuts into banks' liquidity and slashes their profitability; the latter features among the lowest in CESEE. In exchange for these "services," the NBRB intermittently provides liquidity support to troubled institutions, and the authorities continue to intervene on an occasional basis to stave off the collapse of particularly fragile players and to keep the sector afloat.[9] In the long run, once windfall resources evaporate, this strategy appears unsustainable.

Many Belarusian banks tend to mask their weak financial situation by inadequate accounting and asset classification. The legal system makes it onerous and time-consuming to initiate bankruptcy procedures and to seize collateral for delinquent loans. Unfortunately, good reported vulnerability indicators cannot generally be taken at face value. Since 2002, the NBRB has been seeking to tighten prudential norms, raise capital requirements, improve risk assessment rules and step up banking oversight. Thus, minimum capital requirements for credit institutions that take household deposits were raised to EUR 10 million that year. The regulatory and supervisory framework has been significantly upgraded with the aim of reaching international standards. But supervisors do not seem to wield sufficient power to compel large state-owned banks to comply with regulations, which are systematically flouted by some of them.

In recent years, senior officials, including the president, have become concerned about bad credits. Therefore, in mid-2003, the NBRB issued an instruction to banks to cut non-performing loans to no more than 5% of total credits by end-2003. In the event, banks reported the overfulfillment of this target. The following

[9] *For instance, a large recapitalization of two state-owned banks (probably Belarusbank and Belagroprombank) occurred in December 2005 (NBRB, 2006a, p. 21).*

year, banks reported a further reduction of the share of bad loans. The authorities attribute this performance to strengthened payment discipline, but to a large extent it probably also occurred as a result of portfolio growth and of "evergreening" (informally rolling over) loans (Jafarov, 2004, pp. 38, 41–42). Bad credits reportedly declined to 1.2% of the total credit volume at end-2006.

3.2.3 Fragile Credit Boom

From 2004 through 2006, the Belarusian banking sector appears to have joined the credit boom that has taken hold of all of the country's neighbors, although the Belarusian credit volume is still comparatively modest and the extent to which the surge is market-driven rather than the result of forced growth is unclear. The volume of loans expanded from 15% of GDP in 2003 to 20% in 2005, and accelerated to 25% of GDP in 2006 (table 2). The IMF estimates lending at the government's behest for designated purposes to have grown from 4¼% of GDP in 2005 to 5½% of GDP in 2006 – which in both cases corresponds to more than one-fifth of total lending (IMF, 2007, p. 6). Other sources (Minuk et al., 2005, p. 198) gauge recommended lending to comprise up to one-third of the total credit volume.

Consumer lending has started to play a role and has shown a particularly high growth rate – from a very modest basis.[10] This happened on the back of rising deposits, triggered by (afore-mentioned) strong wage growth, which has apparently been facilitated by a tightening of monetary and fiscal stances (macrostabilization). Spreads between deposit and lending rates contracted substantially over the years and in 2006 are recorded to have fallen to a little over 1%. Of course, state interventionism contributed at least partly to this latter outcome, thus calling into question its significance.[11] Since 2004, a degree of nominal exchange rate stability was reached in relation to the U.S. dollar and the Russian ruble. Therefore, a new outbreak of inflation was averted despite persisting inflationary pressures. A tenuous rise of confidence in the banking system helped stabilize and foster money demand and remonetization tendencies.

Still, accelerating loan growth triggered a liquidity crunch in late 2004, which particularly affected two large state-owned banks. However, the authorities quickly stepped in and increased government deposits in the credit institutions concerned, and also instructed some state enterprises to transfer their accounts to these destinations. These steps alleviated tensions on the interbank market. However, new capital injections into the two banks became necessary a year later, as mentioned above. In July 2006, a series of amendments to the Banking Code were adopted, strengthening the supervisory role of the NBRB and streamlining licensing procedures. It remains to be seen to what degree this new legal overhaul will change the reality on the ground. Progress has been made lately toward

[10] *As of end-2006, loans to households exceeded a quarter of the entire credit volume. A year earlier, on the average every third citizen of Belarus was reported to possess an account equipped with an ATM card (kartschet) (NBRB, 2007b, p. 16; NBRB, 2006b, p. 13).*

[11] *However, according to information provided by the NBRB, even the large state-owned credit institutions have recently become multi-purpose banks involved in operations in various segments of the financial sector. For example, Belpromstroibank has extended its focus to foreign trade business.*

Table 3

Belarus: Top Ten Banks (end-2006)

Rank	Credit institution	Major owners (participation in %)[1]	Number of branches	Assets (EUR million)	Market share (in total banking assets in %)
1	Belarusbank	State (99.95)	119	4,520	43.8
2	Belagroprombank	State and government-related shareholders (99.2)	128	2,009	19.5
3	Belpromstroibank	State and government-related shareholders (87.1)	43	855	8.3
4	Priorbank	Raiffeisen International BeteiligungsAG (61.3), EBRD (13.5), State and government-related shareholders (10.5)	15	837	8.1
5	Belinvestbank	State and government-related shareholders (86.2)	48	760	7.4
6	Belvneshekonombank	State and government-related shareholders (48.4), Nationalny kosmicheski bank (32.5), Pinskdrev (6.3)	24	286	2.8
7	Belgazprombank	Gazprom (33.9), Gazprombank (33.9), Beltransgaz (23.5), state (8.6)	7	182	1.8
8	Slavneftebank	Belneftekhim (32.6), other large domestic owners (46.4)	6	148	1.4
9	Bank Moskva-Minsk	Bank Moskvy (Russia, 100)	5	121	1.2
10	Mezhtorgbank	State (40.9), Daltotrade (Cyprus, 42.7), Vikash Investments (U.K., 9.3), Bank Vozrozhdenie (Russia, 6.4)	5	94	0.9

Source: NBRB, IMF.

[1] Owners with a stake of more than 5%.

adopting legislation on upgrading deposit insurance and payment operations, and on establishing credit bureaus and mortgage laws. In August 2006, a presidential decree exempted credit institutions from the golden share rule. If this proves to be a durable change, it should, by removing some distortions of property rights, facilitate private and foreign investment in the sector.

Box by Michael Boss[1]

The Significance of the Belarusian Banking Sector for Austria:

An Initial Step with the Potential for Future Development

At first sight, the linkage of the Belarusian and the Austrian banking sector seems to be of marginal significance for both countries. While Belarusian banks have not invested in Austria at all, currently only one Austrian bank is present in Belarus. Raiffeisen Zentralbank Österreich AG (RZB), the third-largest Austrian bank, holds about 61% of the total equity of Belarusian Priorbank through its subsidiary Raiffeisen International. The second-largest shareholder in Priorbank is the European Bank for Reconstruction and Development (EBRD), with a share of 13.5%, and three state-owned Belarusian companies hold the remaining equity. However, although Priorbank is the fourth-largest bank in Belarus, it accounts only for about 8% of of the overall banking sector's total assets. In terms of total assets, this participation is almost insignificant in regard to the Austrian banking sector, as

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Priorbank's share of the Raiffeisen group's total assets is below 1%, while the group itself accounts for about 13% of total assets of the overall Austrian banking sector on a consolidated basis.

Given these purely financial indicators for end-2006, the mutual significance of the respective banking sectors seem to be rather limited indeed. However, if one takes into account some additional aspects, the overall picture becomes somewhat more differentiated. While Austrian banks play a big role in many other CESEE countries, they do not play a predominant role in Belarus yet. However, in the past Austrian banks in general and RZB in particular followed a strategy of being present in the CESEE emerging markets at a very early stage to have a competitive advantage as soon as the banking systems in the respective countries start to evolve. For example, RZB founded its first subsidiary in the region (Hungary) as early as 1986. RZB's investment in Belarus obviously follows a similar strategy. Given the fact that the share of the Belarusian banking sector's total assets in the country's GDP is approximately 38% – compared to roughly 300% in Austria – there is an enormous potential for future development. Taking also into account that – after the large state-owned banks – Priorbank is number four in the Belarusian banking sector and hence the largest privately owned bank of the country, this would indeed correspond to a competitive advantage in case the Belarusian banking system evolves into a less state-dominated and more privatized and competitive model. Though in relative terms, Priorbank already is a highly profitable subsidiary within the RZB group, it could gain even more importance in terms of volume under such a scenario. In such a context, Priorbank would also be of heightened significance from the Belarusian perspective, as it is not only the largest private, but also the largest foreign-owned bank and is the only Belarusian bank with a major shareholder from the EU.

Hence, it can be concluded that the current investment of Austrian banks in Belarus, which is limited to the single case described above, is rather insignificant for both sides from a purely financial point of view. Accordingly, the respective financial risks for the RZB group are fairly low and, unlike in some other CESEE countries, the systemic relevance of the presence of the Austrian bank for the local banking sector is also limited in Belarus. However, taking into account the strategic dimension, there is potential for future development, which would comprise both additional risks and opportunities from the Austrian and from the Belarusian perspective.

4 Terms-of-Trade Shock in 2007 – Immediate Consequences for the Belarusian Economy and Banks, First Reactions of Authorities

4.1 The Shock

Following repeated prior announcements, Russia for the first time in years substantially lifted Belarusian energy import prices at the beginning of 2007. The agreement reached between the two countries in mid-January provides for:

(1) the near-doubling of the Belarusian natural gas import price to USD 100 per 1,000 m^3 and its subsequent gradual further increase to reach the Western European level by 2011;[12]

(2) the acquisition of 50% plus one share of the Belarusian natural gas pipeline operator Beltransgaz by Gazprom for USD 2.5 billion,

[12] *However, Gazprom reportedly agreed to let Belarus technically pay the old price (USD 46 per 1,000 m^3) in the first half of 2007, the remaining amount was financed by a bridging loan provided by the Russian Finance Ministry (WPS, 2007). In August 2007 the Belarusian authorities paid off the accrued debt.*

payable in four annual tranches of USD 625 million;[13]

(3) the introduction of a Russian customs duty for crude oil deliveries to Belarus of USD 53 per ton, and the transfer to Russia of the lion's share of the profits from Belarusian exports of refined products to Europe;

(4) the increase of the Belarusian gas transit fee from USD 0.75 to USD 1.45 per 1,000 m^3 (Lechner and Laschevskaya, 2007, p. 1; Bayou, 2007, pp. 56–57).

Even with the current increase, the Belarusian gas import price remains at the lower end of the relatively cheap import price scale in CESEE. For instance, as of 2007, Ukraine has had to pay USD 130 per 1,000m^3 of imported Russian gas, whereas the average price for the western part of the continent is currently USD 250 per 1,000 m^3, as mentioned earlier. However, should the planned convergence to the market level actually be implemented (as declared) in a few years, this would constitute a major shock for an unreformed economy. The Russian "reclaiming" of oil trade profits hitherto appropriated by Belarus is certainly painful for the enterprises concerned as well as for the economy more generally. While the substantial proceeds from the sale of half of Beltransgaz and the transit fee hike may cushion the blow a bit, the coming years and measures (or lack thereof) will tell whether the further evolution of the country's terms of trade will fatally erode the foundations of the "Belarusian model" or not.

4.2 Immediate Aftermath and Reactions of the Authorities

Given the country's long-standing current account deficit (4.1% of GDP in 2006), lack of FDI and low foreign currency reserves (less than one month of goods and services imports), the new energy deal with Russia quickly gave rise to concerns that the NBRB might not be able to uphold the ruble's exchange rate stability and might be forced to devalue sharply. This triggered a banking scare in Belarus in January and February 2007, which the president himself referred to in an interview in April. Mr. Lukashenko pointed out that the authorities had spent about a third of their gold and foreign exchange reserves amid bank run fears in early 2007. Moreover, the Belarus central and local governments as well as the NBRB increased their deposits in commercial banks. The NBRB also raised its refinancing rate by 100 basis points at the beginning of February (Luzgin, 2007, p. 4). Interbank lending rates spiked in February and March.

"We did not publicize the matter amid a souring of relations with Russia in the economic sphere, but I was very much worried about the trends in the banking sphere. I will be honest with you: there was no bank run in which people would rush to withdraw money from banks. This did not take place. But there were enough people, a part of the population, who still went to banks to withdraw money and keep it under the pillow or elsewhere." According to the Belarusian leader, the outflow of money from banks had been halted and cor-

[13] *The first tranche was transferred to the Belarusian state budget in early June 2007.*

porate as well as private accounts had started to grow again. "The banking system has withstood this blow. And what matters most is that people have started believing in this. I'm very grateful to my Belarusians, my people for this," he added (BelaPAN, 2007a).

Official statistics for the first months of 2007 depict a slowdown of economic activity, but not a dramatic one. GDP is reported to have grown 9.0% in January–May 2007 (year on year) compared to 10.5% in the first five months of 2006 and 9.9% in the entire year.[14] Consumer price inflation remained more or less stable at 7% in May (year on year), although producer prices had spiked in early 2007 and came to 14% in May (more than twice the year-earlier level). Obviously, the pass-through of energy price adjustments to consumers has been very limited. The profitability of oil refineries is reported to have plummeted from 20% in 2006 to about 5% in the first months of 2007. Exports stagnated in real terms in the first four months of 2007 (–0.4% compared to the same period of the previous year), whereas imports expanded slightly (+4.6%). Gold and forex reserves (IMF definition) are reported to have slightly dipped from end-December 2006, when they stood at EUR 1.06 billion, to end-February 2007, when they came to EUR 990 million, before strongly recovering to EUR 1.72 billion at end-June.[15]

Bank deposits contracted by about 5% in January 2007 (compared to the preceding month). While total deposits had recovered by end-March 2007, ruble deposits only recovered in June, and corporate ruble deposits have not yet recovered to their level of end-December 2006. Whereas the total credit volume to the economy continued to expand in the first semester of 2007 (by around 15% over the level of end-2006), ruble loans grew about half as fast, and short-term ruble loans contracted by more than half, which seems to signal concern about devaluation pressures. During the first six months of 2007, nonperforming credits are reported to have declined further from 1.2% to 0.9%. Overall, in May 2007 the credit volume was reported to be about 50% higher (in real terms) than 12 months earlier.[16] Capital adequacy decreased from 24.4% at end-2006 to 20.2% at end-May 2007. In July, the NBRB lowered the refinancing rate by 25 basis points again.

Whatever the concerns, as of August 2007, the exchange rate of the Belarusian ruble has held steady.[17] In the first two months of 2007, Belarusian banks' forex liabilities to foreigners (nonresidents) rose by almost half to EUR 1.48 billion. This may explain how the authorities, after re-

[14] *According to Prime Minister Sidorsky, the GDP slowdown in the first quarter of 2007 (to 8.4%) was due to the energy price shock (Neue Zürcher Zeitung, 2007).*

[15] *This recovery obviously benefited from Gazprom's payment of the first tranche for Beltransgaz (see subsection 4.1).*

[16] *In early June 2007, NBRB Governor Prokopovich assured President Lukashenko that the banking sector had been providing "unprecedented" support to the real sector. The president instructed the monetary authority to keep up the current lending pace and to try to curb loan interest rates (BelaPAN, 2007b).*

[17] *The decision of mid-August to discontinue the (loose) peg to the Russian ruble will probably not have much economic impact and may rather be seen as a symbolic political step in the aftermath of the Russian gas price hike.*

portedly spending a third of their international reserves on supporting the domestic currency, seem to have been able to quickly replenish these reserves – with the result that the statistics show hardly any weakening of reserves in the critical period. The banking system's acquisition of foreign debt also impacted on the country's external liabilities, which expanded by over EUR 900 million to EUR 6.1 billion in the first quarter of 2007, but remain relatively low (about 20% of GDP). The dedollarization trend appears to have been stopped, at least temporarily (NBRB, 2007a).

In terms of economic policy, as of August 2007, no significant or fundamental changes are perceptible in the position of the authorities. In late May, the government adopted a Program of Energy and Money Saving until 2011; it envisages targeted measures of energy import substitution, the introduction of energy saving technologies and upgrades of industrial facilities. Yet few concrete steps appear to have been taken so far. However, there is some momentum on the privatization front. Apart from upholding and possibly intensifying state-directed lending support to the economy, the authorities seem to have taken a two-pronged approach to Belarus' terms-of-trade shock: (1) solicitation of external financial assistance, linked with (2) attraction of FDI to some key enterprises to help modernize the economy.

Among the initiatives the authorities (and state-owned institutions) resorted to in early 2007 are the following: In mid-February, the Belarusian government asked Russia for a USD 1.5 billion interest-free "stabilization loan" to help it pay for the energy price hike; at end-April the government in Moscow declared its preparedness to meet this request – under the condition that shares of Beltransgaz are used as security. Since February, the government has been negotiating with Raiffeisen Zentralbank on conditions of assistance in borrowing up to EUR 1 billion from the international capital market (possibly bonds raised with investors and syndicated loans) for investment projects to raise the efficiency of domestic companies. Alternatively, these funds could be used in the forex market to maintain the stability of the exchange rate. However, so far no agreement with Raiffeisen seems to have been reached.[18] The Finance Ministry plans to sell up to RUB 10 billion worth of bonds on the Russian market to strengthen the budget. To further this borrowing strategy, Belarus applied for a credit rating and received one in late August 2007 from Standard & Poor's and from Moody's. In both cases (Standard & Poor's: B+, Moody's: B1), the rating is a few notches below investment grade (Börsenzeitung 2007).[19] Given the country's relatively low foreign debt (table 1), the borrowing strategy may be a promising one in the short run.

In February 2007, the government instructed the Ministry of Economy to draw up a list of state-controlled industrial enterprises in

[18] *Negotiations have also taken place with other international banks. Thus, a declaration of intent was signed in mid-June with ABN AMRO for the Dutch credit institution to provide lending to Belarus' two oil refineries (in Mozyr and Novopolotsk).*

[19] *Major state-owned banks – Belarusbank, Belagroprombank. Belpromstroibank and Belinvestbank – as well as Belgazprombank have already been rated by Fitch (EBRD, 2006, p. 94; information provided by the NBRB).*

which stakes could be sold (Pirani, 2007, p. 22). The authorities are reportedly considering selling majority stakes in Beltelekom (fixed-line operator), the Krynitsa brewery, the Minsk auto plant, some chemical plants, and sugar and oil refineries. But the difficult business environment may restrict the circle of potential investors from the outset.

With regard to Belarusian bank privatization (supported by the decree of 2002), Russian investors appear to have taken the initiative lately. In April, Russia's Alfa Bank agreed to buy the state's stake (about 40%) in Mezhtorgbank. Also in April, Russia's Vneshtorgbank purchased a controlling stake (50% + one share) in Slavneftebank for EUR 18 million (corresponding to a multiple of 2.7 times book value). In May 2007, Russia's Vneshekonombank sent out proposals to all shareholders of Belvneshekonombank in a bid to buy out all stakes in the credit institution. In June, Vneshekonombank was reported to have acquired 51.5% of its Belarusian namesake, although the deal has not yet been closed. All three above (planned) transactions had received the explicit green light from the president of the republic.[20] Meanwhile, the four largest state-owned banks (see table 3) remain important tools of economic policy. Belarusbank (the country's largest credit institution) plans to issue its first Eurobonds worth up to EUR 150 million in 2007.[21] Belagroprombank (the second-largest bank) intends to take out a syndicated loan of up to RUB 1 billion, VTB (Vneshtorgbank, Russia) is earmarked as the arranger of the loan. The plan of Belinvestbank (the fifth-largest bank) is to take out a debut dual currency syndicated loan of EUR 5 million and USD 10 million for six months. VTB again features among the loan arrangers.

5 Outlook

If terms of trade deteriorate further in the coming years – as has to be expected according to the energy agreement – the above-described strategy of the authorities (acquisition of debt, selective opening to foreign capital) will not be able to do more than buy time and postpone a serious crisis, unless profound economic restructuring efforts start. Possible future instability emanating from the authoritarian political system add to concerns.

According to most recent studies or articles (Lechner and Laschevskaya, 2007; EIU, 2007; BMI, 2007; IMF 2007) experts largely concur on the following macroeconomic perspectives for Belarus: Economic activity will slow down (by 2 to 4 percentage points in 2007, then by a further 1 to 2 percentage points in 2008). The trade and current account deficits will rise as the energy shock unfolds. The current account shortfall will almost double to 6% to 8% of GDP in 2007, and further expand in 2008. With insufficient FDI to be expected to cover the widening gap and only relatively modest forex reserves to resort to, the external deterioration will likely translate

[20] *According to Prime Minister Sidorsky, the country attracted more than USD 1 billion (about EUR 750 million) of foreign investments in the first half of 2007, or 20% more than the same period last year. However, he did not specify (RIA OREANDA, 2007).*

[21] *So far, Belarus has never placed a bond on a foreign market.*

directly into a sizable increase of foreign debt and growing depreciation pressures on the Belarusian ruble. The swelling of liabilities will be only temporarily cushioned by incoming proceeds from the Beltransgaz sale. The fiscal balance is bound to deteriorate, because tax revenues fall as enterprise profitability drops, and larger subsidies and transfers are needed to support loss-making firms and consumers. The fiscal deterioration could augment pressure on the NBRB to loosen or accommodate monetary policy to fiscal needs that, together with a probable devaluation, threaten to substantially push up inflation.

What does this mean for banks?

- Taking the events of January and February as an example, one can conclude that a substantial depreciation may quickly reignite deposit withdrawals and trigger banking turbulences. Given that, in the circumstances alluded to above, the authorities will find it difficult to avoid a weakening of the ruble altogether, they will probably try to opt for a gradual, gentle devaluation that will not upset savers.
- A major impact can be expected from declining enterprise profits and growing losses, which are liable to boost nonperforming loans and to swell credit demand and risk from a less competitive real sector. As a consequence, banking system capital adequacy, profitability and solvency will fall markedly.
- This will likely trigger growing and increasingly urgent recapitalization needs for credit institutions, which, given the already precarious fiscal position, in the end might only be covered by the issue of money.
- Once this stage is reached, spiraling inflation or demonetization would trigger destabilization of the banking sector, which might contribute to the unraveling of the model.

However, one should repeat that the collapse of the Belarusian economic model via the breakdown of banks as instruments of redistribution and subsidization of the real sector would appear plausible *only* if rents derived from economic relationships with Russia (all but) disappeared and if at the same time no appreciable structural modernization or opening up of the economy to FDI took place. As Belarus remains a key geopolitical partner for Russia, such a medium-term scenario does not appear probable from the present point of view, but cannot be totally ruled out either.

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