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The Belarus Economy: The Challenges of Stalled Reforms

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Executive Summary

Twenty-five years after the dissolution of the Soviet Union, Belarus stands out as a special case in transition blending, on the one hand, signs of relative prosperity, socially oriented policies and sprouts of entrepreneurialships and, on the other hand, remnants of the communist past. The core of the Belarusian economic model throughout most of this period was a combination of external rents and soft budget constraints on the state-owned part of the economy backed by a strong system of administrative control. In periods of favourable external conditions this mix provided for relatively high rates of economic growth and allowed the authorities to maintain a 'social contract' with the population targeting close to full employment. But this model also led to the persistent accumulation of a quasi-fiscal deficit which time and again came to the surface, and its subsequent monetisation provoked macroeconomic and currency turmoil. At present, Belarus' economic model has run up against its limits and policy changes seem inevitable.

Is Belarus a transition outlier?

The unique experience of Belarus defies many beliefs about the nature and the features of the process of post-communist transition. Belarus embarked on a transition path of its own, different from what was happening in other countries but still delivering a peculiar path of economic transformation.

By the conventional measures of 'progress in market reforms', Belarus is basically 'frozen' in a state of stalled, unfinished market reforms, a point that most other post-communist countries passed by already in the mid-1990s. By this token Belarus lags behind not only the more advanced Central and Eastern European economies but also the countries of the Commonwealth of Independent States and Ukraine.

At the same time, during both of the past two decades, GDP growth in Belarus was higher not only than the average in its closer neighbours, but also than that of the countries of Central and Eastern Europe (CEE) as well as the average rate of GDP growth in Southeast Europe. As a result, Belarus achieved a considerable degree of catching-up: by 2015 Belarus' GDP per capita reached some 70% of the CEE-11 average, up from 48% in 1995. Thanks to its policies of social welfare and internal cohesion, Belarus also achieved a relatively equitable distribution of the growth dividend.

At the same time, Belarus was the country with the highest average inflation rates among all economies in transition; it did not manage to achieve lasting macroeconomic stabilisation and was hit by several subsequent currency crises. Thus in many ways Belarus challenges some of the conventional wisdoms about the transition process: it has been visibly different from other transition economies, following its own transition path, pursuing different political and policy objectives and achieving different outcomes.

How was Belarus different from others?

The mainstream interpretation of Belarus' opaque transition path (also upheld by most international financial institutions) is that Belarus has been buying time to delay inevitable reforms thanks to rents

extorted from Russia in exchange of political concessions. The Belarusian authorities did that by negotiating energy subsidies from Russia in exchange for political loyalty and alliance with its big neighbour. Belarus negotiated access to Russian gas and oil at prices significantly below world market prices which resulted in direct subsidies to Belarusian businesses and consumers; plus, it could export processed fuels and other oil- and gas-based chemicals at international prices. All this was equivalent to an implicit cash transfer to Belarus.

Other interpretations drawing on the political economy of transition look at delayed reforms as a rational choice of local politicians and policy-makers. In most transition economies, the choice of the reform course was not a premeditated policy choice but a self-imposed one, forced by the limited available options. Only countries that had sufficient available or accessible resources to cushion the transition shocks could make deliberate choices on their policy course. Thanks to the long-lasting 'loyalty rent' from Russia, Belarus was among the very few post-communist economies that could make such choices with longer planning horizons.

One original interpretation of Belarus' unique experience draws on the notion of organisational capability and associates its decent growth performance with the preserved organisational capability of the country. Thanks to strong central controls Belarus prevented asset stripping in state-owned enterprises, reduced rent-seeking behaviour, prevented disorganisation and preserved engineering and production capabilities.

Yet another specific in Belarus' transition was the 'social contract' with the population under which the authorities provide stability, order and low levels of income inequality. It has been pointed out that the social values prevailing in Belarus and this 'social contract' played a special role in the way transition evolved in Belarus.

Belarus' unique economic model

It has been suggested by Belarusian economists that the political and economic system that evolved in Belarus can be classified as 'state capitalism'. Such a categorisation differentiates it from the previous system of central planning but also highlights the significant role that the state plays in the economy.

The backbone of the political system is the highly centralised decision-making pyramid, featuring excessive powers concentrated at the top. Belarus adheres to a lopsided presidential system, in which the president de facto has greater power than the legislative branch (a 'super-presidential' political system) while the National Assembly has limited autonomous powers even in its legislative mandate. The members of the Council of Ministers are directly appointed by the president; the Council serves mainly to operationalise the rulings coming from the president's office.

Belarus pursues long- and medium-term policy objectives through 'state programmes' which usually cover a five-year cycle. There is a complex hierarchy of such programmes which is topped by the so-called 'programmes of socio-economic development'. As regards day-to-day policy-making and implementation, there exists an elaborate system of legislative and regulatory arrangements which prescribe specific top-down mechanisms of administrative control over the economy.

However, a deeper and more critical look at the Belarus model of 'state capitalism' reveals one key feature that weakens this self-assertion, namely, the absence of hard budget constraints on the operation of state-owned firms. So there is still much more 'state' than 'capitalism' in the Belarusian economy of today.

In principle, the state has all the levers to impose hard budget constraints on the firms that are under its patrimony. However, the fact is that Belarusian state-owned firms and banks still largely operate under soft budget constraints. State-owned banks have been actively engaged in financial support to state-owned firms, in particular, related to the implementation of different state programmes through the so-called mechanism of 'directed lending'. Such loans are extended at preferential terms (below market interest rates) for the beneficiaries while the banks were subsidised by the government for the interest rate differential. Directed lending generated market distortions and had serious negative micro- and macroeconomic implications – such as the erosion of incentives of SOEs to restructure, deterioration of the quality bank portfolios and economy-wide misallocation of resources – and, ultimately, led to macroeconomic instability.

No privatisation but growth of a de novo private sector

One of the key differences of post-Soviet Belarus from other transition economies has been the restraint on large-scale privatisation of state-owned firms inherited from Soviet times. Privatisation has been a sensitive and contentious economic policy issue and the authorities have been reluctant to embark on privatisation on a mass scale; only a handful of experimental deals were launched. Some institutional change did take place in the management of state-owned firms mostly in terms of corporatisation – the transformation of Soviet SOEs into corporate business entities.

The reasons behind the repeated privatisation failures are complex. Apart from the lack of political will, there has been a systematic conflict between ask and bid prices as the authorities usually based the ask price on book value while potential investors assess the 'going concern' value of the businesses, which is usually much lower. The government also would pose additional post-privatisation requirements and conditions, mostly about preserving employment and output levels, which make the offer unattractive to investors. Plus, potential investors perceive high political risks in Belarus, after several re-nationalisation cases. As a result the few privatisation opportunities in Belarus mostly attracted Russian state-owned corporations. The latter have been able to set prices in closed-doors non-transparent and often politically driven negotiations. Such Russian investors also de facto have sufficient political power of their own to ensure their property rights after the privatisation.

Consequently, the state sector still dominates the economy of Belarus, both in terms of ownership and employment. State ownership prevails especially in the sector of manufacturing; at the other end of the spectrum are the sectors of retail trade and business services. While privatisation has been largely absent in these sectors too, the private sector is already by far the dominant one in most business services, both thanks to the organic growth of de novo private firms and the entrance of foreign firms on the Belarusian market.

Economic governance subordinate to state targets

The governance of SOEs is integrated into the Belarusian administrative system, within the ministries with functional responsibilities in economic policy implementation. The most important governance tool used to be the system of 'state targets' that are communicated from the top to individual state-owned firms and, in some case, to all economic agents. The targets have a hierarchical structure starting from key macroeconomic objectives in the programmes for socio-economic development. These are then translated into annual ones, which are in turn translated into indicative targets by sectors and regions, lower-level indicative economic performance targets as well as main targets for state-owned companies.

This system prevailed during the 1990s and 2000s but it has been weakening in recent years as direct interference into the operations of state-owned companies was diminishing. Nevertheless it has had lasting effect on the performance of firms and banks which are still under state ownership.

There has been a persistent productivity gap between the state sector and the private sector which negatively affected the overall growth in the country. Labour hoarding is key evidence of SOEs' inefficiencies and poor performance. Maintaining or increasing employment levels is usually one of the performance targets of the enterprises, and this in itself is a barrier to restructuring. Directed lending also contributed to inefficient corporate performance as access to cheap loans made SOEs eager to overinvest in physical capital. Moreover, it creates wrong incentives in inefficient companies, as soft budget constraints serve to discourage restructuring.

Energy and agriculture are two sectors that epitomise the opaque system of explicit and implicit subsidies that give rise to soft budget constraints and generate quasi-fiscal deficits.

Distorted financial intermediation leading to misallocation of resources

According to its formal legal status, the National Bank of the Republic of Belarus (NBRB) is 'independent in its decision-making', however, it is subject to informal pressures coming from the top which affect the central bank's decisions. This has implications not only for its relations with commercial banks but also for its wider monetary and exchange rate policy decisions.

The banking sector has a dominant role in the Belarusian financial system as capital markets are practically inexistent. The state still maintains a dominant position in Belarus' commercial banking system: state-owned banks account for some 66% of the total assets of the banking system.

The business model of state-owned banks implies using the capital base as an additional funding source for active operations thanks to their relatively high capitalisation. This translates into greater (compared to private banks) credit exposures including in directed lending by some state-owned banks. On the liability side, state-owned banks enjoy a relatively high share of deposits, largely due to informal instructions to state-owned enterprises to hold their accounts in state-owned banks. In the case of households, state-owned banks are successful in attracting deposits mainly due to their large regional networks.

In the past several years the profitability, capital adequacy, and key indicators of the banking sector have been deteriorating primarily due to an increasing share of non-performing loans in the banks' balance sheets.

Flexible labour contracts and low unemployment protection

The labour market in Belarus has some specific features: on the one hand, it is characterised by flexibility in terms of the duration and conditions of the employment contracts and, on the other hand, by excessive regulation generating rigidities.

The availability of employment opportunities has been an important part of the social contract in Belarus. The principal declared objective of public labour market policies have been the access to jobs for everyone as well as rising personal income, in the first place, through wage growth, in the absence of significant wage differentials. The main policy instrument to target desired wage levels has been the wage scale regulating the salaries for every profession.

There are two types of employment contracts in Belarus: permanent and fixed-term. Most of the employers prefer the fixed-term contract, with the usual duration of one year. This contract does not carry commitments for renewal of the employment after its expiration. It also allows firing an employee with only three-month severance payment if the occupied position is abolished. Thanks to the flexibility of the labour market in terms of contracts, employment has gradually shifted from less productive and low-paid jobs in agriculture and manufacturing to the emerging and rapidly growing services sector.

Economic growth in Belarus during the past two decades was pro-poor, delivering some benefits of growth to everyone, decreasing poverty and preventing high inequalities in the society. The period from 2000 to 2015 saw a 4-fold increase in average real disposable income. As per the 'social contract', the government did not rely on targeted handouts to vulnerable groups but instead sought to provide everyone with opportunities to find a job, offered a wide range of complimentary services and subsidised some prices and tariffs.

At the same time, Belarus is a socially-oriented state without proper unemployment insurance or unemployment benefits. Technically unemployment benefits for the registered unemployed do exist, but they are very low and do not depend on the previous wage level. Moreover, to obtain the benefit the registered unemployed often have to participate in social or public works for free.

Still eastbound trade ...

Historically Russia has been the most significant trading partner of Belarus both in terms of exports – over a half of total, and imports – over a third of total. The EU-28 has also been prominent as a destination for exports, as well as a significant origin of imports. Exports to Russia are relatively diverse, comprising, besides commodities and agricultural/food products, also transport equipment and machinery; imports are dominated by petroleum products. By contrast, exports from Belarus to the EU are mostly comprised of mineral fuels, while imports are formed by more advanced goods, including chemical products, machinery and transport equipment.

Mineral fuels traditionally dominated both exports and imports as the key commodity group, constituting over a third of the country's total trade with a wide gap from other products. Belarus inherited large oil refineries from the Soviet Union and processes crude oil coming from Russia into refined fuels, gasoline, etc., to be further exported to the EU. Over time, the share of primary commodities in Belarusian exports has been gradually increasing and squeezing the share of manufacturing exports that could only find a market niche predominantly in the CIS region. The global competitiveness of Belarusian industries is mostly concentrated in agricultural and food products, as well as chemicals.

Both exports and imports of services have been growing steadily in the past 15 years. The positive balance in services trade partly offsets the chronic deficit in the trade in goods. In terms of their composition, services exports are dominated by the transports sector, with transit freight transportation via railway, motor transport and pipelines being the key modes of transport. Also, the ICT and travel sectors increased their shares in the total services exports. The import side is dominated by construction services, transport and travel.

... FDI flows ...

FDI inflow in Belarus was marginal before 2007, but since 2008 annual inflows have been fairly stable, amounting to about EUR 1.5 billion per year. After controlling for the size of the country, Belarus has received more FDI than some of its neighbours but less than the new EU Member States.

FDI in Belarus is mainly of Russian origin, amounting to nearly 60% of the stocks. Some Western companies are also finding their way to Belarus also through Russia. In addition, FDI from Cyprus is in all likelihood of Russian origin as well, thus the direct and indirect FDI dependence on Russia is probably greater. The second most important investor by a large distance to Russia is Austria, which accounts for only 3.5% of the FDI stocks.

A significant part of FDI has taken place in the framework of large privatisation transactions; joint ventures with state-owned enterprises and greenfield investments account for smaller stocks. The low number of greenfield investment projects – which are the genuine FDI enterprises – is telling proof of the difficult business conditions in the country. Joint ventures between local state-owned companies and foreign investors are FDI practice favoured by the authorities of Belarus. While the number of such deals is considerable, they do not contribute to larger inflows.

Most of the greenfield FDI projects in Belarus are located in special economic zones. Three such forms exist in Belarus: six free economic zones, a Chinese-Belarus industrial park and the Belarusian High-Technology Park. Special zones can be useful vehicles of FDI policy especially in countries with a risky business environment and vague property rights.

... and integration ties

Traditionally, Belarus' external economic relations have been closely associated with its strong economic linkages with Russia and, more recently, with the Russia-led Eurasian integration project. Eurasian economic integration has been progressing very fast formally, starting from the formation in 2010 of the Eurasian Customs Union by Belarus, Russia and Kazakhstan. Two years later the bloc was replaced by the Eurasian Customs Union–Single Economic Space, and in 2015 by the Eurasian

Economic Union (EAEU). The latter also expanded geographically and now includes, besides the three founding members, also Armenia and Kyrgyzstan.

While the customs union arrangement dealt only with the liberalisation of mutual trade in goods via elimination of tariffs and introduction of a common external tariff, the EAEU will seek to bring integration to a qualitatively new state reaching beyond trade-related matters, and also facilitating the so-called 'four freedoms' – a common market for goods, services, capital and labour, as well as the coordination of economic policies and energy markets, which is envisioned to be accomplished by 2025.

Concurrent membership of the EAEU members in the WTO represents a challenge. Belarus remains the only country within the bloc that is not a WTO member and, in general, among the very few countries in the world still not in the WTO. At the same time, it has to indirectly adhere to WTO rules via commitments of its EAEU partners. Belarus itself still appears to be rather far from satisfying the original demands expressed by the WTO related to agricultural subsidies and the high level of government involvement in the economy.

A growth model leading to macroeconomic instability ...

During the period 1996-2008 Belarus enjoyed a period of high growth thanks to, on the one hand, a favourable external environment (the re-integration with the Russian economy which opened the way for Belarusian exports and external rents) and, on the other hand, expansionary policies promoting fixed investment and rising incomes.

Things started to change around 2007 when Russia began claiming back part of the Belarusian export oil duties and doubled the gas export prices for Belarus. The Belarusian authorities were faced with a dilemma: to change the policy course more radically (which would eliminate the demand surplus supported by rents) or to keep it while searching to attract additional external resources compensating for the reduction in rents. The first policy option would have been associated with unpopular austerity measures, so the authorities opted for the second solution.

The combination of a policy focused on demand-driven growth and diminishing external rents resulted in a persistent widening of external imbalances and fast growth of foreign indebtedness: in the second half of the 2000s, Belarus' current account deficit kept growing, reaching over 15% of GDP in 2010 while gross external debt quadrupled between 2005 and 2010.

One of the main sources of macroeconomic imbalances was the quasi-fiscal deficit resulting from inefficient directed lending and soft budget constraints. Directed credit, one way or another, entailed contingent fiscal liabilities as it was de facto underwritten by the Belarusian state. The bad loans resulting from inefficient directed lending ultimately accumulated as a quasi-fiscal deficit.

The other main source of macroeconomic imbalances was the populist incomes policy which prevailed through most of the period of high growth. Mandated wage increases resulted in significant rises in unit labour costs and competitiveness losses as real wage growth outstripped productivity growth. This was also a source of inflationary pressure as there were no checks on the pro-inflationary effect of wage growth. In effect, monetary policy completely accommodated the upshots of expansionary incomes

policies; plus, the quasi-fiscal deficit resulting from directed lending was gradually transformed into an open deficit and was also monetised.

Thus both soft budget constraints and inconsistent incomes policies ultimately generated inflationary pressure and microeconomic instability.

... which has hit its limits

The policy mix prevailing in 2003-2007 was in broad terms a combination of: (i) exchange rate peg; (ii) monetary stimulation; (iii) direct wage stimulation; and (iv) fiscal stimuli (directed at the stimulation of both consumer and investment demand). Trying to mitigate the chronic pressure in the currency market, the authorities resorted to active external borrowings and this happened against the background of a considerable gap between the equilibrium exchange rate and the actual one. As a result, there was a sharp rise in foreign debt after 2008.

Given the built-in inconsistencies of the underlying policies, between 2009 and 2015, Belarus experienced three episodes of currency crises (in 2009, 2011 and 2014-2015) which epitomised the inconsistency of the macroeconomic policy mix. All three cases entailed a massive forced devaluation of the Belarusian rouble reflecting the necessary real exchange rate adjustment.

The policy setup stayed roughly unchanged until end-2014, perpetuating macroeconomic disequilibria. More emphasis on demand stimulation now led not only to a price overhang and a delayed impact on the real exchange rate, but also to direct pressure on prices and the exchange rate through less demand for national currency and more for hard currency. These inconsistencies further reduced the effectiveness of the policy efforts to boost output and incomes.

Is Belarus moving towards a new policy model?

At the turn of 2014, it became evident that the currency peg could no longer be sustained. In several steps, the authorities undertook a complete overhaul in the macroeconomic policy setup. In the first place, the currency peg was abandoned and a floating exchange rate regime was adopted. At par with the change in the exchange rate regime, monetary targeting was announced as the NBRB policy framework with rather restrictive targets for 2015. In turn, the government declared its intention to abolish or curb some of the demand stimulation tools.

The policy setup at present could be summarised as follows: (i) floating exchange rate framework; (ii) monetary targeting with a tight intermediary goal; (iii) fiscal policy tightening; and (iv) less reliance on unconventional demand stimulation tools (directed credit, wage stimulation, etc.).

The introduction of the floating exchange rate regime brought about positive outcomes by helping restore equilibrium and serving as a more effective shock-absorber. A relative tightening of fiscal policy also accompanied the dramatic changes in the monetary sphere. In particular, there were significant cuts in public capital expenditure as well as a reduction in the public procurement of goods and services and budget transfers.

The macro environment in Belarus changed. Before 2015, the stylised macroeconomic picture was a combination of, on the one hand, GDP growth (albeit weakening in recent years) and low unemployment, and, on the other hand, substantial current account deficits, exchange rate overhang and high inflation. After 2015 the picture changed to the reverse: the actual exchange rate roughly corresponds to the equilibrium rate, the current account deficit is close to its estimated mid-term equilibrium and there are signs of disinflation; but this was coupled with output contraction and growing unemployment. In terms of GDP growth, 2015 was the worst year in the past two decades.

Belarus is now facing new challenges and risks to financial stability ...

In the current macroeconomic environment, Belarus needs to find new impetus to invigorate growth. The question is whether and how policy can contribute to such impetus, given the challenges that policy-makers are facing at present.

High inflation expectations have become a challenge for the monetary authorities in many respects, effectively reducing its room for manoeuvre. They drive up real interest rates and curb fixed investment. Hence firms may be reluctant to invest, having in mind the poor growth potential and the low expected returns on investments even in the case of an improving external environment.

Suppressing inflation expectations can be regarded as one of the priority goals of monetary policy and macroeconomic policy as a whole. Although the monetary targeting regime reduces the risks of currency crises, it does not help in addressing the problem of high and persistent inflation expectations (the Belarussian rouble was re-denominated in mid-2016).

Breaking the current constellation of 'dampened capital investments' requires numerous changes relating both to structural and short-term issues and securing a stable monetary environment. Instability in expectations causes an obvious conflict between the price stability and output smoothing goals for the NBRB. From this viewpoint, prioritisation of price and financial stability leads to a tough stance of monetary policy in terms of output, which dampens business activity.

These policy challenges are amplified by new risks to financial stability, in particular, the growing debt problems which pose risks for future macroeconomic stability. At the micro level, two groups of firms – state-owned enterprises (particularly the beneficiaries of directed lending) and foreign currency borrowers – were the most affected with respect to debt sustainability. The recession of 2015 and the significant depreciation reinforced the debt service problems.

As regards the banking sector, there has been an increase in non-performing loans. The reported share of NPLs, which has already reached an alarming level, may still underestimate the real situation due to irregularities in accounting and reporting practices.

The growing corporate debt burden could be damaging in many respects. The companies facing debt problems are to give up or downsize their investment plans. Banks that are burdened with non-performing loans are forced to provision, which affects their lending capacity and reduces borrowing opportunities which impacts negatively on economic activity. Substandard portfolios affect banks' operations; further deterioration may be a threat to their solvency, potentially creating risks for the banking system as a whole.

The authorities are aware of these risks. Banks facing deteriorating quality of assets have been advised to seek recapitalisation; however, this may be difficult to implement, especially for state-owned banks. Recapitalising them will generate significant new claims on public resources which may be a threat to public debt sustainability. The government is considering establishing a special agency for managing non-performing loans.

At the macro level, the main risks to public debt sustainability are associated with the currency structure of the debt, where hard currency obligations are dominating. While the level of future forex debt service will be rising, the amounts of future forex revenue of the government is uncertain; the level of international reserves is also low. The government will need to solicit new forex borrowings in order to service its forex obligation or roll over old debt. Public debt sustainability may become questionable in case new borrowings become unavailable, or if the debt burden continues to rise.

... and needs to reinvent its relations with the IFIs

During the 1990s, Belarus concluded two stand-by arrangements with the IMF (in 1993 and 1995); subsequently, however, these were scaled down on the initiative of the Belarusian side, due to contradictions between IMF conditionality and national policy priorities. The global financial crisis of 2008-2009 and the urgent need by Belarus of external finance to support the currency peg pressed Belarus to apply in 2008 for IMF financial assistance through a stand-by arrangement.

In this environment, the Belarusian authorities were more flexible in the negotiations and undertook a number of commitments not only with respect to short-term macroeconomic indicators, but also as regards a number of structural issues, which earlier had been considered as a taboo. The IMF, in turn, took a more flexible stance with respect to structural issues, which in the past had been considered as a starting point for negotiations with Belarus.

Throughout 2009 Belarus abided strictly to the IMF conditionality and most of the stabilisation measures were implemented. However, the situation changed in 2010. The Belarusian authorities were keen to achieve rapid economic recovery and return to the habitual growth rates of output and incomes before the presidential elections.

Aversion of the IMF agenda and availability of other sources of external finance (first of all, the Eurasian Fund for Stabilisation and Development – EFSD) made the Belarusian side reluctant to seek a new IMF-supported programme in 2011-2015. Instead, in 2011, Belarus applied for a stabilisation EFSD loan with the implicit expectation that its conditionality would clash less with their policy objectives and that EFSD monitoring may be subject to political pressure, which indeed turned out to be the case.

At present, Belarus seems to be playing a strategic game between the two possible sources of external financial support, seeking to achieve most favourable lending conditions for itself.

What comes next?

The most intriguing question now is whether Belarus can continue experimenting with an economic strategy and policy agenda which are so different from what other post-communist countries did in the past or whether it will have to accept the mainstream transformation reforms and converge to the common pattern seen elsewhere.

It is important to distinguish between the sustainability of the country's policy course and the sustainability of Belarus' economic model as such. What concerns the first aspect, the answer seems clear: the past policy course has run its course and must be changed. Actually, change is already happening as a new policy model seems to take shape at present.

As regards the sustainability of the country's economic model which is rooted in Belarus' brand of state capitalism, there are no obvious arguments to assert that this type of model is not sustainable. However, to ensure its longevity, the authorities would also need to undertake some reforms in the direction of 'more capitalism – less state'.

The key test of the viability of the Belarusian model of 'state capitalism' would be the willingness of the authorities to impose hard budget constraints on state-owned firms and banks. Capitalism partly based on state ownership is in principle possible; however, it is not consistent with the policy of soft budget constraints. For the Belarusian authorities to be able to justify their claim of 'state capitalism', they would need to move in the direction of imposing hard budget constraints on state-owned firms and banks.

However, such a policy change would have severe social consequences as it would entail restructuring of the state-owned sector of the economy to make it more efficient, including the shedding of redundant labour. Another component of the current economic model that needs reform for making it more efficient is the strictly hierarchical policy decision-making process. It remains to be seen whether the Belarusian authorities would be prepared to take radical steps in these directions.

Keywords: Belarus, economic transformation, macroeconomic policy, soft budget constraints, currency crisis

JEL classification: E65, O52, P30, P52

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Introduction

After more than 25 years of post-communist economic and political transformation and tonnes of related literature it would appear that everything that can be said on the topic has already been said, and then repeated or re-interpreted many times. However, the unique transition experience of Belarus to some extent defies such a proposition. Moreover, for one reason or another, the country was rarely in the focus of pundits' scrutiny for its own sake or merit. The reasons for that may be different: no dramatic events happened in this period; no radical economic or political reforms were undertaken domestically; no lobbying diaspora existed abroad. Plus, the opaque authoritarian model of ruling the country which is in existence for more than 20 years incited prejudice and a predisposition to criticism by the West of everything that was happening in Belarus. Western sanctions prompted ostracism by the outside world, and this served to further discourage deeper economic analysis. All this is a pity as outliers like Belarus can also provide thought-provoking and useful lessons of transition experience, both in terms of their peculiar transformation path and also in a comparative perspective. The picture that we observe nowadays in this country is the outcome of a unique policy course which defied the Washington Consensus in many ways.

One debatable issue related to Belarus is: What was actually happening in this country during the past two decades? Was Belarus a 'non-starter' in the transition from plan to market? Is Belarus a case of 'stalled' transition or of a 'gradualist' approach to transition reforms? The literature on Belarus is abundant in epithets and metaphors seeking to epitomise the nature of post-communist development in this country.

By the token of the type and nature of changes observed in other post-communist economies, Belarus can be seen as a case of frozen transition, as gradualism would still suggest an ongoing process of reforms but at a slower pace; however, starting from the mid-1990s, there have been very little reforms of this type in the country. At the same time, as discussed in the report, the economic system of Belarus by no means remained frozen during the past 20 years. Belarus actually embarked on a transition path of its own; it moved in a different direction and established its own economic model. These changes were also performed in a gradual way, at the pace chosen by Belarusian policy-makers; nevertheless, they still delivered some type of systemic transformation of the economy, though different from what happened in other countries. Moreover, as discussed in the report, the Belarusian economic system at present is rather heterogeneous and fragmented, with a coexistence of markets, regulated markets and non-market features. From this perspective, there are probably arguments supporting all the different categorisations outlined above.

Notwithstanding the different degrees of advancement with market reforms proper, all post-communist economies, including Belarus, nowadays are completely different from what they were some 25-30 years ago. For those who remember the past, change and progress in all these countries were enormous, albeit different in scope and scale, and can be seen everywhere, in all aspects of socioeconomic and political life, but the progress of each country needs to be assessed with attention to its specific characteristics. It would be misplaced, erroneous and unproductive to apply analytical models

and assessment criteria similar to those that were addressed to the countries during the 1990s. Respectively, when looking to the future, the agenda for the next phase of reform policies needs to take due account both of the current state of the economy and the specificity of the current context – the opportunities and constraints stemming from it.

The analytical study presented in this report is an attempt to fill some of the gaps in understanding the process of economic and political transformation in Belarus since the breakup of the former Soviet Union. Leaving aside the more theoretical insights and interpretation, one key argument in this paper is that, unlike the picture depicted by the conventional measures of progress in transition – which seem to portray a country frozen where it was some 20 years ago – Belarus has gone a long way in this period, but has done this in its own way, coming to a point somewhat different from that of the majority of the post-communist economies.

Chapter 1 of the study looks at Belarus' post-Soviet experiences and performance taking a longer view and seeks to put these experiences into a comparative perspective vis-à-vis other countries that underwent the transition from plan to market. Chapter 2 presents an overview of Belarus' economic structure and institutional environment and analyses some of the challenges faced by the country. Chapter 3 reviews Belarus' trade and international economic relations and analyses their effects on the domestic economic scene. Finally, Chapter 4 turns back to the current macroeconomic situation in the country and explores some of the challenges and dilemmas faced by Belarusian policy-makers at present.

Belarus' experience has its own merits and weak points; ups and downs. One may agree or disagree with the arguments behind its policy course. But in any case, it enriches our understanding of the process of economic transformation with some unique features and provides some interesting new lessons for both economists and policy-makers.

1. Belarus' unorthodox political and economic transformation

BY RUMEN DOBRINSKY

IS BELARUS A TRANSITION OUTLIER? A SNAPSHOT OF THE EVIDENCE

Amongst the countries that started economic and political transformation after the fall of communism, Belarus is probably the only country that implemented a truly gradualist strategy of change over the past 25 years. This is especially evident by the conventional measures of 'progress in market reforms' such as those applied by the EBRD. By those measures, Belarus has basically been 'frozen' in a state of stalled, unfinished market reforms, a point that most other post-communist countries passed by already in the mid-1990s (Figure 1.1).

Moreover, by this token Belarus lags behind not only the more advanced Central and Eastern European (CEE) economies but also the countries of the Commonwealth of Independent States (CIS) and Ukraine.

The lags are particularly pronounced in two of the reforms that are considered central to the economic transformation as a whole: privatisation and financial reforms. Thus the state-owned sector still accounts for a dominant share of GDP in Belarus which is not the case for any other post-communist economy. Commercial banks in Belarus are also still predominantly in the hands of the state; private and foreign ownership in the banking sector is limited and much below the level prevailing in other countries (Figure 1.1).

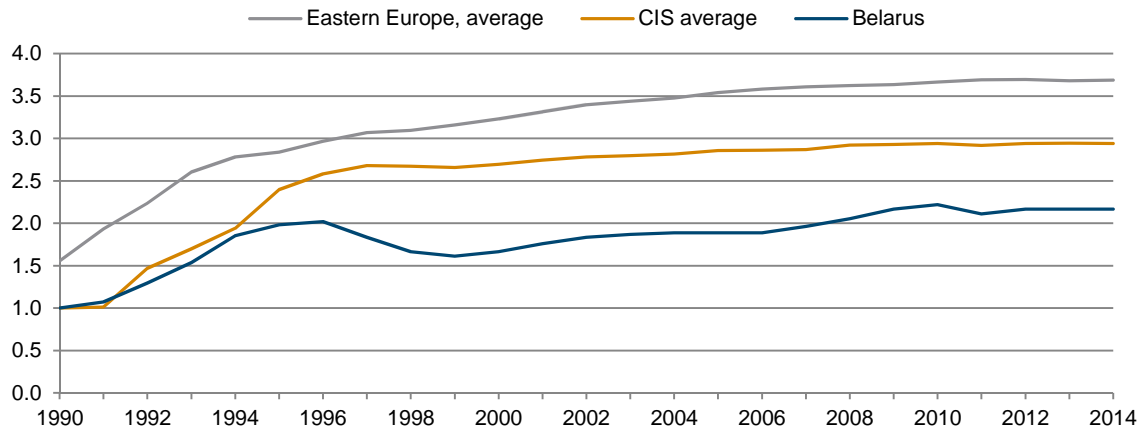
Thus, as regards some of the key ingredients of the process of systemic transformation – which, in turn, are also considered as fundamental characteristics of the transition from plan to market – Belarus is a genuine outlier among the countries that embarked on this process some 25-30 years ago.

At the same time, when looking at the growth performance of these countries in a medium-term perspective, Belarus is one of the countries that fared quite well (Table 1.1).

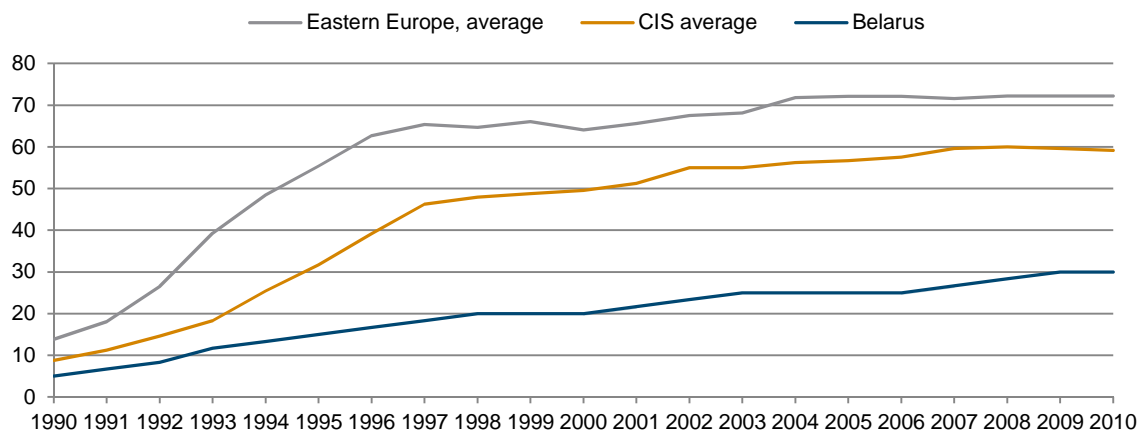
During both past decades (1996-2005 and 2006-2015), GDP growth in Belarus was higher than the average in its closer neighbours (CIS and Ukraine), that of the countries of Central and Eastern Europe (CEE) as well as the average rate of GDP growth in Southeast Europe (SEE).

Figure 1.1 / Progress in market reforms in Belarus compared to other post-communist countries

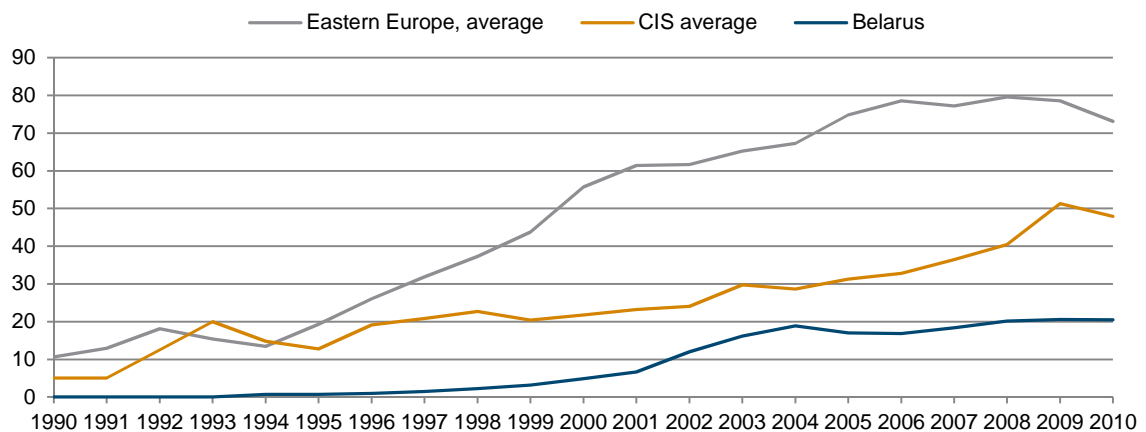
A. Averages of the EBRD transition indicators, 1990-2014



B. Share of private sector in GDP, %, 1990-2010



C. Share of foreign-owned commercial banks, % of total assets, 1990-2010



Source: EBRD.

Table 1.1/ Comparative economic performance of selected transition economies, 1996-2015

	GDP, annual average rate of change, %		CPI, annual average rate of change, %	
	1996-2005	2006-2015	1996-2005	2006-2015
CIS and Ukraine				
Armenia	8.8	4.0	5.6	5.2
Belarus	6.9	4.2	66.8	20.9
Georgia	6.6	5.0	10.2	5.1
Kazakhstan	6.4	5.4	11.7	8.5
Kyrgyzstan	4.7	4.5	13.6	9.7
Moldova	2.2	3.4	16.0	7.4
Russian Federation	3.8	2.4	25.5	8.8
Tajikistan	4.0	6.5	47.9	9.5
Ukraine	1.0	-0.7	18.3	10.1
SEE				
Albania	5.5	3.5	7.8	2.6
Bosnia and Herzegovina	13.4	2.0	..	2.8
Macedonia	1.9	3.0	1.9	2.7
Montenegro	..	3.1	..	2.8
Serbia	3.7	1.5	38.0	8.1
Memorandum items:				
CIS and Ukraine average	4.9	3.9	23.9	9.5
SEE-5 average	6.1	2.6	15.9	3.8
CEE-11 average ^{*)}	4.2	2.0	12.9	3.5

*) Includes the following countries: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.

Source: wiiw databases; UNECE statistical database.

It is quite instructive to compare Belarus' relative performance in terms of growth of GDP per capita at PPPs vis-à-vis the same groups of countries (Figure 1.2).¹ Amongst its immediate neighbours (panel A), it was only resource-rich countries such as Russia and Kazakhstan that displayed similar or better performance than Belarus by this measure, and that was mostly thanks to the favourable world market conditions for hydrocarbons in the past decade. Importantly, panel A of Figure 1.2 indicates that by the same token, Belarus performed better in a medium-term perspective than the CEE-11 (the new EU Member States) taken as a whole; the group that is also considered as comprising the leaders in the process of systemic transformation.²

As a result, Belarus achieved a considerable degree of catching up to the CEE countries taken as a whole: by 2014 Belarus' GDP per capita reached some 70% of the CEE-11 average, up from 48% in 1995. When comparing Belarus to the Southeast European (non-EU) economies (panel B of Figure 1.2), none of the SEE countries can boast such catching up to CEE.

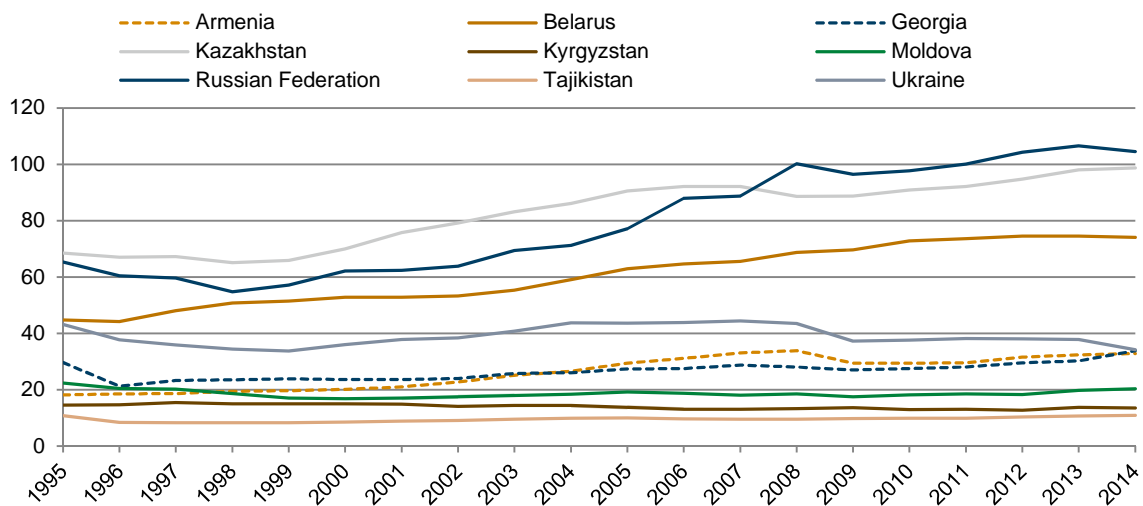
¹ When measuring GDP per capita growth and catching up, transition economies are usually compared to more developed economies. By contrast, Figure 1.2 indicates relative GDP per capita growth within the former centrally planned economies with the group CEE-11 taken as a reference point which illustrates in a straightforward manner the relative catch-up performance of individual countries vis-à-vis its peers.

² At the level of individual countries though there were CEE countries that performed better than Belarus.

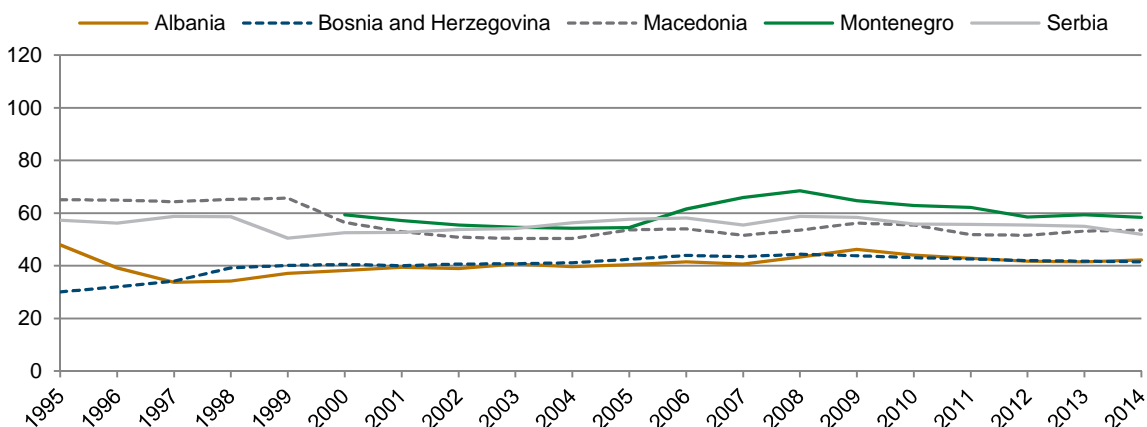
There has been extensive research on the relationship between market reforms/systemic transformation, on the one hand, and growth performance during the transition from plan to market, on the other hand,³ and it is not the objective of this paper to reopen the debate associated with such research. Nevertheless, as an oversimplified stylised conclusion, this research indicates a positive correlation between the two, when properly controlling for some factors, in particular, institutions and initial conditions.⁴ Thus Belarus' medium-term growth performance is a clear challenge to this conclusion stemming from rigorous research.

Figure 1.2 / GDP per capita at PPP in selected non-EU transition economies relative to the CEE-11*) average, %, 1995-2014

A. CIS and Ukraine



B. SEE



*) Includes the following countries: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.

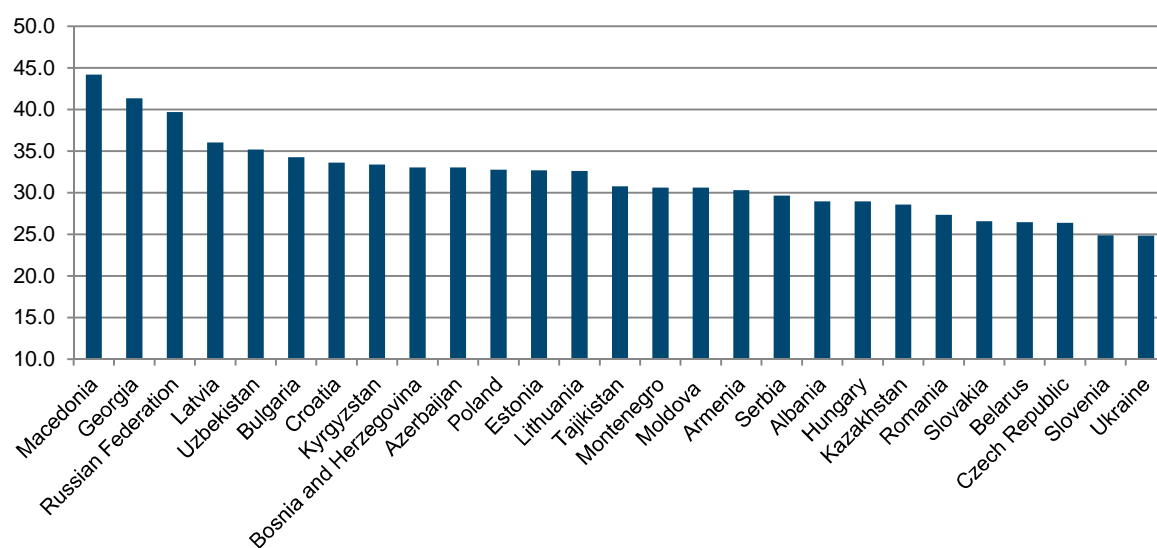
Sources: wiiw databases; UNECE statistical database.

³ See Hare and Turley (2013a); Babetskii and Campos (2007); Falcetti, Lysenko and Sanfey (2006); Grinberg, Havlik and Havrylyshyn (2008), among others.

⁴ Campos and Coricelli (2013).

Moreover, Belarus achieved a relatively successful growth performance in this period while at the same pursuing policies targeting social welfare and internal cohesion. By and large, wide circles of the population seem to have benefited from the aggregate welfare gains as evidenced by the Gini coefficient of income inequality: Belarus is one of the post-communist countries with the lowest degrees of income inequality (Figure 1.3).

Figure 1.3 / Gini coefficients of income inequality in post-communist economies, averages for 2005-2013



Sources: UNDP (Human Development Report 2015).

In this regard, the absence of large-scale privatisation in the way this was done in Russia and other post-Soviet countries may have been an advantage in maintaining social equity and a higher degree of internal cohesion. It also restrained to some extent the process of emergence of a powerful local oligarchy (the latter exists in present-day Belarus but its degrees and spheres of influence on domestic economic and political life are notably lower than, say, in Ukraine or in Russia of the 1990s).

In Soviet times, Belarus used to be one of the manufacturing workshops of the Soviet Union, specialising in a number of industries in the higher value added segment and relying on the large Soviet market. Agriculture was also relatively well developed, in particular industrial livestock production. Food processing, especially dairy and meat products, was another pillar of the traditional economy. In the main, this structural orientation of the Belarusian economy has been preserved over that past 25-30 years, largely thanks to the gradualist approach to economic transformation and deliberate public policy (for more details see Chapter 3).

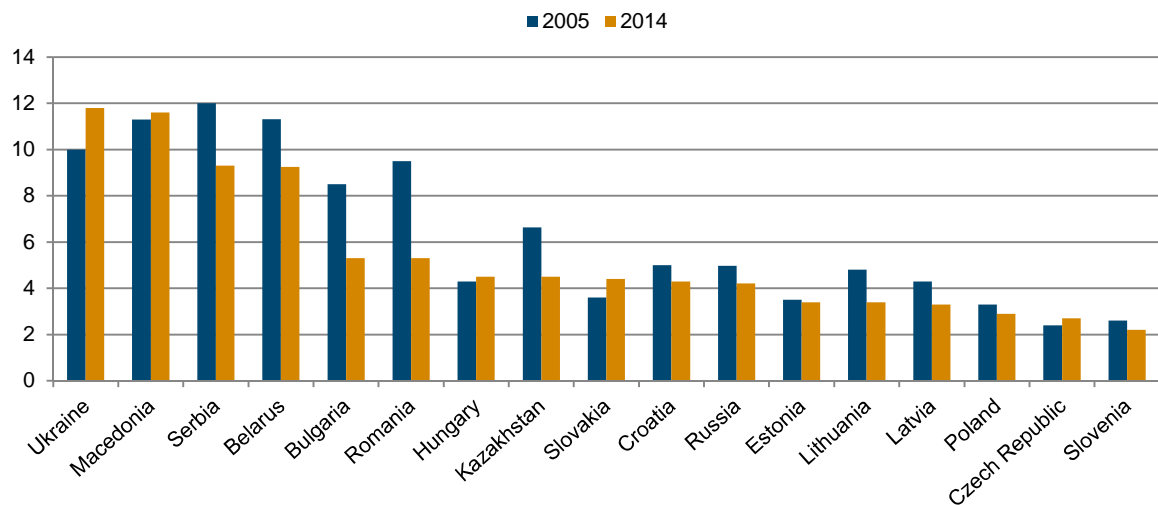
In a cross-country comparative perspective (Figure 1.6), Belarus is still one of the post-communist countries with the largest shares of industry⁵ in total value added produced, although this share has been declining over the years. At the same time, Belarus is also one of the countries with the largest shares of agriculture (although the weight of agriculture also dropped substantially compared to the

⁵ In this paper industry stands for mining, manufacturing and utilities.

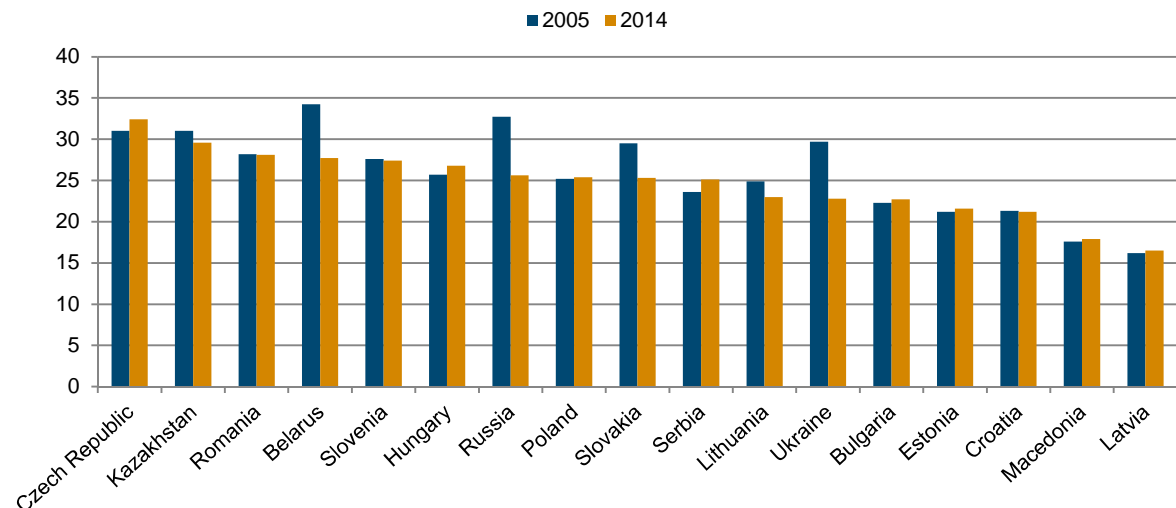
past). As can be seen in Figure 1.6, it is this combination of specialisation in both industry and agriculture that makes the structure of the Belarusian economy stand apart from that in other post-communist countries.

Figure 1.4 / Share of agriculture and industry in gross value added in selected countries, 2005 and 2014, %

A. Agriculture¹⁾



B. Industry²⁾



1) Including forestry and fishery.

2) Mining, manufacturing and utilities.

Source: UNECE; National Statistical Committee of Belarus.

According to the World Bank's 'Ease of Doing Business' rankings, in recent years Belarus has made dramatic progress in improving the local business climate: it moved up from 106th position in the overall ranking in 2005 to 44th position in 2016 (see Table 1.2). In 2010 Belarus was ranked 4th in the world in terms of the measured improvements in the business climate.

Table 1.2 / Belarus and selected other countries in the World Bank's 'Ease of Doing Business' ranking, 2005-2016

Country	2005	2008	2012	2016*
Lithuania	15	28	27	20
Latvia	26	29	25	22
Poland	54	76	55	25
Armenia	46	44	32	35
Kazakhstan	86	70	49	41
Belarus	106	85	58	44
Russia	79	120	112	51
Azerbaijan	98	96	66	63
Ukraine	124	145	137	83

* Due to changes in methodology 2016 ranking is not directly comparable to other years.

Source: The World Bank (2016).

At the same time, Belarus was also the country with the highest average inflation rates among all economies in transition (CIS, CEE and SEE) (Table 1.1). As discussed in more detail later, during these years it did not manage to achieve lasting macroeconomic stabilisation and was hit by several subsequent macroeconomic crises. The combination of relatively high growth and high inflation also seems to go against the established understanding that macroeconomic stabilisation during the transition is a precondition for achieving sustained economic growth.

Thus in many ways Belarus defies the conventional wisdom about the objectives and the nature of the process of economic and political transformation in the post-communist countries. Belarus has been visibly different from other transition economies, following its own transition path, pursuing different political and policy objectives and achieving different outcomes.

This being said, Belarus is relatively little known in the West and largely remains a puzzle not only to the wider public but also to much of the mainstream economic community. Many questions related to the transition experience of this country remain without clear-cut answers. Why and in which features was Belarus different from other economies in transition? What were the factors and driving forces of this peculiar transition path? What is transition success and failure judging from Belarus' experience in comparison with that of other countries?

One could go one step further and ask even more fundamental questions based on this experience. Does Belarus' performance provide evidence that transition in other countries could have followed different paths from what was observed in reality? Could such alternative routes have alleviated some of the pain of the transition and could they have helped achieve better outcomes?

The next parts of this paper as well as the remaining chapters of the study will address these questions and will seek to provide some clues.

WHY WAS BELARUS DIFFERENT? AN OVERVIEW OF INTERPRETATIONS

It would be unfair to say that economists overlooked Belarus' atypical transformation pattern during the transition. Indeed, it has been the topic of a number of studies, both academic and analytic, and they have offered a range of conjectures on this experience and its determinants. In this section we present a brief overview of the literature devoted to Belarus' transition experience and its interpretation as well as to other related literature that may provide clues to this effect.

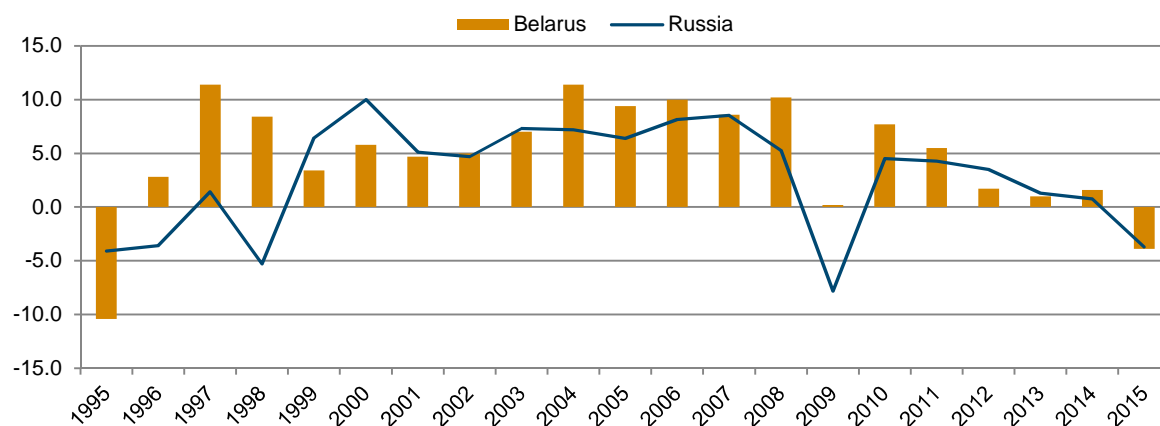
Mainstream interpretation: Belarus buying time to delay inevitable reforms

This is the most widely held view to which all international financial institutions also adhere, so it could be taken to represent the 'Washington Consensus' interpretation of the Belarus phenomenon. It amounts to the understanding that economic reforms in Belarus were put on hold in the middle of the 1990s (see Figure 1.1) as a result of a political backlash by conservative powers who established an autocratic political regime resisting market reforms (see a discussion on Belarus' political system below). Given the lack of political will to pursue economic and political transformation, the authorities have been looking for – and finding – ways to buy time to delay the inevitable reforms, as undertaken by most of the other economies in transition, thanks to its status as a 'rentier state'.

Belarus, similarly to all transition economies, experienced grave external shocks when its inefficient Soviet-type economic structure was exposed to the powerful competitive pressure of the international market. It also experienced a period of deep transformational recession in the first half of the 1990s and was facing similar policy dilemmas related to the speed of economic restructuring and the sequencing of transition reforms as other post-communist countries. However, instead of choosing one way or another to restructure the economy, Belarus chose a way to postpone market reforms by securing access to extraordinary external resources allowing it to cushion, at least partly, the magnitude of the external shocks. The Belarusian authorities did that by negotiating energy subsidies from Russia in exchange for political loyalty and alliance with Russia. Belarus' negotiated access to Russian gas and oil at prices significantly below world market prices resulted in direct subsidies to Belarusian businesses and consumers plus, in addition, the exports of processed fuels and other oil- and gas-based chemicals at international prices. This was equivalent to a supplementary cash transfer to Belarus.

The details of these bilateral arrangements have been changing over the years and the total amount of the subsidy has systematically been decreasing (for details see Chapter 3) but, one way or another, they are still in place. The availability of these considerable resources ('loyalty rent') at the hands of the authorities have made it possible for them to continue subsidising inefficient local economic structures and thereby delay the market reforms that would lead to their painful restructuring as happened in other countries.

The loyalty rent can be considered as part of the historically strong economic, political and cultural links between Russia and Belarus which have been maintained after the breakup of the Soviet Union. Russia remains Belarus' main trading partner and market thanks to both the traditional long-term cooperation links and to political support on both sides (see Chapter 4). As a consequence of the close economic ties, Belarus' economic growth is strongly dependent on the state of the Russian economy and subject to shocks originating in Russia (Figure 1.5).

Figure 1.5 / GDP growth rates in Belarus and Russia, %, 1995-2015

Source: wiiw database.

The analytical publications of the IMF, World Bank and EBRD have systematically followed the above interpretation of Belarus' transition experience throughout the years and up until the present day.⁶ Consequently, this interpretation has set the tone for the majority of the analytical writings on Belarus. IFIs have systematically put the emphasis on their conclusion that Belarus' economic course and growth performance are not sustainable and that postponing market reforms will not eliminate the need to undertake them at some point but will only make the adjustment more painful when these reforms become inevitable.

This interpretation alone, however, leaves one important issue open. It does not provide a clue as to why Belarus turned out to be the only post-communist country to attempt cushioning the transition shocks, and hence delay reforms, thanks to the access to rents. Resource-rich countries, Russia included, obviously had access to rents that could have been diverted to such policies. But the fact is that no other transition economy, including resource-rich countries, chose a transition path similar to that of Belarus.

The pure 'rent-based' interpretation of Belarus' post-1995 growth also ignores another factor that probably gave a similar push to the Belarusian economy. In 1995, Belarus and Russia entered into a Customs Union which removed most of the tariff barriers in their mutual trade and served as a key driver boosting Belarus' exports to Russia. In a way, the Customs Union was a powerful factor for the recovery of the Belarusian economy and reinforced the effect of energy subsidies.

The political economy of transition: delayed reforms as a rational choice?

The political economy of transition is about the political decisions on reform policies: How do these decisions take shape? What motivates such decisions? Which are the driving forces (and actors) behind the decisions on reforms (or non-reform)? How are reforms implemented? When implemented, how successful are the policies in achieving their objectives? Why are some attempted reforms successful while others fail?

⁶ See, e.g. IMF (2009, 2012, 2015).

Experiences of other transition economies (Bulgaria being a case in point) have provided evidence that delayed reforms can be a rational choice, at least up to a certain point.⁷ The arguments draw on the peculiar political economy of transition, in particular, the understanding of the endogeneity of the political process in a situation of a dynamic political equilibrium. In such a situation, market responses to economic policies affect the political equilibrium and can induce changes in policy; on the other hand, economic interests are very often a function of past policies.⁸ The literature on the political economy of transition also emphasises the role of political constraints, which by and large determine the space of feasible reforms as well as the degrees of freedom of policy-makers. Consequently, one should distinguish between ex ante political constraints (political factors that may block the adoption of reforms) and ex post ones (possible reversals after the reforms are implemented and their outcomes are known).⁹ Another important feature of these models is the focus on the re-distributional nature (related to costs and benefits) of most economic reforms which gives rise to 'winners' and 'losers' of the reforms.¹⁰

It should be pointed out, however, that most of the theoretical political economy models of policy reform assume fully democratic societies and their capacity to impose policy change and even policy reversal through electoral cycles. As will be discussed later, Belarus' political system has some peculiarities that deviate from these assumptions. Nevertheless, it is beyond doubt that political economy arguments did play an important role in shaping the course of transition in Belarus.

The degrees of freedom of policy-makers in transition economies to make autonomous and independent choices on the course of reforms, especially at the onset, were severely limited by the capacity of the economies to cushion transition shocks with available reserves or accessible resources such as foreign exchange and fiscal reserves, the ability to borrow on foreign exchange markets (hence the sustainability of foreign debt), and the ability of governments to borrow (hence the sustainability of public debt). In many cases, the choice of the reform course (e.g. between gradualism and radical reforms) was not a premeditated policy choice but a self-imposed one, forced by the limited available options, or the possibility to make a choice was simply overtaken by events such as macroeconomic crises when crisis-management or adjustment reforms imposed themselves on politicians and societies. At one extreme of the transition strategies, a fundamental crisis and the full depletion of reserves and resources could drive fast fundamental reforms which would otherwise not be possible due to political constraints. This was the case when the triple macroeconomic crisis in Bulgaria in 1996-1997 triggered the establishment of a currency board and speedy structural reforms.

Only countries that had sufficient available or accessible resources to cushion the transition shocks had the luxury of being able to make deliberate choices on their policy course. Thanks to the long-lasting 'loyalty rent' extracted from Russia in the form of oil and gas supplies at below-market prices, as well as the preserved access to the Russian market, Belarus was probably among the very few post-communist economies that could make such choices with longer planning horizons, including the luxury to consider options for gradual change and a change towards a direction different from most of the other post-communist countries. It is thus at the other extreme of the spectrum of transition strategies. Furthermore, policy-makers in the country in principle could afford to consider ex ante the pros and cons of a

⁷ Dobrinsky (2013).

⁸ Krueger (1993).

⁹ Roland (1994, 2000).

¹⁰ Fernandez and Rodrik (1991).

gradualist course of slow reform, on the one hand, and that of painful reforms of economic restructuring, on the other hand. The above suggests some arguments in favour of the understanding that delayed reforms in Belarus also bear elements of a 'rational choice'.

At the same time, the possibility to make choices does not explain the actual choice of the policy course itself as policy-makers in Belarus presumably had at their disposal various options. Had they opted for a different course say, some 20 years ago, Belarus could have been very different today. It is argued below that the choices the country made at that point in time were determined by the specific context and the balance of power within the society.

Preserved organisational capability

One original interpretation of Belarus' unique experience draws on the notion of organisational capability and associates its decent growth performance with the preserved organisational capability of the country.¹¹ In this interpretation, the notion of organisational capabilities is understood as organised human capabilities such as knowledge, skills, experience and teamwork that are essential to exploit the potential of technological processes that lead to economies of scale or of scope.

The broader argument in this interpretation is that mainstream transition economics as a strand in the economics literature was biased towards the theory of markets while ignoring the organisational side of the economy. It is furthermore argued that this provides an insufficient perspective which may represent a distorted picture of the transformation process and its outcomes if applied as a single framework. It is then conjectured that Belarus' uniqueness among the transition economies is due to the fact that it largely preserved the inherited organisational capabilities of the economy. The argument is based on the understanding that organisational capabilities can represent an important factor behind growth of economies that operate behind the technology frontier and whose growth is based on imitation, as was largely the case in the post-socialist economies.

The organisational capabilities perspective highlights some distinctive benefits and costs of the Belarusian economic model. On the positive side, strong central controls have prevented asset stripping in state-owned enterprises, reduced rent-seeking behaviour and prevented disorganisation; the country preserved engineering capabilities and developed production capabilities. On the negative side, there was little restructuring of old firms because enterprises were shielded from competitive pressure. However, it is still surprising to see the extent of enterprise restructuring activities which cannot be explained by 'external' pressures but largely by internal patterns of behaviour of large enterprises. Foreign direct investment and entry of new enterprises remain heavily controlled which deprives the economy of potential imports of new technologies as well as of an array of SMEs as potential specialised suppliers. Belarus also shows weak 'experimentation activities' and dynamic allocation in the economy which limits its potential to effectively participate in the international division of labour.

Within this framework it is claimed that the case of Belarus provides evidence of the power of organisational economics as the inherited organisational capabilities allow firms to be efficient in terms of 'static allocation' and preserve some production and engineering capabilities in a new external market

¹¹ Radosevic (2011).

context. But a key challenge for the Belarusian economy will be whether it can liberalise and democratise while at the same time preserving its organisational capabilities.

The role of social values, expectations and external anchors

Social values, expectations of economic agents and external anchors were an important part of the environment in which politicians made their policy choices – and hence of the political economy of transition. Belarus does provide ample evidence of their importance in shaping the course of transition.

Thus, in analysing the Belarusian case, the EBRD pointed out the role of the specific social values prevailing in Belarus and the 'social contract' that the Belarusian authorities concluded with the population. Under it, 'the authorities provide stability, order, modernity and low levels of income inequality. In return, the electorate remains politically quiescent ... Media control reinforces this contract and shapes people's choices ... independent surveys show that a large proportion of the population – although not a majority – values order over freedom.'¹²

However, as discussed in this chapter, the Belarusian 'social contract' – which implies rising wages and nearly full employment – was to a large degree financed by external rents and the preservation of soft budget constraints on state-owned firms and banks. The key parameters of this contract (in the way it has been functioning until now) may be inconsistent with an absence of external rents.

As regards the role of expectations for the shaping of the reform agenda, one needs to consider it in a dynamic perspective. In the 1990s and even in the early 2000s, expectations of economic agents in transition economies were largely shaped by the success or failure in their transformation reforms, especially in a comparative cross-country perspective. With the accession of a large group of CEE countries to the EU, the effect of the countries' reform agenda on expectation has gradually declined, first as regards the new EU members and later as regards non-EU post-communist economies. To the effect that expectations do affect economic performance due to their potential to become a self-fulfilling prophecy, the indirect effect of reforms as a factor shaping some aspects of economic performance (transmitted through expectations) has also diminished. Now the 'keeping up with the Jones's' motive does not seem to play a perceptible role for the shaping of domestic economic reform agenda in any of the former communist countries, Belarus included.

External anchors played an extremely important role for institutional change in the transition economies and, ultimately, for the success (or failure) of the process of political, economic and social transformation, partly through their effect on the expectations of economic agents.¹³ Thus, the realistic prospect of EU membership was one of the most important drivers and catalysts of the reform process in the countries of Central and Eastern Europe that either joined the EU or are in a process towards accession, providing a powerful impetus for the acceleration of their market reforms.¹⁴

By contrast, in terms of the external anchors Belarus has been in a zone of 'no gravity' throughout its transition. EU membership has never been seen as a realistic perspective for Belarus on either side. On

¹² EBRD (2013), pp. 31.

¹³ Di Tommaso, Raiser and Weeks (2007).

¹⁴ EBRD (2013); Roland (2000); Dobrinsky (2013).

the other hand, despite the close economic and political ties with Russia, after independence Belarus was keen on keeping its distance from the big neighbour, especially in view of the perception of a corrupt transition in Russia. Due to that, Russia did not serve as an attractive external anchor for Belarus either. In these circumstances, visionary politicians can shape (even manipulate) local expectations more easily, offering development models that are not anchored externally.

Short-, medium- and longer-term aspects of the dichotomy 'reforms – growth'

As already noted, there has been extensive research on the relationship between market reforms and growth performance during the transition from plan to market. The positive association between the two, as suggested by many of these studies, has served as an argument and impetus for policy-makers in the transition economies to speed up market reforms.

It should be pointed out, however, that with time, the above association has become more obscure. During the initial years of transition, common transition-related factors – as well as changes therein – dominated the performance of the transition economies as a whole. Over the years, divergences in performance as well as the advance in transformation led to a considerable decline in the effect of transition-related factors while country-specific, idiosyncratic factors have become the dominant factors defining the performance of individual countries. At present it would be meaningless to judge policies and reforms in the former communist countries, even those that are lagging significantly behind in economic and political transformation, by the measures and criteria used 20 years ago.

Most growth-related research on the transition economies so far has focused on the common factors that drove their growth performance during the transition period proper, when their performance was mostly determined by transition-related factors, and in terms of the time horizon had at best a medium-term perspective. If one had to repeat similar exercises now, they would need to, on the one hand, take a longer-term perspective and, on the other hand, focus on idiosyncratic factors.

As already noted, despite the rigorous analytical research of the dichotomy 'progress in transformation reforms' – 'economic growth', it would be an exaggeration to claim that this research produced clear-cut answers to this effect. Undoubtedly this research has helped deepen significantly the knowledge about the causal relationships between reform agenda and reform outcomes, but it has not revealed a magic recipe for success for any specific country taken on its own.

As seen in the previous section, Belarus' experience during the past 20 years largely defies the arguments that market reforms – under the agenda undertaken in other transition economies – have been an indispensable factor for achieving high economic growth. On the contrary, Belarusian policy-makers have used arguments based on their own experience to claim that the Belarusian model of gradual transition can support better economic performance and can secure higher welfare to the population. Of course, the long-term sustainability of this model is something that still will need to pass the reality check.

In summary, each of the above interpretations offers some evidence-based arguments and provides a different perspective to Belarus' unique transition experience. These interpretations are not necessarily mutually exclusive but rather complementary, highlighting different aspects of this experience. The next

sections will seek to provide a deeper insight into the empirics of Belarus' experience, which should shed further light on the possible empirical justification of these conceptual conjectures.

BELARUS' UNIQUE ECONOMIC MODEL

Analysing the driving forces – and restraints – behind Belarus' economic performance is hardly possible without a more in-depth understanding of its institutional structure and policy-making process, i.e. what is referred to in the paper as the 'Belarus' economic model'. During the past 25-30 years there were significant – albeit gradual – institutional changes which made this structure and its working completely different from what it was in Soviet times. At the same time, the Belarus' economic model is quite unique and different from the way that the CEE countries are run nowadays.

Belarus' brand of state capitalism

It has recently been suggested by some leading Belarusian economists that the political and economic system that gradually evolved in Belarus can be classified as 'state capitalism'.¹⁵ Such a categorisation reflects at least two main characteristics of the Belarusian economic system and model:

- › on the one hand, it highlights the significant role that the state plays in the economy, in terms of ownership of production and business assets and direct interference in the economic process;
- › on the other hand, it differentiates it from the previous system of central planning as evidenced, in the first place, by the withdrawal of the state from the type of direct allocation of resources typical of central planning.

The conjecture of state capitalism in principle implies that markets have a leading role as mechanisms and drivers of resource allocation. However, in Belarus this role is often constrained by the direct interference of the state in the working of markets; as discussed below, the state still plays a considerable role (both directly and indirectly) in the allocation of some resources. So if one is to adhere to such a definition, one needs to bear in mind that there is probably more 'state' than 'capitalism' in the Belarusian economy of today.

The self-asserted categorisation of Belarus as a 'state capitalist' economy also contains a claim of significant systemic transformation from the starting point of a Soviet-type economic and political model to a different socio-economic and political system nowadays. At the same time, it also implies that this transformation was different from what happened during these years in most CEE countries, all of which were pursuing fundamental market reforms intertwined with pluralistic political systems.

In line with such an understanding and self-perception, the points of reference for international benchmarking (including in terms of policy practices) in Belarus often are countries like China, Chile, South Korea and other Asian 'tigers' (all of which achieved economic success while at the same time adhering to authoritarian political regimes), rather than the leading EU economies.

¹⁵ See Rudyi (2016).

However, a deeper and more critical look at the Belarus model of 'state capitalism' would reveal one key feature that weakens the credibility of this self-assertion, namely, the absence of hard budget constraints on the operation of state-owned firms. As will be discussed below in this chapter and throughout the report, state-owned firms and banks in Belarus still largely function under soft budget constraints, with the state always on standby, ready to extend a helping financial hand to bail out firms and banks in financial distress.

The importance of soft budget constraint (a notion first introduced by János Kornai) as a legacy of central planning and a factor to be dealt with during the transition from plan to market was widely debated in the literature on transition in Central and Eastern Europe.¹⁶ Finding a radical way of uncoupling firms and banks from the state as a lender of last resort was among the key policy rationales for speedy privatisation in many CEE countries.

In principle, the state has all the levers to impose hard budget constraints on the firms that are under its patrimony. However, the fact that Belarusian state-owned firms and banks still largely operate under soft budget constraints provides evidence that, as long as the symbiotic ownership relation exists, it may be next to impossible to do that. The political economy aspects of soft budget constraints in Belarus are discussed below; the fact to be stressed here is that the incidence of soft budget constraints is at odds with the self-asserted categorisation of Belarus as a 'state capitalist' economy.

Political system

An economic model based on 'state capitalism' requires a matching political system that governs and support such a model, and this has also been the experience of other countries adhering to similar economic systems. The backbone – and key building block – of Belarus' political system is the highly centralised decision-making pyramid, cemented in the constitution of the country and featuring excessive powers concentrated at the top.

Belarus adheres to a lopsided presidential system, in which the president de facto has greater power than the legislative branch (a 'super-presidential' political system). The fundament of the current political system was laid with the constitutional reform initiated in 1996 by the acting president Alyaksandr Lukashenka during his first mandate and approved by a referendum in the same year. The new constitution empowered the president with far-reaching authorities such as the right to dissolve parliament, call referenda, issue decrees with the force of law, nominate the prime minister, appoint half of the members of the Constitutional Court and the Supreme Court, and a quota of the members of the upper house of parliament.¹⁷ An upper house of the National Assembly was instituted which consists of members appointed by the president and the local governments, diluting the power of the elected lower chamber of the National Assembly. In addition, there are no limits as to how many terms in office the president can serve.

In accordance with these arrangements, the top of the decision-making pyramid is the president's office which is equipped with the necessary administrative capability to support a comprehensive decision-making process. The National Assembly de facto has limited autonomous powers even in its legislative

¹⁶ See, e.g., Schaffer (1998), among others.

¹⁷ Rontoyanni and Korosteleva (2005).

mandate. Thus, before a parliamentary vote, the draft of each piece of legislation needs first to be cleared with the presidential administration; many draft laws are actually prepared by the presidential administration. Plus, many areas of legislative ruling, which in a parliamentary democracy are usually subject to parliamentary statutory laws, are governed by presidential edicts in Belarus. The presidential office de facto has a veto power on all important public sector decision, overruling all other layers of state power.

The members of the Council of Ministers, the executive branch of power, are directly appointed by the president (without the need of even formal parliamentary vote) and serve mainly to operationalise the rulings coming from the President's office. The working of the lower levels of state power follow a similar pattern, mostly transmitting decisions originating at the level of the Council of Ministers along their respective vertical reporting lines (see an aggregate organigram of the economic administration in Belarus in Annex Figure 5).

There are 24 ministries in Belarus each of which is responsible for policy implementation in the respective sector. Among them there are several dealing with economic policy issues: the Ministry of the Economy, the Ministry of Finance (in charge of the budget, but not tax collection), the Ministry of Tax Collection, the Ministry of Trade, the Ministry of Industry, the Ministry of Labour and Social Protection, the Ministry of Agriculture, the Ministry of Architecture and Construction. The Ministry of Foreign Affairs has an economic function of promoting exports. The functional responsibilities of the ministries sometimes overlap, which leads to rivalries, inefficiencies and sometimes paralysis.

Political parties play a limited role in Belarus' political life. Apart from incidences of political oppression of voices critical to the ruling elite, the weak constitutional power of the National Assembly has acted as a deterrent to the formation of a proper partisan system as it does not provide sufficient incentives for parties to compete for parliamentary seats. In the absence of limits to the number of presidential terms in office and the lack of alternative party-centred power bases, the presidential office has become a gravity centre for the political elite in the country.

Given this power structure, the presidential elections are also by far the most important political events which define the political cycle in Belarus. In turn, in the absence of excessive economic turmoil, the outcomes of the political cycles are largely predictable. The political goal of preventing economic turbulence has thus been a key motivation of the ruling elite for pursuing a gradualist transition strategy in Belarus. Another key determinant of the policy agenda has been the intent to appease the population (i.e. the voting constituency) at large, including its less affluent segments. The lasting leaning of the top decision-making level towards more socially orientated policy choices has often produced openly populist policy decisions.

While by Western standards, the political system in Belarus is far from being pluralistic and democratic, it does have pragmatic merits of its own. For example, as the political cycle de facto plays a relatively limited role, the ruling elite has in principle the privilege of longer planning horizons in policy-making and implementation than is usually the case in pluralistic democracies. This system also ensures a fairly high degree of predictability of the framework conditions for doing business.

Key policy instruments and mechanisms

The central policy practice of the Belarus public administration in pursuing long- and medium-term policy objectives is through the so-called 'state programmes' which usually cover a five-year cycle. There is a complex hierarchy of such programmes which is topped by the so-called 'programmes of socio-economic development'. The backing of programmatic objectives by financial resources which are explicitly included as part and parcel of an adopted state programme is a kind of guarantee that these financial resources will then be included in the budgetary framework for the respective period covered. In turn, the mid-term budgetary framework follows the socio-economic forecast outlining the output targets for the economy as a whole and for key sectors. However, there are no clear procedures to justify the efficiency of public spending and no established practice of open discussion on targets and the budgetary process, nor an evidence-based impact assessment of policy evaluation.

As regards day-to-day policy-making and implementation, there exists an elaborate system of legislative and regulatory arrangements which prescribe specific top-down mechanisms of administrative control over the economy. These are effectuated by a subordinate hierarchical system of rulings by the respective administrative bodies. Notably, Belarus maintains a class of well-educated and capable civil servants and administrators at all levels of the public administration who ensure its smooth running.

What is specific for the existing system – and distinctly different from the central planning system under communism – is the relatively high degree of transparency of policy-making in Belarus. Coupled with the generally good level of ICT culture in the country, Belarus has gradually developed an efficient system of publicly available policy documents of various kinds. The process of policy-making and implementation takes place within the system of public administration and there is no parallel (and superior in power) decision-making process taking place along party lines; neither is there a dominant political party in the country.

However – and this is one more specificity of the Belarus model – 'transparent' in the Belarusian sense is by no means synonymous with 'democratic'. The actual process of decision-making is manifestly top-down, along clearly defined vertical reporting lines. In addition, its autocratic nature also shows up in the disconnect between top-level ruling and responsibility.

In reality, the ultimate decision-making authority (which is largely concentrated in the top level of the administrative pyramid) is practically uncoupled from the nominal responsibility for the outcomes of economic policy decisions (which are in principle delegated hierarchically to the various levels of the pyramid). This does not necessarily take the form of direct interference in lower-level decision-making processes. For example, some desired macroeconomic objectives (which may not be internally consistent) are usually set top-down as mandatory targets in the top level programmes for socio-economic development. Subsequently, the macro targets are decomposed and channelled to the lower level of administration, carrying with them the inconsistencies they embody. However, such a constellation makes it possible for the top level, in the case of unfavourable outcomes of some economic policy decisions, to transfer the political responsibility for the unfavourable outcome to the stratum where the respective nominal responsibility is delegated. Thus changes at different levels of public administration have often been employed to absorb social pressure stemming from economic mismanagement.

Furthermore, there is much less transparency as regards the implications and outcomes of economic decision-making and their ultimate consequences for public finances. In the first place, there is no established practice of (ex post) policy evaluation that would feed into ex ante policy-making. The problem is further complicated by irregular – but widespread – practice of opaque off-balance sheet fiscal operations and lack of proper fiscal accounting. Thus, very often the economic upshot of some economic decisions does not show up in the headline fiscal balance but results in various contingent fiscal liabilities which may surface only after some time lag. Consequently, the headline fiscal balance (and deficit) figures are not really meaningful as regards the fiscal position of the government as the true position should take into account the (often very large) quasi fiscal deficit.

And third, what is peculiar in Belarus is the coexistence of rule-based and discretionary policy-making and implementation. Discretionary interventions coming from the top of the pyramid are frequently applied, especially as crisis management mechanisms, interfering into the working of rule-based processes and overruling rule-based decisions. While discretionary decisions may be made in good faith and be well meant to achieve positive economic outcomes, there is no guarantee that they are consistent with the overall policy objectives and environment and with the other components of the policy mix. Consequently, such decisions carry the risk of giving rise to market distortions and quasi-fiscal liabilities.

One widely used discretionary mechanism in Belarus' system of state capitalism has been the imposition of price controls of different kinds such as fixed prices, price caps, markup ceilings, rate of return ceilings, and governmental indicative prices, among others. The extent of price controls has varied over time and periods of price liberalisation were followed by the re-imposition of price controls, especially in times of macroeconomic turbulence.

Given the significant role of the state in the economy, line ministries in Belarus are also mandated with functional responsibilities that are not very typical of similar bodies of the public administration in a market economy. In particular, different line ministries are delegated with the authority to represent the state as the owner of state-owned companies that fall under their functional responsibilities. While these authorities are different and smaller in scope than was the case under the system of central planning, there is still a considerable degree of governance power and control over the behaviour and performance of state-owned companies which is channelled through such reporting lines.

The state ownership representation is spread across the whole administration including the line ministries and the regional authorities and virtually all such bodies perform these functions. Apart from that, a few state-owned companies are under the direct control of the presidential administration which performs similar functions with respect to these selected companies which are among the cash cows of the Belarusian economy.

Economic governance

One of the key differences of post-Soviet Belarus from other transition economies has been the restraint on large-scale privatisation of state-owned firms inherited from Soviet times. Privatisation has been one of the most sensitive and contentious economic policy issues over the past 25 years and the authorities have been plainly reluctant to embark on privatisation on a mass scale. No proper privatisation law has

ever been enacted in Belarus and only a handful of experimental deals were prepared to be launched, without much success.

Some institutional change did take place in the management of state-owned firms mostly in terms of corporatisation – the transformation of Soviet SOEs into corporate business entities. As noted above, this matched the recognition of the withdrawal of the state from direct allocation of resources in support of the mandatory planning output targets and the transfer of business management responsibilities to the companies. The respective line ministries were delegated with the authority to exercise the shareholder ownership rights of the state. This reorganisation can be considered as an initial stage of enterprise restructuring and preparation for privatisation; however, in Belarus it was not followed by the main next step – the ownership transfer.

The governance of SOEs is integrated into the Belarusian administrative system, in particular, within the ministries with functional responsibilities in economic policy implementation. In addition, there are several State Committees and Agencies under the authority of the Council of Ministers.¹⁸ Among the Agencies there are four sectoral 'concerns' (de facto holding companies): Belpischeprom, bringing together 57 food-manufacturing companies; Bellegprom (110 light industry companies); Belneftekhim (more than 60 oil refining and chemical companies); and Bellesbumprom (46 companies in wood processing industries). The concerns have managerial responsibilities over the state-owned enterprises that are part of them; oddly enough, some private companies are also members of these concerns.

Economic governance by the state under Belarus' system of state capitalism is performed through different instruments, the most important of which is the system of 'state targets' that are communicated from the top to the individual state-owned firms¹⁹ and, in some case, to all economic agents.²⁰ The targets have a hierarchical structure, starting from key macroeconomic targets contained in the medium-term programmes for socio-economic development. These are then translated into annual ones, sanctioned in annual presidential edicts on the main macroeconomic targets for the respective calendar year. In a next step, the Council of Ministers adopts decrees, translating the annual targets of socio-economic development into indicative targets by sectors and regions, lower-level indicative economic performance targets as well as main targets for state-owned companies. These last targets are in fact among the main instruments for direct governance of state-owned companies.

While the targets communicated to individual state-owned companies are in principle also proclaimed as indicative, de facto they act as mandatory since company managers are held personally responsible for their achievement. The mechanism of such company targets is the closest counterpart to the old system of central planning but there are also significant differences in the way these two mechanisms operate. Under the system of central planning, at least theoretically, the planning output targets were backed by the main input resources (also supplied by the state as represented by the central planning body) considered necessary for achieving these targets. I.e., the state at least had a declared responsibility to supply the enterprise with the necessary inputs; in reality it often failed to deliver on this responsibility.

¹⁸ The State Control Committee is the only economic committee in direct subordination to the president. Its functions are to implement legislation on control and auditing, and to prevent money laundering and other economic crimes.

¹⁹ As discussed below, the system of firm-level targets have lost substantially in importance in recent years.

²⁰ For details see Rudyi (2016).

Under Belarus' system of state targets, the state does not claim such an openly proclaimed responsibility on the input side while the indicative output targets are de facto treated as mandatory. On the other hand, however, through direct interference into the economy, the Belarusian state does provide indirect support to some state-owned companies to achieve targets that are considered vital for the economy and for achieving the overall macroeconomic targets. In fact, maintaining the practice of soft budget constraints acts as a matching financial mechanism of the system of state targets.

The actual setting of individual company targets is one of the key governance tasks of the public bodies (line ministries and regional authorities) under whose functional responsibilities the respective companies fall. Apart from the setting of individual targets, there exist also other elements of direct state governance of state-owned companies such as negotiation and coordination of the companies' business plans, monitoring of business activity and performance, support to sales and access to finance of selected activities.

Notably, the degree of such direct economic governance by the state into the economy and into the operations of state-owned companies has been diminishing in recent years. In the first place, there has been a gradual withdrawal of the state from direct control of individual companies and reduction of the scope of such control. Thus, while during the 1990s, virtually all state-owned companies were subject to direct targeting, in 2010 it only covered 140 companies and in 2013 77 companies.²¹ In the 2015-2016 annual planning cycle, the list of companies subject to direct government control has been reduced to 29.^{22 23}

Concomitantly, the list of company targets has also been on the decline and their effect on resource allocation in the targeted firms has visibly weakened. Thus, in the latest (2015-2016) planning cycle, the list of such targets has been reduced to five: 1) export sales (for exporters), 2) profit rate, 3) profit level, 4) reduction of excessive stocks of finished goods and 5) reduction of production costs.²⁴ In previous years the list of such targets was much broader, including some rather fundamental performance indicators such as output level, productivity and wage level which distort much more significantly firm behaviour and performance.²⁵ Moreover, there has been a general shift from 'volume-based' targets to 'qualitative' ones which has been quite visible in the last couple of years. Thus, in general, the company-level system of targets as described above seems to on the way of being phased out.

Judging from the above, the trend of recent years suggests a possible intention of gradually phasing out the individual company targets as policy instruments of direct interference by the state in the running of state-owned firms. Moreover, the share of the state-owned sector of the economy itself is also declining.

At present, the ownership structure situation in the Belarusian economy is rather mixed and heterogeneous across sectors of economic activity (Chapter 3). The sectoral differences are the upshots

²¹ Ibid.

²² Government decree (2015).

²³ The firms under direct state control are mainly large companies; there are many more firms which are controlled by line ministries, concerns, district authorities and other public bodies. But these SOEs are not subject to centralised firm-level targets.

²⁴ Ibid.

²⁵ As a simplified illustration, compare the production decisions of a firm maximising output under exogenously set labour cost with a firm maximising profit with no such constraints on the cost of labour.

of a mix of factors and, significantly, the outcomes of a differential public policy stance across sectors. A range of businesses, in particular those that are viewed by the top decision-making level as performing 'social functions' (e.g. large employers, cases of 'one city, one factory', large collective farms, etc.), as well as businesses with questionable restructuring prospects have enjoyed preferential policy treatment and open policy support, which has enabled most of them to survive during the past 25 years or so. In other sectors such as business services where de novo private businesses were keen to enter and saw good prospects to grow, allowing swift redeployment of labour, the policy has been less interventionist and Belarus saw fast emergence of a new private sector that now dominates these industries.

As an illustration of some of the outcomes of the diverse patterns of economic dynamics at the firm level, Annex Table 2 provides a concise rating of the largest companies in Belarus in 2014 by four criteria: the value of output; the value of tax contribution; the value of exports; and the number of employees. The group of 'national champions' as depicted in the table is still dominated by traditional large SOEs which are present in different sectors of economic activity, but it also includes de novo private firms as well as foreign-owned firms and joint ventures.

Financial architecture

State-owned banks, especially the two largest among them (Belarusbank and Belagroprombank), were actively engaged in financial support to the implementation of various state programmes through the intervention of the state into the process of credit allocation by the banks – the so-called mechanism of 'directed lending'. Such intervention is effectuated through the banks' management boards which are staffed by top-level civil servants. These boards are the intermediary bodies which channel government policies and plans to the banks and translate higher-level plans into banks' lending policy and operational lending decisions. There is a second important characteristic of directed lending in Belarus: such loans as a rule are extended at preferential terms (below market interest rates) for the beneficiaries while the banks are subsidised by the government for the interest rate differential.

The mechanism of directed lending is close in spirit, though not equivalent, to the mechanism of central allocation of financial resources under central planning. Notably, it is far from market-based credit allocation matching the demand for credit by autonomous profit-making economic agents and credit supply by profit-maximising banks who perform stringent screening of such demand. As a result, directed lending generates market distortions and has serious negative micro- and macroeconomic implications such as the deterioration of the quality bank portfolios (due to the high share of substandard and not-performing loans), generally low profitability of banks' credit activity and, ultimately, economy-wide misallocation of resources.²⁶

In turn, as shown by the experience of the past about 20 years, the accumulation of financial distress in state-owned banks and the escalating risks of possible bank failures has on several occasions prompted another form of state intervention: the recapitalisation of ailing state-owned banks with public funds (either directly from the budget or through ad hoc refinancing decisions by the central bank). Thus state-owned banks by and large also have been performing under soft budget constraints, at least up until now. The repeated pattern of such interventions gives rise to moral hazard among recipient economic

²⁶ See Kruk and Haiduk (2013).

agents (both state-owned banks and state-owned firms) and dampens external market restructuring pressures on them.

The top-down administrative intervention model in Belarus also affects the operations of the country's central banks – the National Bank of the Republic of Belarus (NBRB). Although according to its formal legal status the NBRB is 'independent in its decision-making', similarly to other policy mechanisms in Belarus, it may be subject to informal pressures coming from the top which may and do affect the central bank's decisions. This has implications not only for its refinancing policy and the relations with commercial banks (as discussed above) but also for its wider monetary and exchange rate policy decisions (as will be discussed later).

The model of the banking sector as described above was typical of the late 1990s and the 2000s when significant amounts of directed credit were channelled to support government programmes, in the first place in agriculture and housing construction. In recent years, similarly to the corporate sector, the situation in the banking sphere has also gradually been changing and the degree of state intervention in the financial sphere has notably decreased.

The most important institutional change was the establishment in 2011 of the Development Bank of the Republic of Belarus (DBRB). The DBRB is a specialised financial institution which was established with the main purpose to fund government development programmes and hence took over the respective portions of the portfolios of the two main commercial banks (Belarusbank and Belagroprombank) which had been engaged in such operations before it came into existence. Accordingly, the DBRB was due to become the only provider of directed credit in Belarus while the NBRB was due to discontinue non-standard liquidity support to the commercial banks.

However, the actual transfer of such functions to the DBRB took several years to be fully implemented and in the meantime the old and the new funding systems coexisted in parallel. As of the moment of writing, the DBRB had acquired only a small fraction of directed loans from Belarusbank and Belagroprombank. In reality, the DBRB has sought to position itself more as a development institution managing new directed credit rather than as a hospital bank and resisted the transfer of 'old' (and bad) directed loans. So, it still remains to be seen what the actual role of the DBRB will be in future.

Another relatively new development was the establishment in 2005 of the budgetary National Development Fund. The revenue of the fund is provided by targeted mandated contributions by the most profitable Belarusian SOEs. At the beginning of every year, the Council of Ministers issues a decree listing those SOEs (97 in 2008, 60 in 2011, 36 in 2014 and 30 in 2016) which are mandated to transfer a portion of their profit to this national fund.

The National Development Fund was conceived to function as a sovereign development fund. In principle it should accumulate adequate financial resources for the purpose of engaging in large-scale socio-economic projects. The funding decisions are to be approved at the level of the President of Belarus. However, in the case of Belarus, it is so far quite insignificant in terms of its endowment with funds and hence has limited capacity to perform such functions.

ECONOMIC PERFORMANCE UNDER A GRADUALIST TRANSITION STRATEGY

The drivers of growth in Belarus

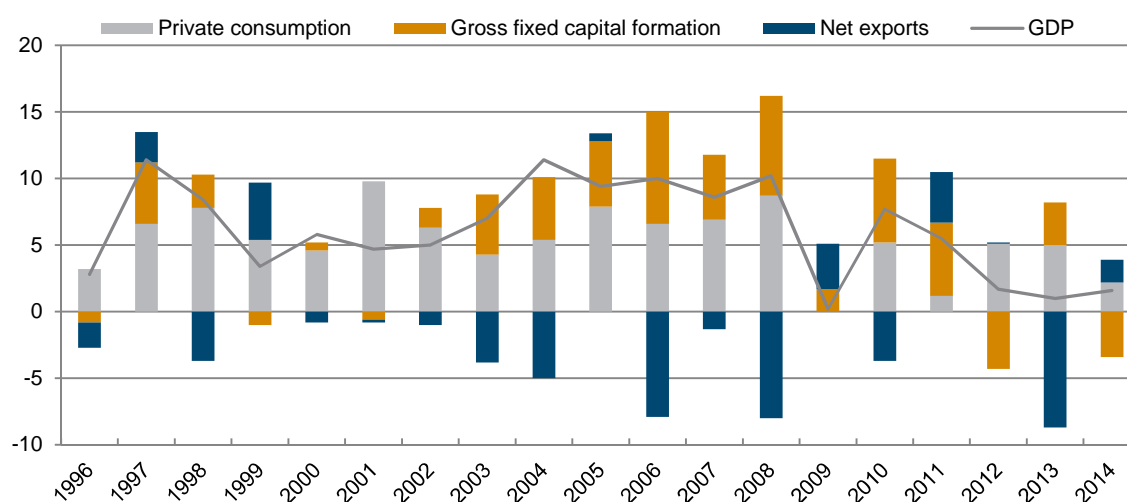
Between 1995 and 2011, Belarus experienced a period of unprecedented and uninterrupted high economic growth which produced impressive outcomes: real GDP tripled (Table 1.1, Figure 1.4 and Annex Table 1) and, in terms of catching up, Belarus was among the front runner transition economies.

In chronological order, the period that we review in this paper (1996-2016) can probably be broken down into two:

- › A decade plus of growth (1996-2008)
- › A period of turbulence (2009-2015)

The recovery that started in 1996 followed several years of transformational recession in the first half of the 1990s. It was followed by a phase of lasting and robust upturn with double-digit GDP growth in some years. Economic growth in Belarus in this period was predominantly driven by domestic demand (Figure 1.6). In statistical terms, private consumption made sizeable contributions to GDP growth throughout the period of robust recovery; in the first half of the 2000s and up until 2008, this was also matched by the important contributions of fixed investment.

Figure 1.6 / Contribution of final demand to GDP growth in Belarus, %, 1996-2014



Source: UNECE statistical database.

The start of recovery coincided with the setting-up of the new political system in Belarus and the gradual establishment of its building blocks and economic model, so it is tempting to seek some causal links between the two. The observed type of economic performance is consistent with the conjecture that Belarus not only managed to preserve to a large degree the organisational capabilities and production capacity inherited from the past but also introduced targeted policies to support them which were underpinned by the 'rent dividend'. These policies also targeted social welfare and contributed to the

recovery of incomes and consumption so that a significant portion of the rent was oriented towards establishing and maintaining the 'social contract' with the population.

In addition, the Belarusian economy benefited from the close economic ties with Russia which also experienced a robust economic upturn between 1999 and 2008 (Figure 1.4). The invigoration of economic ties with Russia after the introduction of the Customs Union in 1995 was probably the most important growth factor in this period. The strong import demand in Russia supported growing exports of Belarusian engineering products and capital goods (partly thanks to the supply chains preserved from the past) thus contributing to the revival of these sectors of the Belarusian economy. In turn, the production of engineering and capital goods stimulated both the imports of intermediaries and domestic demand in general, including private consumption, and the imports of consumer goods.

One of the downsides of these policies was the development of a 'rent addiction' syndrome as what might at the surface appear as an economic miracle was partly boosted by the implicit transfers from Russia originating in below-market prices charged for the supplied oil and gas (by some estimates, in earlier years, the later amounted to several billion euro per year). Part of these implicit subsidies was channelled directly to recipient firms and the households through cheap energy and another part generated fiscal revenue through the export tariffs collected from exporters of fuels and oil-based chemicals and resided in the state coffers. There were different additional mechanisms (discussed below) that performed further redistribution and channelling of resources to businesses and households. Ultimately, this model of growth was partly driven by the artificially boosted domestic demand as rents were transmitted towards supporting fixed investment and private consumption.

Publicly supported investment was a key component of many government development programmes that were implemented in this period. These programmes targeted accelerated fixed capital formation in a wide range of areas including purely public investment in infrastructure development but mostly business and household fixed investment supported by directed lending (such as the modernisation of industry, the construction of new production facilities, household construction, support to agricultural investment). Consequently, the Belarusian economy performed at unusually high investment ratios during much of the past two decades: gross fixed capital formation was above 30% of GDP between 2006 and 2014 (Figure 1.7).

The potential recipients of directed credit (these categories were specified in the respective government programmes) enjoyed two types of privileges: easier access to credit and subsidised (below-market) interest rates. Respectively, lending banks were compensated for the interest rate differential by the budget and government-recommended credits could carry state guarantees.²⁷ Plus, state-owned enterprises were mandated to place their deposits in the banks engaged in directed lending.

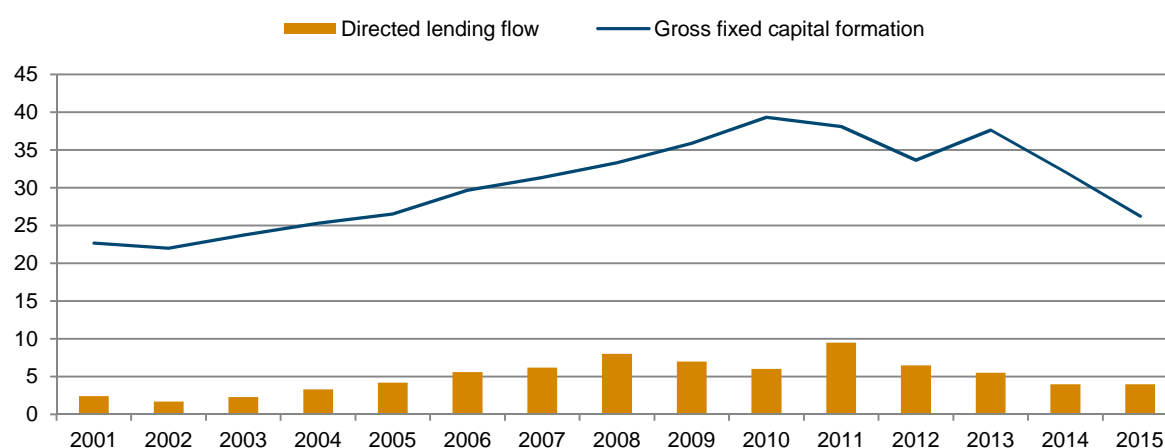
There are no comprehensive official statistics on the extent of directed lending but IMF estimates suggest that they were quite sizeable (Figure 1.7). In some years the level of directed lending reached between 5% and 10% of GDP, and it funded some 20-25% of gross fixed capital formation.

While the activist industrial policy supported by an external stimulus boosted economic growth, it also produced significant distortions in the Belarusian economy. In the absence of proper market-based

²⁷ IMF (2009).

intermediation through a well-functioning financial system, many of the investment decisions in the economy were hardly consistent with efficient resource allocation. Empirical studies indicate that fixed investment supported by directed lending in this period was quite inefficient: while the resulting investment boom did boost GDP growth through factor input, this was associated with a significant negative effect on total factor productivity.²⁸

Figure 1.7 / Directed lending and gross fixed capital formation in Belarus, % of GDP, 2001-2015



Sources: IMF; UNECE statistical database.

Apart from investment, government policy targeted also the recovery of income and private consumption. The main policy instrument employed by the Belarusian authorities (especially in the period of high growth²⁹) was represented by wage targets which used to be part of the government programmes of socio-economic development. Through the hierarchy of government programmes and other mechanisms of state control discussed above, wage targets were channelled virtually to all levels of economic governance. This also included the private sector either directly or indirectly as private entities needed to offer competitive wages for the skilled labour they were hiring.

Similarly to directed lending, wage targets had a significant distortive macroeconomic effect as they impeded market-type wage formation. In effect both factor inputs – capital and labour – were subject to such distortive pressure driving allocative efficiency further down. Another specificity of wage policy was that while wage targets were announced in local currency, implicitly they carried the message of targeted dollar wages. These aspects of wage formation in Belarus had a number of negative implications of their own which will be discussed later.

Summing up the above, the enterprise and banking sectors de facto served as extended arms of the government in implementing policy tasks as they performed important redistributive functions which, in principle, should be performed by the budget.

²⁸ Kruk and Haiduk (2013).

²⁹ As already noted, at present the mechanism of wage targets has largely been abandoned.

Despite the distortions, this model of growth performed quite successfully in the period when the rising fixed investment was delivering decent returns and the flow of energy rents was sufficient to back the growing domestic demand, and this was the case during the decade 1996-2005. Things began to change around 2007 when Russia started claiming back part of the Belarusian export oil duties and doubled the gas export prices for Belarus. While energy prices still remained well below international market prices, the amount of the energy rent to Belarus dropped significantly.

The Belarusian authorities were thus faced with a dilemma: to change the policy course more radically (which would amount to eliminating the demand surplus supported by rents) or to keep it while searching to attract additional external resources compensating for the reduction in rents. The first policy option was obviously associated with unpopular austerity measures and the authorities opted for the second solution.

The Belarusian authorities might also have hoped that the terms of energy trade with Russia could be renegotiated towards terms more favourable for Belarus. However, in reality this never materialised; on the contrary, since that time, Russia has been moving ever closer to international market prices in the energy exports to Belarus. On the Russian side, the arguments for this have been its accession to WTO in 2012 as well as the establishment of the Customs Union between Russia, Belarus and Kazakhstan which came into existence in 2010. With the formal launching of the Eurasian Economic Union (which came into force on 1 January 2015), the terms of energy trade between Russia and Belarus as members of the Union became in principle more rigid and, consequently, energy rents even smaller.³⁰

The combination of a policy focused on demand-driven growth and diminishing external rents resulted in a persistent widening of the external imbalance and fast growth of foreign indebtedness: in the second half of the 2000s, Belarus' current account deficit kept growing, reaching over 15% of GDP in 2010 while gross external debt quadrupled between 2005 and 2010 (Annex Table 1).

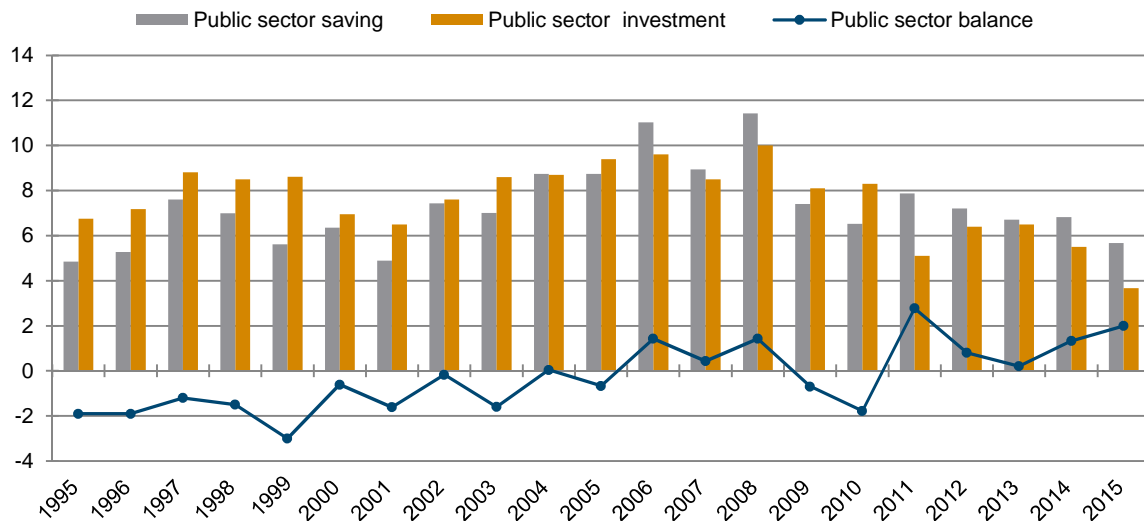
One might have expected to see a similar deterioration in Belarus' public finances as these developments were clearly the outcomes of public policy choices. However, the public finance statistics for the same period do not indicate any major change to the negative, either in terms of the headline fiscal balance or in terms of the open public debt (Annex Table 1). The reason for this is the fact that the authorities basically channelled the implementation of this policy to state-owned enterprises and banks, de facto delegating them with atypical redistributive functions as noted above. This can clearly be traced in the dynamics of Belarus' savings-investment balance broken down by sectors (Figure 1.8).

Thus, while there was no notable worsening in the headline public sector balance in the period 2005-2010 (as seen on Panel A, it was even positive in some years), there was a dramatic shift in the negative direction in the business sector balance (Panel B). In fact, as discussed below, the actual situation of public finances was considerably worse as quasi-fiscal liabilities kept piling up. Figure 8 also clearly demonstrates that the 'investment boom' after 2005 was almost entirely financed by increased foreign borrowing and led to the fast growth of Belarus' foreign indebtedness.

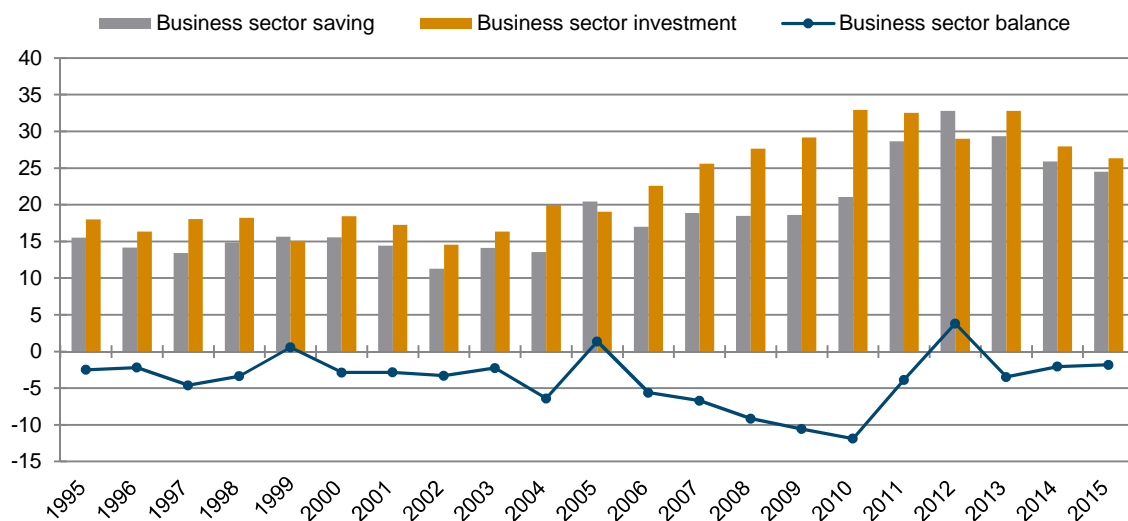
³⁰ Nevertheless, with respect to gas, Belarus managed on several occasions to negotiate bilateral deals with Russia on more favourable price conditions.

Figure 1.8 / Belarus' saving-investment balance: 1995-2015, % of GDP

A. Public sector



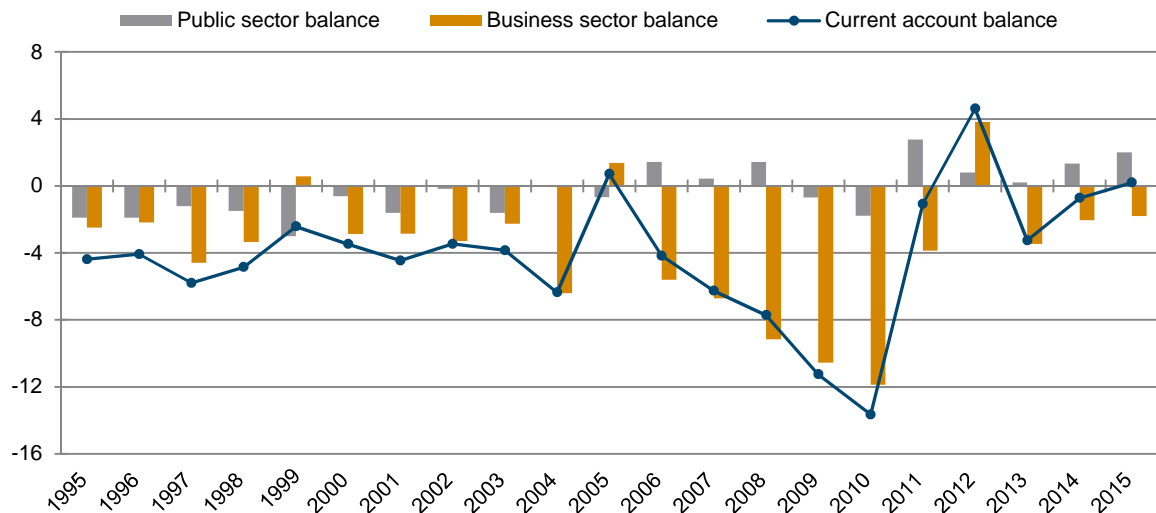
B. Business sector



Source: wiiw database; UNECE statistical database; IMF, author's calculations.

Respectively, the chart illustrating the dynamics of Belarus' current account balance by sectors (Figure 1.9) may also be misleading. By showing that it was the business sector that accounted for the significant rise in the current account deficit in the second half of the 2000s, it might suggest a parallel significant rise in the external indebtedness of the business sector matching this external savings-investment imbalance.

Again this was not quite the case in Belarus. While there were some cases of direct foreign borrowing by Belarusian companies, it was the public sector that was responsible for the overwhelming majority of the new foreign debt through various forms of sovereign borrowing (see below).

Figure 1.9 / Belarus' current account balance by sectors, 1995-2015, % of GDP

Source: wiiw database; UNECE statistical database; IMF, author's calculations.

In summary, one could say that the demand-driven, rent-fed economic model in Belarus came to a halt by 2011 and the Belarusian economy has not managed to return to a stable growth path ever since. Overall, this model was also associated with persistently negative effects on macroeconomic stability as discussed in the next section.

Macroeconomic stability: a delicate balancing act

A superficial look at the two main policies aimed at macroeconomic stability – fiscal and monetary policy – would not reveal the underlying sources of macroeconomic turbulence in Belarus. For instance, there was not a single year in the period 2000-2015 when the headline fiscal balance would plunge in a dangerously negative territory; on the contrary, in many of these years the public sector reported surpluses. As to the monetary side, as noted above, Belarus' central bank (NBRB) is 'independent in its decision-making' by its legal status and is supposed to take independent rulings on monetary policy.

However, the reality has been different on both accounts. On the fiscal side, the headline fiscal balance only reflects the outcome of public policy decisions performed through the instruments of formal budgetary policy.³¹ In Belarus, as already noted, many policy decisions with fiscal and monetary implications were implemented through state-owned firms and banks. The latter de facto served as secondary redistributive mechanisms; however, the outcomes of such redistribution of public funds were not subject to the discipline of budgetary policy and were not recorded in the official budgetary accounts. Over the years, the resulting macroeconomic imbalances kept accumulating and periodically came to the surface in the form of exchange rate crises.

On the monetary side, under the hierarchical decision-making system, with all key decisions being taken at the top of the pyramid, the NBRB was not in a position to take fully independent decisions on key

³¹ It should also be noted that the public finance statistics of Belarus are also blurred by the existence of numerous extrabudgetary funds which also accumulate public funds and, in principle, also implement elements of public policy.

aspects of monetary and exchange rate policy. Ultimately, the central bank was obliged to act as part of the hierarchical system of state programmes even if this was in conflict with its own declared policy goals and objectives.

One of the main sources of macroeconomic imbalances – and instability – was the quasi-fiscal deficit resulting from inefficient directed lending. Directed credit by and large bypassed proper market-based screening and, not surprisingly, led to a deteriorating quality of the portfolios of the lending banks. Plus, directed credit led to maturity mismatches in the banks' portfolios and most of these loans were of a long-term nature. Taken together, these factors started causing liquidity problems in lending banks which, in turn, reduced their ability to engage in new directed lending.

On the other hand, directed credit, one way or another, entailed contingent fiscal liabilities as it was de facto underwritten by the Belarusian state – either formally, in the form of credit guarantees, or informally, as an implicit obligation of the government that adopted the respective state programmes of which such lending took place. Thus the bad loans resulting from inefficient directed lending in effect accumulated as a quasi-fiscal deficit.³²

The appetite of the authorities for more directed lending as well as the banks' liquidity problems led to several interventions by the state. These interventions were undertaken in two main forms: 1) by direct recapitalisation of troubled banks; and 2) via extraordinary financing by the NBRB. According to IMF estimates, the annual recapitalisations of state-owned banks from the state budget averaged about 1% of GDP annually in the period 2007-2010. A major bank one-off recapitalisation operation was undertaken in December 2010 which involved three major state-owned banks engaged in directed lending. This bank restructuring measure alone was estimated at some 5.3% of GDP in 2011; as a result, the statutory capital of the targeted banks was raised by 22%.³³

On top of that, the NBRB supported on a number of occasions the banks that experienced liquidity problems using mechanisms outside its standard refinancing facilities, via ad hoc decisions of the central bank Board. Thus, in 2009, the central bank opened an ad hoc refinancing facility targeting two state-owned banks which amounted to some 45% of their statutory capital or 7% of their total assets.³⁴ This type of central bank operations is an example of direct monetisation of the quasi-fiscal deficit which added to the macroeconomic imbalances in the Belarus economy.

The other main source of macroeconomic imbalances was the populist incomes policy which prevailed through most of the period of high growth in Belarus. Wage targets had a multiple destabilising macroeconomic effect. Mandated wage increases resulted in significant rises in unit labour costs (as real wage growth outstripped productivity growth) and competitiveness losses (Figure 1.10). Excessive wage growth was also one of the main sources of inflationary pressure in the Belarusian economy. Imbalanced wage growth became especially manifest in the period after 2005 when the authorities

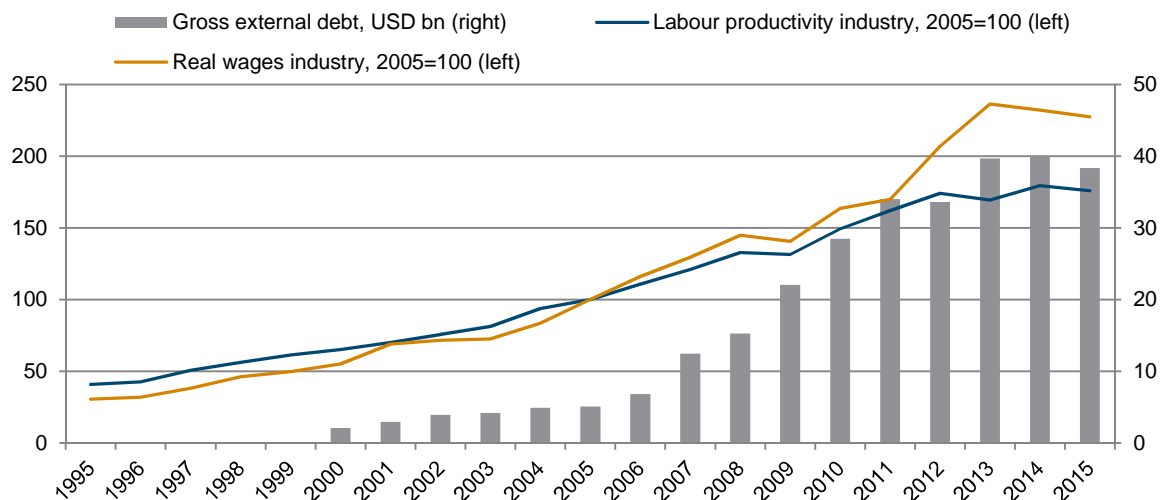
³² Directed lending was probably the main but not the only source of contingent fiscal liabilities (and the quasi-fiscal deficit). Other sources included the operations of the above-mentioned extrabudgetary funds, government guarantees on household deposits, for price controls resulting in the provision of goods and services at below-market prices, cross-subsidisation through public utilities, specific support operations by state-owned banks or enterprises extended to some sectors, employees or to other enterprises, etc. See IMF (2005).

³³ IMF (2012); Kruk and Haiduk (2013).

³⁴ Kruk and Haiduk (2013).

increased the policy emphasis on welfare growth. The rapid accumulation of foreign debt in this period is clear evidence of the inconsistency of these policies.

Figure 1.10 / Labour productivity, real wages and external debt in Belarus, 1995-2015, USD and indices



Source: wiiw database; author's calculations.

The core of this inconsistency is the absence of any checks on the pro-inflationary effect of wage growth: de facto, wage targets were not matched in any way (explicitly or implicitly) by inflation targets. The wage target entirely dominated the macroeconomic policy mix; its other components were just residual. In other words, the social objectives (embodied in the wage targets) outweighed macroeconomic stability considerations; however, the resultant macroeconomic instability and high inflation actually almost fully offset any real wage gains thus annihilating the social effects of this policy course.

Throughout most of the period under consideration, monetary policy in Belarus adhered to a regime of exchange rate targeting; inflation was de facto treated residually, as a target of secondary importance. Initially, the Belarusian rouble was pegged to the US dollar under a crawling peg regime. Under this regime, the central bank could allow the Belarusian rouble to depreciate by 1-1½% per month against the US dollar. In 2009, this was replaced with a crawling peg to a basket of currencies consisting of the Russian rouble, the US dollar and the euro, with a fluctuation band around the central parity. However, informally a return to a US dollar peg occurred in late 2009.

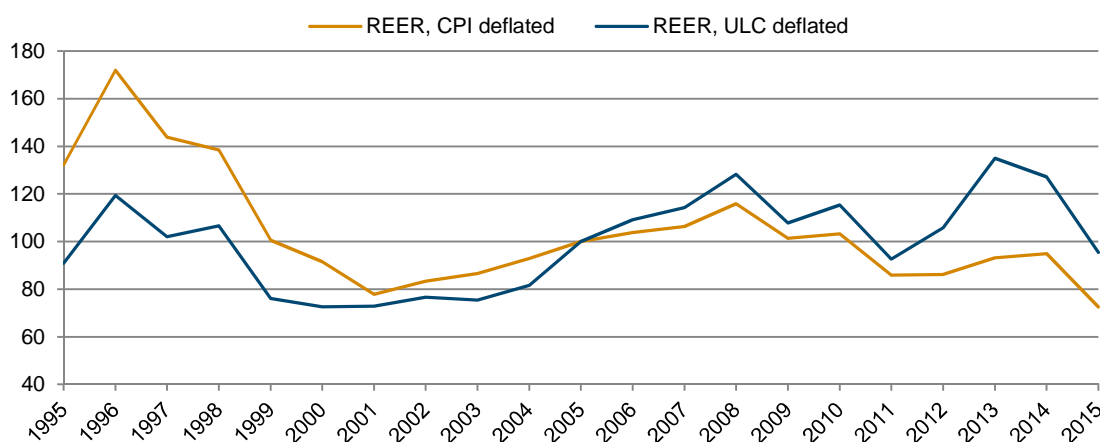
The conduit of this type of monetary policy was a very challenging task in the Belarusian economic environment as the central bank was under different pressures and often faced conflicting objectives. The main problem for the NBRB was that safeguarding price stability – which is the principal *raison d'être* of a central bank – was inconsistent with government interference in NBRB decision-making and the price stability objective usually gave up to direct or indirect pressures resulting from government policies. The technical challenge that the NBRB was facing was the very consistency of the chosen monetary regime with the macroeconomic policy mix in Belarus.

The policies of demand-driven growth pursued by the Belarusian authorities generated persistent inflationary pressure through various channels, in the first place through the mechanisms of directed credit and wage targets and the monetisation of the quasi-fiscal deficit associated with these policies. Through their effect on expectations, price controls have also had a rather controversial effect in the Belarusian context, sometimes adding to inflationary pressure. In turn, this generated persistent depreciation pressures on the exchange rate of the Belarusian rouble well above the monthly devaluation and the fluctuation band; under these conditions periodic devaluations of the currency were unavoidable.

During the period of higher energy rents, part of the forex revenue was directed towards suppressing this pressure which made it possible to conduct relatively smooth devaluations and avoid currency crashes. However, with the gradual drying out of these rents, the smooth conduct of monetary policy became more and more problematic.

One of the tricky outcomes of this type of exchange rate and income policies was the dynamics of the real exchange rate (Figure 1.11). During the 2000s, the ULC-deflated real exchange rate – which is the key measure of international competitiveness – started appreciating systematically and did so much more than the price-deflated real exchange rate.

Figure 1.11 / Belarus real effective exchange rate, 1995-2015, index (2005 = 100)



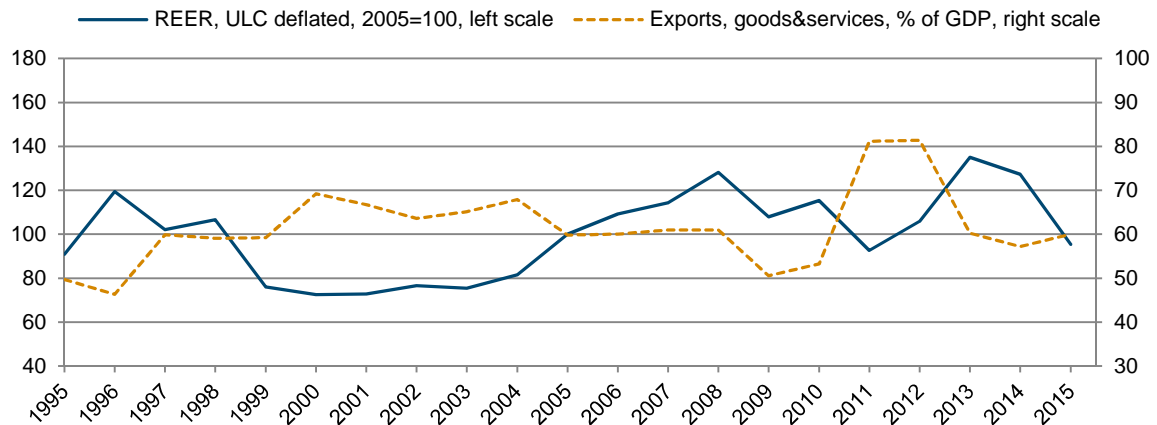
Source: wiiw database; author's calculations.

The data also provide evidence that exchange rate appreciation in Belarus in this period was negatively correlated with the dynamics of export performance and of the current account balance (Figures 1.12 and 1.13). One could speculate that the Belarusian monetary authorities paid less attention to the ULC-based real exchange rate than to the price-based measures and did not adjust their policies to prevent such real appreciation. In any case, the fact remains that the mounting macroeconomic imbalances in the 2000s were closely intertwined with the dynamics of the real exchange rate.

Another interpretation of the real exchange rate dynamics can be that the implicit dollar wage targets interfered with the conduit of monetary and exchange rate policy as there was pressure on the central bank to prevent or reduce exchange rate depreciation which would make it easier to achieve the dollar targets. This type of pressure stemming from wage targets became especially manifest in the 2000s

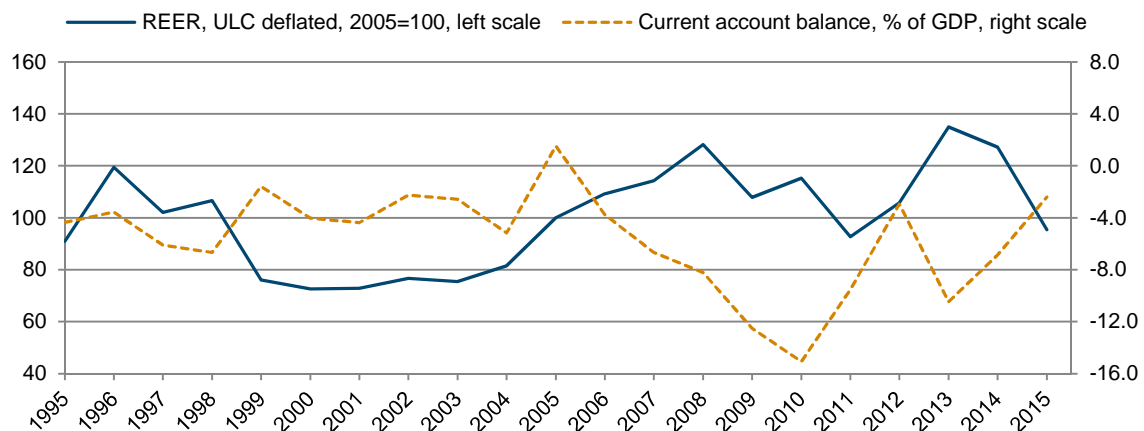
when the authorities were pushing for fast and visible positive welfare effects of their policies. This is also the period of the lasting trend of appreciation of the ULC-based real exchange rate.

Figure 1.12 / Real effective exchange rate and export performance, 1995-2015



Source: wiiw database; author's calculations.

Figure 1.13 / Real effective exchange rate and current account balance, 1995-2015



Source: wiiw database; author's calculations.

Given the rising macroeconomic imbalances and turbulence, on the one hand, and the conflicting central bank objectives, on the other hand, the forex market was frequently questioning the consistency of the exchange rate regime, in particular the par value of the currency peg. In such circumstances, if policy is inconsistent, sooner or later there will be a correction which may take place through an orderly or through a forced adjustment.

As the exchange rate was practically the main, if not the only adjustment mechanism in the Belarusian mix of macroeconomic policy instruments, the necessary corrections did take place through exchange rate adjustments. While the crawling peg was considered to be an instrument for orderly adjustment, it turned out to be insufficient in periods of high exchange rate volatility. In turn, high volatility provoked several cases of speculative attacks on the currency.

The limits of the Belarusian economic model

Between 2009 and 2016, Belarus experienced three episodes of currency crises (in 2009, 2011 and 2014-2015) which epitomised the inconsistency of the macroeconomic policy mix.³⁵ All three cases entailed a massive forced devaluation of the Belarusian rouble reflecting the necessary real exchange rate adjustment. These can be traced with the respective downturns (in 2009, 2011 and 2014-2015) on the real exchange rate charts presented in Figure 1.12.

The key ingredients of the currency crises were those outlined in the previous section and these were present in all three cases. But there were also specific elements that exacerbated the situation in each of these episodes. The 2009 crisis was partly a fallout of the global economic and financial crisis which caused a deep recession in Russia (Figure 1.4), shrinking Russian import demand, further competitiveness losses due to the sharp depreciation of the Russian rouble, deterioration in the current account balance and depletion of forex reserves. At the same time the Belarusian authorities continued pushing an ambitious investment promotion programme supported by directed lending (Figure 1.8). In this situation the Belarusian authorities resorted to IMF financial assistance and concluded a 15-month stand-by arrangement, aimed at adjusting to the external shocks backed by appropriate policy reforms.

In the course of implementing the IMF stand-by agreement, the policy stance was tightened significantly which helped maintain the macroeconomic equilibrium. In particular, there was one-off curbing of the real wage growth in 2009 (Annex Table 1) which contributed to a reversal of the real exchange appreciation and competitiveness gains. Domestic demand was curtailed while net exports contributed positively to GDP growth (Figure 1.7). However, after the last IMF tranche, the austerity policies were immediately reversed and the authorities resumed expansionary wage and credit policies aiming to invigorate economic growth. Then the same story was repeated of competitiveness loss, widening current account deficit and depletion of reserves. Ultimately the central bank abandoned the attempts to defend an inconsistent exchange rate target and allowed a sizeable devaluation of the nominal exchange rate, by more than 200% in 2011.

However, given the reluctance of the authorities to change the policy course, a similar story developed again in the years that followed. A typical example of the populist policy stance that prevailed in this period was the target announced in 2010 to raise average monthly wages in Belarus to the equivalent of USD 1,000 by 2015. Again, this target was pursued through the same instruments: nominal wage targets and the nominal exchange rate. Respectively, the NBRB was subjected to pressure to put a brake on the depreciation of the Belarusian rouble and with time this policy course produced an unsustainable real exchange rate appreciation while foreign debt kept rising rapidly (Figures 1.11 and 1.12). The authorities kept resorting to all possible sources of balance of payments support, but only managed to get such funding from the Russian government and Russian banks as well as the Anti-Crisis Fund managed by the Eurasian Development Bank.

The effect of policy inconsistency were reinforced by contagion from Russia where the rouble was under attack following the drastic fall in oil prices in late 2014. The slump in oil prices also caused a significant drop in Belarus' fiscal and forex revenue, reducing the government's ability to intervene. All this provoked panic purchases on the Belarusian forex market as well as withdrawals of forex deposits towards the end of 2014. The NBRB tried to prevent further escalation of the crisis through a range of

³⁵ For further details see Chapter 4 as well as Miksjuk, Pranovich and Ouliaris (2015); IMF (2015).

administrative measures but ultimately it was compelled to give up these attempts and accepted a sizeable depreciation at the beginning of 2015. The most important monetary policy change was the abandoning of the crawling peg (and of the regime of exchange rate targeting altogether) and the switch to a floating exchange rate regime with monetary targeting. The previous basket of currencies (consisting of the euro, the US dollar and the Russian rouble) now only serves as reference in the conduct of monetary policy.

Ultimately, the currency crises, their nature and frequency in recent years epitomise the limits of the Belarusian economic model as such. The underlying policy strategy in recent years appears to have aimed to maintain the status quo and prevent an outright economic collapse accompanied by a plunge in living standards. During the past two decades, rising welfare has been one of the declared flagship political achievements and the authorities have been rather cautious about possible reversals. However, in the years after 2008, this has been achieved at the expense of large current account deficits (of the order of 10% of GDP or even higher in much of this period) and, consequently, growing external indebtedness.

The most recent crisis demonstrated that the authorities have reached the limits in their ability to cope with such crises with the instruments and resources at their disposal. Apart from cementing in-built macroeconomic distortions, this policy course led to the fast accumulation of considerable external debt. Given the country's current debt service capacity and policy track record, it is highly unlikely that any foreign entity or investor would be willing to continue lending to Belarus unless there is a clear and unequivocal commitment by the authorities to switch to a policy course that would ensure sustainable economic performance and debt service capacity.

In most recent years, the conditions for access to fresh credit from Russia and the Eurasian Development Bank have been tightened considerably and although these remain the main sources of balance of payments support to Belarus, the inflow of such funds has dropped substantially. In 2015, Belarus also opened negotiations with the IMF for a Fund-supported economic programme. By the time of writing negotiations are still under way and it is not clear whether they will be concluded successfully. A key stumbling block is the reluctance by the authorities to take tough radical reform measures (see Chapter 4 for further discussion).

In summary, the present policy course – implying the need to raise continuously new and ever-increasing balance of payments support – is difficult to sustain in the medium and longer run. Addressing the root causes of the balance of payments crisis would require regaining competitiveness by a combination of lasting real exchange rate depreciation and structural reforms supporting productivity gains (the latter is discussed in the next section). Macroeconomic stabilisation accompanied by sustainable disinflation and contributing to a notable reduction in interest rates is also a key prerequisite for establishing a healthy economic environment. Sooner or later, the authorities will have to face these painful adjustment measures; apart from political considerations, the timing of adjustment will depend on the ability to continue financing the external debt and meet the balance of payments constraints. Thus, in a medium-term perspective, the Belarusian economy appears to be at a crossroads between the status quo and a new policy course leading to a more sustainable growth pattern.

IS BELARUS A SUCCESS OR A FAILURE? LESSONS FROM A UNIQUE EXPERIENCE

The transition literature often sought to compare and categorise the types of transition seen in different countries and offered different taxonomies of the process. The most widely advocated dividing line among transition strategies was that between 'big bang' vs. 'gradualism'. With time, dividing lines became less clear and even disappeared as some 'big-bangers' started putting brakes on the process whereas some 'gradualists' started catching up. As Hare and Turley put it, 'In practice, ... the difference between these two approaches is far less that one might suppose, since many of the reforms commenced at the start of the 'big bang' might still take years to implement, while even those countries that went for gradualism mostly dismantled central planning and introduced ... price and trade liberalisation extremely quickly'.³⁶

Against this backdrop, and even within the broader interpretation formulated with the benefit of hindsight, Belarus still stands apart and does not seem to fit into any category. As discussed and argued throughout the paper, in many aspects, Belarus' transition experience has been quite unique and very different from that seen in other transition economies. Belarus' political regime is that of a strong presidential system; in that it may be different from the political systems in the CEE countries but is not much different from that in most countries in the post-Soviet space. What makes Belarus distinctly different from most post-communist countries is the type of economic policies to which the country adhered during the past 20-25 years.

The summary below outlines the most characteristic aspects of Belarus' economic policies during the transition, at least up to the moment of writing, that make it stand apart from other countries:

- › Belarus did not privatise most of the state-owned companies and banks inherited from Soviet times. Most of these firms and banks still exist and operate although they were re-organised and are now managed differently;
- › similarly, most of Belarus' agriculture is still in the hands of collective farms inherited from Soviet times;
- › wide-ranging privatisation of state-owned firms and banks is still on the agenda of possible future policy reforms;
- › the sector of de novo private firms and foreign companies has been the most dynamic part of the Belarusian economy although being at a disadvantage compared to firms enjoying state support under state programmes;
- › targeted industrial policies were the main approach of pursuing the declared economic policy objectives of highest priority such as rising welfare and high employment;
- › large-scale industrial policy was implemented through various state development programmes supporting state-owned industrial firms and collective farms;

³⁶ Hare and Turley (2013b).

- › the authorities also applied a number of unconventional instruments for pursuing policy objectives and implementing industrial policy, in particular, the instrument of directed credit and wage targets (the latter was de facto mandatory for the whole economy);
- › by contrast, price stabilisation was never among the priority objectives de facto followed by the authorities. The macroeconomic policy mix was rather accommodating and price stability was subordinate to policy objectives of higher priority;
- › during the past 25 years, Belarus' achieved economic growth and welfare gains comparable with those of the best performing post-communist countries without undertaking many of the reforms that were vindicated as quintessential prerequisites for achieving such results by mainstream economic advice;
- › in determining its transition model and strategy, Belarus relied mostly on home-grown concepts and expertise drawing, among other things, on the country's preserved organisational capability. External anchors played very little role, if any at all, in shaping the course of economic policy;
- › the viability of the Belarusian economic model was heavily conditional on the availability of exceptional external resources in the form of rents. With the drying up of rents its sustainability became questionable.

With its experience Belarus defies the dogmatic understanding that there was no alternative to the mainstream recipe of a transformation reform agenda advocated at the onset of transition and provides hard evidence that the process of economic and political transformation in the post-communist countries could have indeed been undertaken differently, at least in some of these countries.

In fact, many of the conventional wisdoms that governed the economic thinking about transition during the 1990s have now been revisited with the benefit of hindsight. As an example, one of the more recent conclusions regarding privatisation goes on to claim that: '... rather than concentrating on rapid privatisation, and frequently doing it badly, it would have been far better for many countries to focus on creating good conditions for new businesses to be set up'.³⁷

In this regard, the Belarusian experience offers new arguments and evidence for revisiting – and possibly reconsidering – some other aspects of the policy agenda advocated at the onset of transition. The whole spectrum of distinctively different policies listed above offers food for thought for such possible reconsideration. Both Belarus' transition model and circumstances were unique so it would hardly have been possible to have exactly the same recipe in another country. But one is tempted to speculate that probably some policies in some countries could have also been applied elsewhere and could have brought better results than what happened in reality.

Probably the most intriguing question is whether Belarus can continue experimenting with an economic strategy and policy agenda which are markedly different from what other post-communist countries did in the past or whether it will have to accept the mainstream transformation reforms and converge, with considerable delay, to the common pattern seen elsewhere. At this stage it is difficult to give a clear-cut

³⁷ Hare and Turley (2013b).

answer to such a question and therefore Belarus will remain a very interesting case to monitor and study for some time to come.

In any case, it may again be tempting to speculate on the possible policy courses that the country may choose in the short to medium run. In this it would be important to distinguish between the sustainability of the country's policy course and the sustainability of Belarus' economic model as such.

As argued in the paper, there is strong evidence, especially of more recent times, that the policies pursued through the 2000s and up until now have run their course and could hardly be sustained in the medium term. Belarus has reached a point when its balance of payments constraints impose some needed, if not inevitable, changes in macroeconomic policy. The most urgent policy changes necessary to avoid another round of forced adjustment include abandoning once and for all of the most distorting policy components such as the mandatory wage targets, directed credit and price controls, while maintaining a balanced mix of fiscal and monetary policy. As to the medium to longer run, some structural reforms also seem inevitable if the country is to establish a healthy economic environment and embark on a path of sustained growth. These include the rehabilitation and restructuring of the state-owned part of the economy (the enterprise and banking sector and the collective farms).

As regards the sustainability of the country's economic model, which is rooted in Belarus' brand of state capitalism, there are no obvious arguments to assert that the model as such is not sustainable. On the other hand, within the model as practised in reality, there are obvious flaws that can in principle be corrected to make it more efficient and effective. Here again, one might try to distinguish between the possible corrections of technical deficiencies and eventual changes that are embedded in the existing political system by its design (although a clear differentiation may be difficult).

The key test of the viability of the Belarusian model of 'state capitalism' would probably be the capacity of the authorities to impose hard budget constraints on state-owned firms and banks. Capitalism partly based on state ownership is in principle possible; however, it is not consistent with the policy of soft budget constraints. So for the Belarusian authorities to be able to justify their claim of 'state capitalism', they would need to move in the direction of imposing hard budget constraints on state-owned firms and banks. That is, the state as the owner would only intervene in the allocation of the profit these firms and banks generate at purely market conditions without allocating soft financial resources to them. Imposing hard budget constraints would also be a key policy step towards the restructuring of the state-owned part of the economy and raising its efficiency.

However, such a policy change would have severe social consequences as it would entail the shedding of redundant labour which is apparently now abundant in the state-owned sector of the economy. It is questionable whether the Belarusian authorities would be willing to take radical steps in this direction. However, if such a policy course is implemented gradually and selectively over an extended period of time, it may still be feasible to implement – although ultimately the social price will still have to be paid.

One of the 'technical' weaknesses of the present model is associated with the instruments that the Belarusian authorities applied in the conduct of industrial policy. In a simplified sketch, this comes to the dichotomy of mandatory targets imposed top-down and policy support (direct and implicit subsidies and various administrative measures) to facilitate the achievement of such targets. As argued throughout the

paper, the present policy instruments inherently give rise to market distortions and are not consistent with efficient economy-wide allocation of resources.

As demonstrated by the experience of other countries, industrial policy can be conducted more efficiently with other means and instruments than those applied by Belarus.³⁸ Plus, industrial policy can be implemented with instruments that promote and enhance the competitive environment, rather than distorting it as happens with directed lending and wage targets. For instance, rather than providing public support across the board as often happened with directed lending, public support may be offered through open competitive calls and made conditional on achieving specific targets by recipient firms, especially those that raise productive efficiency and contribute to broader economic objectives.

The replacement of the present outdated policy tools with market-based industrial policy instruments could allow the authorities to initiate the much needed process of rehabilitation of state-owned firms and banks. In turn, this would facilitate their further restructuring and eventual privatisation, in case there is the political will to go in that direction. The modernisation of policy instruments would also be instrumental for the improvement of the overall business and investment climate in the country.

The more difficult and problematic part of an eventual effort to reform the current economic model is related to the strictly hierarchical policy decision-making process which has two principal flaws: 1) the existence of one supreme decision-making centre empowered to overrule; 2) the pervasive ad hoc discretionary policy-making (at the expense of a rule-based process). Such a system is ineffective and inefficient by all accounts and its continued functioning in this form will keep generating distortions in the economy. As an example, the establishment of a truly independent central bank – which is considered a *sine qua non* (though not sufficient) condition for pursuing macroeconomic and price stability – is clearly incompatible with a system of public policy in which there is only one overruling decision-making centre and it is outside the central bank, as is the current situation.

However, the functioning of the policy process is part and parcel of the current political system in Belarus. Any eventual reforms in the policy process (in particular towards amending the two main weaknesses outlined above) would imply changes in the political system, whose constellation is now cemented in the current constitution. In principle the constitution as such is not an obstacle for the introduction of the needed changes in the policy process, but this would require good will at the very top to relinquish some of the powers now concentrated there and delegate them to the respective levels in the decision-making pyramid where they belong and where decision-making would be most effective. However, once a strictly hierarchical decision-making process is put in place – as in the case of Belarus – voluntary surrender or delegation of power and authority is not something that would easily happen on its own. So the effective way of changing the decision-making process would be through a constitutional change but this could be a long and cumbersome process with unclear outcomes. Whether and when this could happen is something still to be seen. And until then, the Belarusian economy will be destined to function with built-in inefficiencies that are inherent to the present decision-making process.

In conclusion, Belarus will continue to be something of a unique laboratory of economic policy experimentation, offering live day-to-day evidence of the outcomes of policies not applied elsewhere. This unorthodox experience and its lessons do merit a deeper scrutiny by economists and policy-

³⁸ See Rodrik (2004).

makers. And, even if at some point in time Belarus changes radically its policies and/or economic model and embarks on a very different policy course, this will not erase the 25 years or so of relatively successful economic performance and the fact that it managed to cushion some of the transition pain experienced by other countries.

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2. Structural challenges

BY KATERYNA BORNUKOVA

ECONOMIC STRUCTURE AND INSTITUTIONAL ENVIRONMENT

In Soviet times, Belarus used to be one of the manufacturing workshops of the Soviet Union, specialising in a number of industries at the higher value added segment and relying on the large Soviet market. Agriculture was also relatively well developed, in particular industrial livestock production. Food processing, especially dairy and meat products, was another pillar of the traditional economy. In the main, this structural orientation of the Belarusian economy has been preserved over that past 25-30 years, largely thanks to the gradualist approach to economic transformation and deliberate public policy. Nevertheless, over the years of independence, there was a significant evolution in the structure of the economy (Tables 2.1 and 2.2).

Table 2.1 / Breakdown of gross value added in Belarus by economic activity, 2000-2014, % of total

	2000	2005	2010	2011	2012	2013	2014
Agriculture, hunting and forestry	13.81	9.64	10.18	9.13	9.48	7.78	8.30
Fishing and fish farming	0.11	0.11	0.11	0.00	0.11	0.11	0.11
Mining industry	1.03	1.49	0.33	1.21	1.23	1.11	0.88
Manufacturing	27.74	29.05	26.55	30.91	29.10	25.67	24.56
Production and distribution of electricity, gas and water	5.71	5.17	3.21	1.87	3.23	2.89	3.21
Construction	7.19	7.69	10.62	7.26	8.25	11.33	11.62
Trade, repair, hotels and restaurants	13.24	12.06	14.27	17.60	16.39	15.33	15.38
Transport and communications	10.27	9.30	8.41	8.03	8.36	9.22	8.74
Financial activities and real estate	7.65	8.96	11.84	11.99	10.81	12.78	13.05
Public administration	3.42	5.05	4.31	3.30	3.34	3.78	3.87
Education	4.91	5.86	4.76	4.18	4.35	4.33	4.42
Health care and social services	3.08	3.67	3.21	2.64	3.23	3.33	3.54
Social, personal services and utilities	1.83	1.95	2.21	1.87	2.12	2.33	2.32

Source: National Statistical Committee of Belarus.

In summary, the current structure of the Belarusian economy can be characterised by some general features:

- › apart from agriculture and industry, construction also has a greater share in Belarus compared to other countries with a similar development level;
- › at the same time, a range of services such as retail trade, tourism, financial services, real estate and other business services are relatively less well developed;

- › within manufacturing proper, food processing is the leading manufacturing sector in terms of its value added contribution; its importance has even increased during the past decade;
- › oil refining and processing into chemicals is another pillar of Belarusian manufacturing;
- › traditionally, textiles, heavy machinery and transport equipment have also been among the leading manufacturing sectors, but their importance has declined over the years.

Table 2.2 / Breakdown of Belarusian manufacturing output by sectors, 2010-2015, %

Manufacturing sectors	2000	2005	2010	2015
Food and tobacco	22.9	20.1	22.4	27.3
Textiles and apparel	8.2	4.6	3.8	3.2
Leather and footwear	2.0	1.0	0.9	0.8
Wood and products of wood	2.0	2.2	1.7	2.3
Pulp, paper and printing	2.0	2.2	2.1	1.7
Coke, refined petroleum products	17.1	21.7	19.6	18.7
Chemicals	11.0	10.0	10.0	13.1
Rubber and plastics	2.6	2.8	4.0	3.6
Other non-metallic mineral products	4.0	4.5	5.8	5.0
Basic metals and metal products	5.6	6.8	7.8	6.9
Machinery and equipment	10.4	10.7	10.2	7.4
Electrical and precision instruments	4.0	4.3	4.3	3.9
Transport equipment	5.3	6.7	5.0	3.4
Other manufacturing	3.0	2.4	2.5	2.7

Source: National Statistical Committee of Belarus.

Ownership transformation

In the 1990s, Belarus, as other economies in transition, was pondering the restructuring and privatisation of its SOEs. In 1991-1999, 3,190 SOEs underwent restructuring, with 1,212 enterprises being transformed into joint stock companies, 561 enterprises sold to the lease holders, and 1,415 were sold directly to investors, either through auctions or during tenders³⁹. However, it is still not clear how many of the corporatised enterprises were truly privatised: in many cases the state held on to 100% of the shares and holds them until now. Belarus also engaged in mass privatisation through vouchers which could be exchanged for stocks and shares in the corporatised companies. Out of 3,190 restructured enterprises in the 1990s, 1,649 were launched for mass privatisation with the use of vouchers. However, due to very low rates of privatisation, a significant share of the vouchers was never used. The vouchers were always traded below their nominal value as the demand for them was low and the opportunities to exchange them for shares were scarce.

The process of ownership transformation markedly slowed down and took different turns after the accession of President Lukashenka to power in 1994. In 1997 the Presidential Decree No. 591 introduced the 'golden share' mechanism. This mechanism allowed the government, either on the national or on the regional level, to intervene in the decision-making of any enterprise with a state share, however small the share is. Along with the practice to always leave some shares in the hands of the

³⁹ Rakova (2001).

state during privatisation, the 'golden share' mechanism de facto allowed the government to intervene in the activities of any privatised entity. The 'golden share' was cancelled only in 2008.

In the 2000s the process of privatisation was in effect put on hold. A number of SOEs continued to undergo corporatisation, but in most of the cases the state still owned 100% of the shares. The largest SOEs such as MAZ, Belaruskali, BelAZ and Integral were turned into joint stock companies, but remained in complete state control.

The State Property Committee has been regularly publishing the list of JSCs that it plans to privatise but these plans were never fully implemented. For example, in 2008-2010 the shares of 155 state-owned SOEs were to be sold according to the initial plans, but in the end only 16 enterprises were partially privatised.⁴⁰ Likewise, the government made several attempts to sell a 51% stake in MTS, one of the three biggest mobile operators in Belarus. At the first announcement in 2011, the State Property Committee set the starting price at USD 1 billion. The main potential buyer, MTS Russia, which already owned the other 49% of the shares, challenged the price as it estimated it to be overly inflated (estimating it at the double of what it was ready to pay) and withdrew from the bid. Consequently, no buyers showed up at the auctions, even when the ask price was lowered to USD 863 million in 2014. At the beginning of 2016 the Ministry of Communications announced that there were no further plans to sell the state shares of MTS.

There are many reasons behind the repeated privatisation failures in Belarus. First of all, as illustrated above, the state often sets the initial prices too high. The conflicts often arise because the authorities usually base the ask price on book value while potential investors are mostly interested in the 'going concern' value of the businesses, which is usually much lower. Also, the government often poses additional post-privatisation requirements and conditions, mostly about preserving the previous levels of employment and output, which make the offer unattractive to investors. In the case of MTS, for example, the requirement was not to decrease the cell network coverage. Last, but not least, potential investors probably perceive high political risks in Belarus, after several re-nationalisation cases.

Due to the above, the privatisation opportunities in Belarus have mostly attracted Russian state-owned corporations. They have been able to set prices in closed-doors non-transparent and often politically driven negotiations. Such Russian investors also de facto have sufficient political power of their own to ensure their property rights after the privatisation. Thus the biggest recent privatisation deal was the sale of the Belarusian gas pipeline company Beltransgaz to Gazprom in 2012, after the major currency crisis in Belarus.

In an effort to make the privatisation process more transparent and clear for the international investors, the Ministry of Economy with the support from the World Bank established the National Agency for Investment and Privatisation (NAIP) in 2010. Thanks to financial support from the World Bank, NAIP was able to hire qualified experts and build on international experience for attracting investors. NAIP has selected eight medium-sized SOEs for the pilot privatisation project. The Agency also managed to find potential investors for all the eight enterprises, and these investors were ready to meet all the requirements. However, none of the deals has been finalized until now, for a range of reasons and lack of political will.

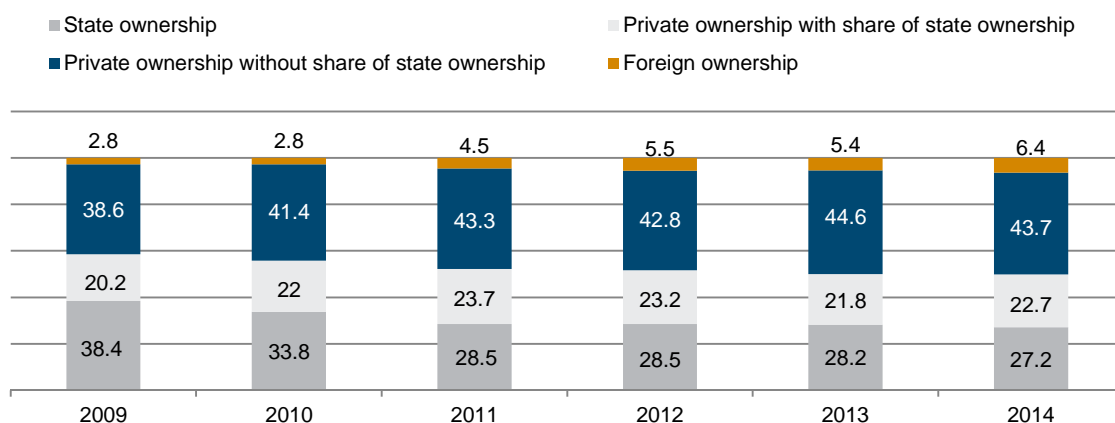
⁴⁰ Skriba (2011).

The 2000s were also marked by several loud nationalisation cases. In some cases the government stepped in when the privatised enterprise met with some dire circumstances; thus an explosion in the Pinskdiv factory led to its re-nationalisation via the ‘golden share’ principle. The government also used the difficult financial circumstances of several companies as a pretext for buying out the shares in exchange for debt. This happened, for example, to the wood processing company Baranovichdiv. In such cases it was often unclear if the previous owners made the decision to transfer their property back to the state voluntarily or under administrative pressure. In 2013, the authorities claimed that the owner of the Kommunarka and Spartak confectionaries was siphoning off profits through shell companies acting as the vendors and dealers. The result was the nationalisation of the companies via a Presidential Decree, and not a court decision following a request by the management board. The most recent case has been the nationalisation of Motovelo, a company producing bicycles and motorbikes, in 2015. The state concluded that the investor did not abide to the terms of the privatisation deal, decreasing the production of bicycles and motorbikes and engaging in other kinds of economic activities, thus diluting the brand. These cases demonstrate the weakness of the rule of law in Belarus and the strong discretionary power of the authorities: even after privatisation, the state continues to view the enterprises as national property, and it feels free to reverse the deal if it is not happy with the developments in the enterprise.

Current ownership structure

Given the stalled transition reforms, the state sector still dominates the economy of Belarus, both in terms of ownership and employment. This dominance is extensive and spreads across most sectors, from very large to micro state-owned enterprises. According to the official statistics there were 3,662 state-owned organisations in the first quarter of 2016⁴¹; this number includes both enterprises owned solely by the state and organisations with mixed ownership.

Figure 2.1 / Gross value added produced in Belarus by type of ownership, 2009-2014, %



Source: National Statistical Committee of Belarus.

State-owned enterprises come in different ownership forms: direct government/municipality property, or joint stock companies in which the state owns stakes (often a controlling stake and even 100% of the

⁴¹ Belstat (2016a).

shares). This variety of forms makes it difficult to estimate the exact size of the state sector. There are many cases of mixed ownership, with private companies owning stakes in state-controlled holdings (for example, Milavitsa, the largest lingerie producer on the post-Soviet territory, is part of the BelLegProm concern). Mixed ownership often limits private co-owners in their ability to make independent decisions and effectively makes them a part of the state sector. The official estimate of the state-controlled economy is 49.9% in value added in 2014, with 27.2% and 22.7% being pure state property and mixed property with a state share, respectively (Figure 2.1).

There are also alternative estimates of the size and importance of the state sector in the Belarusian economy, using different methodologies and definitions. For example, it has been estimated that private sector companies without any government ownership employed 31% of the active labour force in 2013. However, if the private sector is defined to exclude private firms which are part of holding companies reporting to state bodies (like concerns or holdings), then the share of the private sector in employment drops to only 18%.⁴²

In any case, despite the differences in evaluation, all indications are that the state sector has been slowly decreasing in weight over time. Thus, while state-owned and co-owned enterprises contributed to 58.6% of the gross value added in 2009, by 2014 this share went down to 49.9%. The enterprises in state ownership have the largest share in manufacturing, producing 80% of gross output volume. Consequently, the Belarusian private sector still accounts for a relatively minor share of Belarus' industry: in 2014, 59% of total industrial output was produced by corporatised SOEs, 13% by unstructured SOEs, 3% by foreign-owned firms while de novo private firms contributed 25% of the total industrial output.⁴³

The limited scope of the privatisation efforts in Belarus (see next section) created a very specific private sector distinct from its counterparts in Russia and Ukraine. No privatisation of large SOEs resulted in almost no oligarchs or financial-industrial groups. Yet it would be wrong to say that the private business in Belarus is completely separate or independent from state or politics. The list of the largest companies in Belarus at present (Annex Table 2) suggests that most of the private companies present there (except for Eurotorg) represent a lucky symbiosis with the state sector. For example, there are several companies engaged in trade of oil, fuels and tobacco – heavily regulated industries which also function as dealers for state-produced fuel, oil refinery products and tobacco.

As regards agriculture and the organisation of farming activity, similarly to the situation in industry, the core economic structures inherited from Soviet times – the collective farms (kolkhoz) – are still in existence in Belarus. De facto these operate as SOEs employing workers from the surrounding area. Agriculture and farming have traditionally enjoyed close policy attention and support and over the years the authorities launched several state programmes of rural and agricultural development. These programmes entail generous public support to farming both in terms of direct budget subsidies and access to preferential 'directed' credit. In parallel, there is also a tiny de novo private farming sector, but its contribution to output is negligible. In 2014 private farms accounted for just 1.7% of total agricultural

⁴² Akulava (2015).

⁴³ Belstat (2015).

output, while collective farms contributed 76.2% of total output. Subsistence farming accounted for the remaining 22.1% of agricultural output.⁴⁴

At the other end of the spectrum of enterprise restructuring are the sectors of retail trade and 'other business services'. While privatisation has been largely absent in these sectors too, the private sector is by far the dominant one in most business services, both thanks to the organic growth of de novo private firms and the entrance of foreign firms into the Belarusian market. Thus, in 2014, de novo private firms held 59% of all retail trade outlets in Belarus; 24% of these outlets were held by foreign companies and 17% by SOEs.⁴⁵ The picture was similar as regards the respective volumes of retail sales. Also, the largest Belarusian employer at present is the private retail company Eurotorg.⁴⁶

A sectoral success story is also worth mentioning – the IT sector, where Belarus was able to capitalise on the skilled human capital and the high quality of mathematical and engineering education inherited from the Soviet Union. In 2006 the government established the High-Tech Park, a special economic zone with tax exemptions for IT sector companies (see Chapter 3). The operations of the High-Tech Park have been highly successful and today it hosts 152 resident companies with about 24,000 employees. Most of the companies began as outsourcers, but recently many of them have started developing their own products. The High-Tech Park is host to brands such as World of Tanks, Viber and MSQRD. EPAM, the only Belarusian company which went public on the New York Stock Exchange, is also resident of the High-Tech Park.

The most dynamic drivers of structural change in the Belarusian economy have been the newly emerging ('de novo') private firms.⁴⁷ This development has been formally lauded by the authorities but at the same time de novo private firms – unlike traditional SOEs – have never enjoyed meaningful policy support. The Belarusian private sector was born under harsh conditions and unequal treatment on the part of the state.

Business environment

In fact, the business climate in the 1990s and at the beginning of the 2000s was quite hostile to the emergence of a de novo private sector. Entrepreneurs were referred to as speculators, cheaters and robbers in official speeches at the very high level. Since it was very difficult and even dangerous to enter into competition with the state sector companies, newly established private enterprises aimed mostly at export markets or worked in domestic sectors with low presence of the state such as services.

A number of the technological de novo private companies created in the 1990s drew on the technological and scientific inheritance from the times of the Soviet Union. Inventions made by Soviet scientists helped some of these companies become world leaders in some high-tech niche businesses. Examples include (but are not limited to) Polimaster, a company specialising in radiation control solutions; Adani, a producer of high-tech medical equipment; and Regula, a producer of express

⁴⁴ Ibid.

⁴⁵ Ibid.

⁴⁶ Rudyi (2016).

⁴⁷ This is fully consistent with the general finding that in all transition economies, regardless of the speed and extent of privatisation, the large and quick contribution to growth came from the de novo private sector. See Hare and Turley (2013).

document verification equipment, which is installed in customs offices all over the world. These companies for a while preferred to stay as invisible as possible without attracting a lot of public attention. Because of this they are often referred to as hidden champions⁴⁸.

As the business climate improved in the second half of the 2000s and in the 2010s, the private sector as a whole picked up, mostly due to the creation of new micro and small-sized enterprises. Thus, between 2003 and 2013, the number of micro and small-sized enterprises quadrupled, increasing from 2.5 to 9.7 enterprises per 1,000 persons.⁴⁹ If the majority of the first-wave private businesses in Belarus were focused on export markets or created new domestic markets, recently many of the new private businesses are targeting the domestic markets, developing services such as retail, tourist and business services, etc.

But with time the situation started changing and the government stated the improvement of the business environment as a policy goal. A President's Directive⁵⁰ encouraged further liberalisation of the economy and the removal of barriers to business development.

The change in policy attitude contributed to measurable improvements in the business climate. As noted in Chapter 1, Belarus has moved up from 106th position in the overall Doing Business ranking in 2005 to 44th position in 2016, placing Belarus ahead of Russia, but still behind the other Customs Union colleague Kazakhstan (see Table 1.2 in Chapter 1). In some Ease of Doing Business dimensions Belarus has been doing remarkably well. For example, Belarus is ranked 7th in the world by the Registering Property indicator and 12th by the Starting Business indicator in the world (it takes only 3 days and 2 procedures to register a business in Belarus). The most problematic areas are Getting Credit (rank 109), Getting Electricity (rank 89) and Resolving Insolvency (rank 69). While enforcing contracts is relatively cheap and quick, the quality score of the judicial processes index is only 9 out of 18⁵¹.

In 2005-2012 the tax system underwent a major overhaul, becoming lighter, understandable and easier. In particular, a flat personal income tax of 12% was introduced in 2009 which is the lowest in the region (in 2015 this rate was increased to 13%). 26 taxes and duties were cancelled or united into a single government duty. The corporate income tax was lowered from 24% to 18%. While before these reforms enterprises had to pay most of the taxes monthly, nowadays the payments are due quarterly or even once a year. The possibilities to pay electronically have also increased, making it easier to pay taxes. These tax reforms contributed to upgrading Belarus' rank in the Paying Taxes category from 183rd in 2010 to 63rd in 2016.

At the same time, however, social security contributions are considered quite high: currently employers pay a 34% payroll tax, while employees pay a 1% levy. High social security contributions are often cited as the main reason behind tax evasion, which often takes the form of illegal salaries.⁵² Tax collection

⁴⁸ Daneyko and Golenchenko (2013).

⁴⁹ Akulava (2015).

⁵⁰ Directive No. 4 of 31 December 2010, On the Development of Entrepreneurship Initiative and Stimulation of Business Activity in the Republic of Belarus (http://president.gov.by/en/official_documents_en/view/directive-no-4-of-31-december-2010-1642/)

⁵¹ World Bank (2016a).

⁵² Tserlyukevich et al. (2014).

itself is a cumbersome administrative procedure that takes a lot of time, and this is mainly due to excessively complicated regulations.

The Belarusian tax legislation provides opportunities for selective preferential tax treatment, particularly, in the special economic zones. The High-Tech Park is one of them, enjoying exemptions from corporate income tax, property taxes and, most importantly, for labour-intensive industry, a reduced level of social contributions. Medium-sized and small towns in rural areas also enjoy preferential tax treatment since 2012: newly created enterprises there are free from income tax and property tax for 10 years, and also enjoy concessions on VAT. Each of the six administrative regions in Belarus has a free economic zone. Businesses based in these zones benefit from a 5-year exemption from income tax, VAT discounts and do not pay property taxes. There are simplified tax schemes for micro enterprises and individual entrepreneurs which allow paying a single sales tax.

At the same time, businesses and entrepreneurs in Belarus suffer from the excessive regulation and some cumbersome administrative procedures. There are many regulatory and controlling bodies, sometimes with overlapping scope. It is estimated that more than 90% of the inspections end up with levying some charges or fines.⁵³ Laws often change; besides, laws are excessively harsh on some economic wrongdoings, often entailing criminal charges. All this is a downside of the legal environment for the business.

Another problem is that in practice the enforcement of regulations and control is not neutral. The government, both local and national, is de facto more prone to supporting SOEs but not private businesses and tends to favour the state sector of the economy at the expense of private businesses. This is on top of the practice of directed lending which is usually available only to SOEs, while the rest of the business sector pays excessively high market interest rates.

In 2015 Belarusian SMEs named macroeconomic instability, inflation and exchange rate risks as the top barriers to business development.⁵⁴ They also quoted bureaucracy and administrative procedures, size of fines, number of inspections, and licensing and certification as important impediments. Thus, while the business climate (and the tax system in particular) in Belarus have improved greatly over the last ten years, there is still much to be done in terms of macroeconomic stabilisation, in streamlining the administrative regulation and ensuring neutrality of treatment of businesses.

Ownership structure and governance challenges

The Belarusian authorities have been reluctant to fully expose the state-owned sector, including the corporatised SOEs, to market pressure since these firms also serve as tools for the implementation of some state programmes. Various forms of state support, both direct and indirect, have been used over the years to cushion SOEs from market pressure and prevent bankruptcies and massive layoffs. While the degree of state support has been on the decline, especially in most recent years, it helps explain why and how there has been no dramatic change in Belarus' industrial structure.

⁵³ Nazarova (2012).

⁵⁴ All survey data in this paragraph are from IPM (2015).

Economic research indicates that state-owned companies are less efficient than the companies of the private sector: they feature lower labour productivity, total factor productivity and productivity growth.⁵⁵ In the 1990s and at the beginning of the 2000s, the state sector of the economy, and manufacturing in particular, was benefiting greatly from preferential access to the Russian market, but due to low productivity growth it began to lose competitiveness by the end of the 2000s. Nowadays many of the state-owned manufacturing enterprises experience high competition from Russian and Chinese producers on the Russian market.⁵⁶ The increasing productivity gap between the state sector and the private sector depresses overall growth in the country.

There are multiple sources of state sector inefficiencies. As discussed in Chapter 1, despite the corporatisation of many SOEs, de facto most of them are still directly managed by the government and fall short of autonomous decision-making. Plus, the performance targets set by the government generated market distortions and inefficiencies. So even in periods of growth, it was extensive growth without productivity gains. Another problem is the motivation of the management, which is mostly based on 'sticks' rather than 'carrots'. Thus the salaries of the SOE management are lower than that of their private sector colleagues and there are no key performance indicators to award managers for good performance of the firms they run. On the other hand, managers are subject to numerous regulations and controls and often subject to legal pursuit on allegations for corruption and misuse of power. These conditions also suppress the drive for innovation, which often leads to failures and high personal risks for the management.

Labour hoarding is another attribute of SOEs' poor performance. Maintaining or increasing employment levels is usually one of the performance targets of the enterprises, and this in itself is a barrier to restructuring. On the other hand, some studies show that the labour market itself is quite flexible in Belarus, and effectively redistributes labour from the inefficient state sector into the emerging private sector with high labour productivity.⁵⁷

Directed lending also contributes to inefficient corporate performance. Access to cheap loans made SOEs eager to overinvest in the accumulation of physical capital. Moreover, often this form of financial support from the state is offered to help loss-making companies, which creates wrong incentives. Directed lending also leads to misallocation of capital within the country: instead of going to the more efficient private sector, capital flows into the inefficient state sector, multiplying the negative productivity effects.

On the other hand, being the representative of the state as an owner, the government is under constant political pressure to engage in direct financial support of some state-owned companies. The support for the national economy was estimated at around 15.5% of the budgetary expenditures in 2015 and almost half of it goes to support the inefficient agricultural sector.⁵⁸ The majority of these funds cover the interest rate subsidies associated with directed lending. Such political pressures are likely to emerge as long as a large share of the economy is in the hands of the state.

⁵⁵ Akulava (2015); Cuaresma et al. (2012).

⁵⁶ Favaro et al. (2012).

⁵⁷ Kruk and Bornukova (2014). See a more detailed discussion on the labour market below.

⁵⁸ Ministry of Finance (2016).

The fact that up until now the authorities have direct control over a large share of the economy has thus a negative bearing on economic governance. Instead of focusing on the creation of favourable conditions for the development of the economy, the attention of the authorities is diverted towards micromanaging the state-owned parts of the economy. The conflict of interest between ownership, controlling and managing functions often leads to low effectiveness in governance and sometimes to political paralysis.

Antimonopoly regulation was for a long time an example of the conflict between the functions of ownership and control. Since many of the state-owned enterprises are monopolies, and further concentration is promoted through the creation of holding companies, there were few incentives for the government to establish tough antitrust regulations. The antitrust policy was one of the functions of the Ministry of Economy, which also manages part of the state economy. There has been a slight change for the better in 2016, when the antitrust regulation functions were passed on to the Ministry of Trade. However, there are fears that the Ministry of Trade will use the new function mostly to impose price controls, as it often has done in retail trade in the past.

According to the Worldwide Governance Indicators (with scores ranging from 0 to 100, higher indicators meaning better governance), Belarus had a score of 35.1 in government effectiveness, 22.6 in rule of law, and only 13.9 in regulatory quality.⁵⁹ The highest-ranking indicator for Belarus is the control of corruption (47.6), which is also the only indicator where Belarus is doing better than Russia.

Despite the fact that Transparency International gives Belarus a rank of 107 out of 168,⁶⁰ hand-to-hand corruption, common in Russia and Ukraine, is almost nonexistent in Belarus. The surveys of small and medium-sized enterprises in Belarus show that while 14.7% of SMEs consider corruption to be a widespread phenomenon, corruption is not among the top barriers to doing business, being well behind inflation, regulations, taxes and access to credit.⁶¹

Economic institutions and governance in Belarus are thus much in need of reform. Ensuring rule of law, fair courts enforcing contracts and property rights are necessary prerequisites for economic growth in the years to come. As already discussed, institutional and governance reforms will be more efficient if they are part and parcel of broader policy reforms of the economic structure.

THE ENERGY SECTOR

The energy sector is of utmost importance for the Belarusian economy. The energy subsidies from Russia played a key role in shaping Belarus' economic performance during the 2000s. However, the access to cheap oil and gas from Russia is both a blessing and a curse. On the one hand, it provides Belarusian companies with a competitive advantage and supports the oil processing and chemical industries. On the other hand, cheap energy is a stumbling block on the difficult path to energy efficiency and energy security.

⁵⁹ The World Bank (2015a).

⁶⁰ Transparency International (2015).

⁶¹ IPM (2015).

The total primary energy supply⁶² of Belarus is 27.28 mtoe⁶³ as of 2013. The majority of the energy supply comes from natural gas (64%) and oil (27.2%), the rest is generated from biofuels, coal and other types of fuel.⁶⁴ Natural gas is primarily used for the production of heat energy and electricity. Over 80% of Belarusian centralised heating stations use natural gas and nearly 95% of electric energy in the country is produced with natural gas as primary fuel.⁶⁵ The population consumes around 16.8% of electrical energy and 33.3% of the heat energy. On the enterprise side, chemical manufacturing, metallurgy, and oil refineries are the largest consumers.

The role of energy imports from Russia

Belarus imports most of the fuels, while own production covers only about 15% of the needs.⁶⁶ Russia is the dominant source of fossil fuel imports, providing virtually all natural gas supplies to Belarus and more than 90% of oil imports (Table 2.3). It should be noted that, while natural is mostly used for energy generation (and only partially as a chemical input), a significant share of the imported oil is processed in the oil-refining and chemical industries and a significant share of the final products are then exported, mostly to the EU, Ukraine and Russia.

Table 2.3 / Belarus' dependence on fossil fuel imports from Russia, 2005-2014

Imports of fossil fuels			
Oil			
year	Total	From Russia	
	million	million	share of imports from Russia, %
2005	4395.5	4372.0	99.5
2010	7695.5	6171.4	80.2
2011	12871.0	10826.5	84.1
2012	13710.3	13299.6	97.0
2013	8562.2	8475.4	99.0
2014	7942.3	7861.7	99.0
Natural gas			
year	Total	From Russia	
	million	million	share of imports from Russia, %
2005	997.9	997.7	100.0
2010	4188.0	4186.7	100.0
2011	5434.4	5433.8	100.0
2012	3564.4	3563.9	100.0
2013	3512.2	3511.7	100.0
2014	3594.6	3594.3	100.0

Source: National Statistical Committee of Belarus.

⁶² Own production plus imports minus exports of energy.

⁶³ Million tonnes of oil equivalent.

⁶⁴ IEA (2015).

⁶⁵ Salnykov (2011).

⁶⁶ Salnykov (2011).

Russia offers important discounts on energy prices for Belarus. The negotiated subsidised price of oil is usually not announced (though it can be inferred later from the foreign trade statistics). The price of natural gas for Belarus in 2010 was 188 USD per a thousand m³, and it went down to 142 in 2015.

The total amount of implicit Russian energy subsidies is significant but there is no official statistics on their volume. According to different recent estimates, the amount of subsidies ranged from 4% of GDP in 2010 (the year of joining the Customs Union with Russia and Kazakhstan) to the peak of 12% of GDP in 2012. With the drop in world energy prices, the relative amount of Russian energy subsidies also declined, to around 7% of GDP in 2015.⁶⁷ However, these estimates are probably also distorted and inflated as the consumption of energy and oil in Belarus would be lower at market prices.

Energy was often a contended issue in the relations between Belarus and Russia and even led to 'gas wars' between the two due to different interpretations of the terms of gas supply agreements; in 2004, Russia even cut the supply of natural gas for one day. The important gas pipeline network in Belarus (which is also used for gas transit to Europe) was also a bargaining chip in energy disputes but in the end it was privatised to Russia's Gazprom which gained total control over it in 2012. In compensation, Russia secured from the Eurasian Development Bank balance-of-payments support to Belarus which was shattered by the currency crisis.

Belarus did attempt to get access to alternative oil suppliers. In early 2010, the Belarusian government signed an agreement with Venezuela and a first delivery was made by a railroad from the sea port of Odessa. The idea was to use the reverse of the Odessa-Brody pipeline to deliver the Venezuelan oil to Belarus. But Russia stepped in and in effect killed this deal by offering more lucrative oil supply conditions to Belarus.

Oil processing plays an important role for the economy of Belarus. There are two big oil refineries: the Naftan (in Novopolotsk) and the Mozyr Oil-Refining plants (in Mozyr), both are subordinate to the Belneftechim holding company. The state controls 43% of the Mozyr oil refinery and holds a 99.8% share of Naftan. These enterprises generate over 30% of total Belarusian exports⁶⁸ and are also very important taxpayers (Annex Table 2). Both refineries are obliged to supply gasoline to the domestic market at the administratively set low prices. Novopolotsk is a monocity, with Naftan employing a significant share of the town's labour force. Thus the dependence on Russian oil supplies puts Belarus in a very vulnerable position not only due to energy security considerations but also social ones.

When Belarus buys oil for its own consumption, it does not have to pay export duties to Russia. However, if the crude oil is re-exported, or used as an input for oil refineries and the oil refinery products are later exported, Belarus has had to refund the oil export duties that it charges to the Russian budget. Due to the narrow definition of refined oil products, Belarus on several occasions used different schemes of exporting alternative products, not formally covered by the agreements, without paying the export duties. For example, in 2012, Belarus increased dramatically its exports of dissolvents and dilutants.⁶⁹ In 2014, Belarusians used bitumen exports to shirk on paying Russian export duties⁷⁰. Of course, such

⁶⁷ Chubrik (2015).

⁶⁸ Some export deals of processed oil products are performed by intermediaries.

⁶⁹ Total exports of these goods in 2012 amounted to USD 2.8 billion, 77% more than in 2011.

⁷⁰ Avtushka-Sikorsky (2014).

schemes do not remain unnoticed but, in the event, Russia afterwards agreed on Belarus not having to return the export duties to the Russian budget. As a result, starting with 2015 Belarus receives a de facto subsidy of around USD 1-2 billion in unrefunded oil export duties.

Despite the fact that Belarus enjoys low oil and natural gas prices, this does not necessarily translate into low energy prices for businesses. The state often sets low energy prices for households and charges the business sector with the price difference. For example, in 2010, when the natural gas import price was USD 188, businesses had to pay USD 240, while households only paid USD 158.⁷¹ This practice of cross-subsidisation leads to higher energy costs for Belarusian enterprises, and reduces their competitiveness on the Russian market.⁷² The increase in heating tariffs for the population is supposed to fix this problem.

Nuclear power: is this a way out of energy dependency?

Belarus has long been contemplating the idea of building a nuclear power plant as a way to reduce the dependence on natural gas imports from Russia and address energy security concerns. The authorities however were facing opposition from the public as the memories of the Chernobyl tragedy were still too powerful.⁷³

Despite these public concerns, in 2011 Belarus signed an agreement with Russia on a USD 10 billion loan to construct a nuclear power plant in the town of Astravets. The loan will finance 90% of the costs of the construction, mainly carried out by Russian subcontractors. The nuclear power plant will consist of two energy blocks producing 1200 Mw each. The first energy block is due to be launched in 2018; the second one in 2020. After the construction and launch of the plant Belarus will start repaying the loan to Russia in 2021; the loan repayment over 15 years will amount to almost USD 1 billion per year, a significant burden on the Belarusian current account.

It is expected that the construction of the Astravets plant will supply around 40% of electricity consumption in Belarus.⁷⁴ If this materialises, it will allow reducing significantly the dependence of Belarus on imports of natural gas, lowering it to 57% in total energy consumption.⁷⁵ There are also plans to export electricity to Poland and Lithuania. But the infrastructure that allows electricity exports to Poland does not exist yet while Lithuania has recently announced plans to disconnect from the electrical power grids of the former USSR. Moreover, Lithuania is actively opposing the construction of the plant as Astravets is situated near the Lithuanian border.

The opponents of the construction of the nuclear station claim that it would probably be cheaper to simply buy electricity from other nuclear plants also constructed in the region (in Lithuania and in the Kaliningrad region of Russia). Indeed, it is estimated that the launch of the nuclear plant will increase the electricity costs by some 16%.⁷⁶ Energy dependence on Russia will not decline either, as Belarus will

⁷¹ Ibid.

⁷² However, some industrial users still enjoy energy price discounts. See Balmaceda (2014).

⁷³ Novikau (2016).

⁷⁴ Padalko and Dmitriev (2013).

⁷⁵ Zorina et al. (2015).

⁷⁶ Ibid.

have to buy nuclear power fuel from Russia. While the nuclear plant will reduce the current emission levels, it will generate new environmental hazards. Thus, the construction of the nuclear power plant will just change the nature of energy dependence and of the environmental risks.

Energy efficiency

On the regulatory side, the Belarusian government has introduced a range of policy initiatives aiming to increase energy efficiency. National Energy Savings Programmes are approved once in five years, and these Programmes are supported by substantial funding. The funding of the Energy Savings Programmes increases from year to year, from USD 1,200 million in 2008 to USD 1,784 million in 2013.⁷⁷ The funding comes mostly from the own financing of the organisations and from loans, with the budget financing only 20% of all expenditures. There are also several projects of the World Bank, UNDP and EU also aimed at improving energy efficiency. The major directions to increase energy efficiency in these programmes include:

- › increase in the efficiency of energy generation;
- › decline in losses in transporting energy;
- › utilisation of secondary energy resources;
- › increases in the energy efficiency of manufacturing companies and in the distribution of heating, gas and water to the population;
- › increase in the use of renewable energy sources.

As a result of these efforts, energy efficiency in Belarus has increased. The energy-output ratio (measured as the consumption of energy in toe per USD 1000 GDP at 2005 PPP) decreased from 0.38 in 2000 to 0.19 in 2013. Currently Belarus' energy-output ratio is lower than in Russia, Ukraine or Kazakhstan, but higher than in Lithuania or Poland.⁷⁸ Belarus is also developing the use of renewable energy resources, but they constituted only 5% of the total energy in 2012 (compared to 12.4% in Germany or 34.7% in Finland). Most of the renewable energy came from firewood.

However, given the artificially low energy prices in Belarus, energy efficiency can only achieve a limited effect. The way towards genuine energy efficiency should go through a comprehensive price reform in the energy sector as a whole.

THE BANKING SECTOR

A general profile of the banking system

The banking sector in Belarus has a traditional two-tier structure. The National Bank of the Republic of Belarus (NBRB) performs the functions of a central bank, which in particular develops the licensing procedures for the rest of the banks and oversees their activities. The second tier consists of commercial

⁷⁷ Semashko (2014).

⁷⁸ IEA (2015).

banks. As of June 2016, there were 26 licensed commercial banks, two non-bank financial organisations and five representative offices of foreign commercial banks.

The state still maintains a dominant position in Belarus' commercial banking system: state-owned banks account for some 66% of the total assets of the banking system; 32% of the assets of the banking system are held by foreign-owned banks while local private banks account for the remaining 2% of the assets (Table 2.4). The ownership structure of Belarusian banks is closely associated with the size of the banks. State-owned banks are mainly large banks; foreign banks are mainly medium-sized and small ones⁷⁹; and private Belarusian banks are small ones.

Table 2.4 / Breakdown of commercial bank assets in Belarus by type of banks' ownership, %

Groups of banks by ownership	01.01.2009	01.01.2012	01.01.2014	01.01.2016
State-owned	78.0	71.2	63.8	65.7
Foreign	20.5	27.9	35.2	32.3
Private national	1.5	1.0	1.0	2.1
Total	100	100	100	100

Source: NBRB.

The banking system is heavily regulated and relatively stable. The statutory capital requirement is BYR 450 billion (around EUR 20.5 million). Before 2014 the statutory capital requirements were denominated in euro, creating problems for the banks immediately after episodes of fast depreciation, especially after the currency crisis of 2011.⁸⁰ The introduction of a blanket guarantee on household deposits in 2008 contributed to an increase in confidence in the banking system and turned out to be a very timely measure before the crises of 2009 and 2011.⁸¹ During the period of independence of Belarus, 25 banks were liquidated but most of them were small ones and none of these cases led to a general bank panic. Business surveys also indicate high levels of confidence in the banking system: over 59% of respondents consider the banks as reliable.⁸²

In terms of financial intermediation, the banking sector has a dominant role in the Belarusian financial system, since the stock market is practically inexistent. The excessive role of the government is another distinctive feature of the Belarusian banking sector as the state-owned sector has privileged access to finance. The mechanism of directed lending directly supports government programmes and fulfils some other 'non-market' functions for the government.

State capital dominates in five banks (three large banks, one medium-sized and one small). Among these are the two largest banks, Belarusbank and Belagroprombank, which account for some 60-65% of the capital and assets of the entire banking system. They have also been (at least until recently) the main agents for implementation of directed lending schemes, and fulfil other functions required by the

⁷⁹ According to the NBRB's classification, BPS-Sberbank and Priorbank are frequently classified as large banks as well. However, they are operating near the threshold between being large and medium. Furthermore, these banks are much smaller than Belarusbank and Belagroprombank. Hence, these banks may be treated as medium-sized ones.

⁸⁰ De la Rubia et al. (2012).

⁸¹ Towe and Belka (2009).

⁸² Lafyuk et al. (2014).

government.⁸³ Belarusbank is mostly responsible for securing directed lending for manufacturing and housing loans in urban area, while Belagroprombank deals mainly with agriculture and housing in rural areas.

One more bank, Belinvestbank, is owned by the government, but the authorities have been seeking for a strategical investor in this bank during the past decade. A similar situation prevails in the case of Bank Moskva-Minsk. It is owned by NBRB after the bank was saved from bankruptcy, but the authorities are looking for opportunities to sell it.

Until the mid-2000s, there was almost full dominance of the state-owned banks. This constrained the access to capital by the de novo private sector as state-owned banks at large were reluctant to acquire private sector exposures and engage in the more elaborate and laborious credit screening and monitoring practices needed for that purpose (especially as regards small businesses). They also had excessive exposures to state-owned enterprises which were in effect crowding out the private sector. Most private banks were relatively small and could hardly meet the demand of the private sector. Moreover, private banks preferred to concentrate in the retail segment of the banking market, which was expected to secure higher returns.

Given the growing demand for financial intermediation since the mid-2000s, foreign banks have become more active on the Belarusian market. The Belarusian authorities generally welcomed the local expansion of foreign banks, in contrast to their attitude regarding other sectors of the economy. For example, while there exists a formally set ceiling for the share of foreign capital in the banking system, this regulatory lever was never enacted as a barrier for foreign banks to enter the Belarusian market. Instead, the ceiling was actually raised from 10% at the beginning of the 2000s to 50% at present.⁸⁴

Russian banks were the most aggressive in the period of foreign bank expansion in Belarus. This was due to the close ties of the Belarusian economy with the Russian one, and the geographical neighbourhood. Furthermore, during the era of expensive oil, Russian banks deepened their capitalisation and were looking for options of expansion in foreign markets. The CIS region, and Belarus in particular, were among the easiest targets for such expansion. In turn, the Belarusian authorities, despite striving to diversify by origin the banking capital entering the Belarusian market, had limited alternatives to Russian capital. Hence, many large Russian banks became active players on the Belarusian market through their subsidiaries. Foreign banks of other capital nationality are mainly smaller (Priorbank being an important exception).

The ownership structure of the Belarusian banking sector to a large extent also matches the banks' strategies. The business model of state-owned banks implies using the capital base as an additional funding source for active operations thanks to their relatively high capitalisation. This translates into greater (in comparison to other groups of banks) emphasis on credit exposures. Some of these banks also have a bulk of directed lending in their asset portfolios. On the liability side, state-owned banks enjoy a relatively high share of deposits, largely due to informal instructions to state-owned enterprises to hold their accounts in state-owned banks. In the case of households, state-owned banks are successful in attracting deposits mainly due to the largest regional network of their branches.

⁸³ The Development Bank of the Republic of Belarus is due to gradually take over these functions.

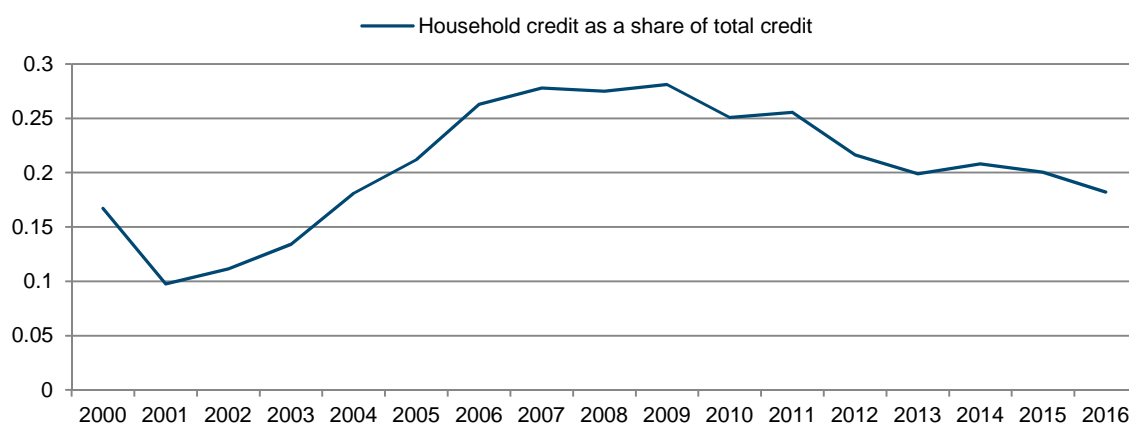
⁸⁴ The actual share of foreign banks in the total capital of the banking system at present is about 15%. See NBRB (2016a).

Furthermore, once they are servicing large state-owned enterprises, these banks have the privilege to service card accounts for wages and salaries. Finally, until 2008, state-owned banks had advantages within deposit insurance regulations, which could still influence depositors' preferences.

Foreign banks can reasonably be divided into two subgroups, depending on their size. Those that are larger usually focus on an individual industry or individual large firms which are somehow affiliated with the bank, and correspondingly represent a core of the business model. Servicing energy, construction, oil-refinery or retail are examples of such a specialisation of individual foreign banks. On the assets side, a large part of their portfolio usually matches this specialisation; for the rest of the portfolio these banks prefer a high degree of diversification. Hence, they tend to target different industries of private business, and some of them are also actively engaged in retail banking. On the liability side, the main advantage of these banks is the access to cheap and sizeable resources in hard currency from their parent banks. Due to this advantage, foreign banks try to expand in the targeted segments of the market. Attracting large household deposits is not necessarily a priority objective for some of these banks.

Smaller foreign banks and small private Belarusian banks are usually mainly concentrated on retail business. Respectively, consumer loans and household deposits are the dominating items on the two sides of their balance sheets. Retail banking (both in the loan and deposit market) is probably the most competitive segment in the Belarusian banking sector: the number of banks specialising in retail banking is high, and larger banks sometimes exert extra pressure on the market by exploiting their scale advantages. The trend of rising competition in retail banking and the increasing importance of this market are among the most important features in the evolution of the banking sector during the last decade.

Figure 2.2 / Evolution of household credit in Belarus in 2000-2016, %, at the beginning of the year



Source: NBRB.

Before the global financial crisis of 2008-2009, household credit was developing rapidly in Belarus: its share of consumer credit in total banking credit in the economy grew from only 9.8% in 2001 to 28.1% in 2009 (Figure 2.2).⁸⁵ Household credit was always dominated by long-term housing loans, which were subsidised and promoted by the state. These housing loans are mostly not mortgages, but guaranteed

⁸⁵ NBRB (2016b).

loans, as mortgage legislation in Belarus does not make it possible to claim the property from the non-paying debtor. Household loans were denominated both in national and foreign currency, although the national currency was predominant – subsidised housing loans could be issued in national currency only.

Household credit grew not only due to subsidised housing lending. In 2002-2009 several new private banks (most of them with foreign capital) entered the market, and since most of the incumbent state banks were mostly focused on subsidised housing credit only, the new banks targeted the empty niche of the market – retail short-term consumer loans. By the end of 2008 almost half of the household credit was non-housing consumer loans; 60-80% of new cars were bought with credit funding⁸⁶.

After the 2009 currency crisis when the Belarusian currency lost 33% of its value overnight, the NBRB temporarily banned household credit in foreign currencies in order to protect the population from the currency risk. Furthermore, in 2011 the ban was extended for an indefinite period. This regulation had a significant restraining effect on household credit as high inflation (and inflationary expectations) drove up the interest rates in national currency and new loans became unaffordable or unattractive to consumers. As a result household credit again refocused on long-term loans mainly.

The economy rebounded relatively quickly after the currency crisis of 2011, and despite the exorbitant interest rates consumer credit picked up slightly in 2012-2013 (Figure 2.2). Many Belarusian banks with Russian capital, which enjoyed access to cheaper resources on the Russian financial markets, started promoting retail consumer credit as a means to capitalise on this access to resources. But the National Bank saw risks in these developments, and implemented several steps to cool down the retail consumer credit market. One of the main restricting regulations was the requirement to present an income certificate with any application for a loan. The drop in real incomes in 2015 led to a further decline in household credit.

Are Belarusian banks financially sound?

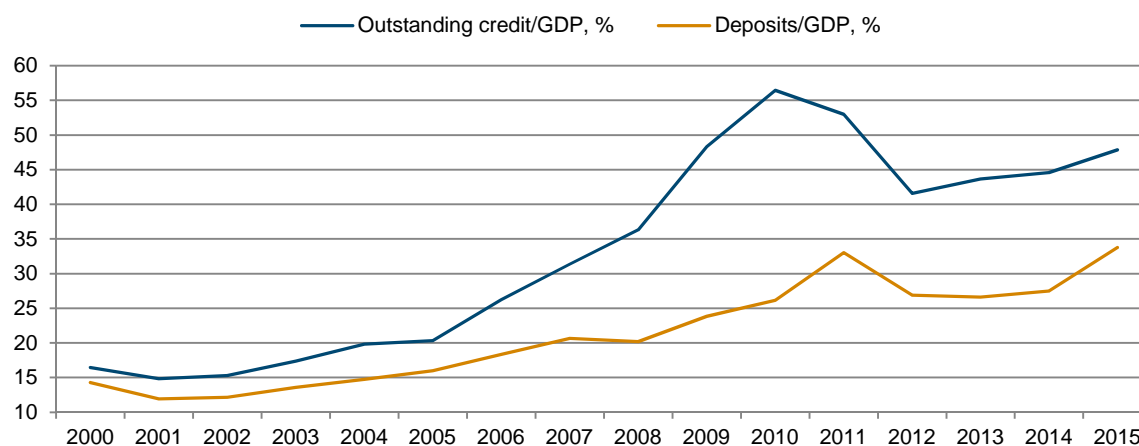
A characteristic of the Belarusian banking system during the last decade was that it granted loans aggressively, having secured a long-lasting credit boom (Figure 2.3). The start of the credit boom happened in 2005, and it lasted until the currency crisis of 2011. Relaxed access to external capital is a major explanation for this boom, as the growth in credit substantially outpaced the growth of deposits (Figure 2.3). Furthermore, intensification of directed lending and soft monetary policy also contributed to this credit boom. However, these factors were less influential, as they exerted only a temporal influence. Moreover, without the support of external finance, a domestically induced credit boom could not have survived for a long period, or would have led to high inflation/devaluation faster than it happened in fact.

The major financial indicators of Belarusian banks were generally in a safe range during the credit boom, but started to deteriorate as the boom faded (Table 2.5). The downward trend in profitability, capital adequacy and other indicators is primarily due to an increasing share of non-performing loans in banks' balance sheets. To a large extent, it is the outcome of the rapid credit expansion in the past which led to an accumulation of low-quality assets (Table 2.6). Declining profitability also means that banks can

⁸⁶ Kisel (2010).

hardly fix the situation by new loans as generally there is a systematic reduction of the pool of borrowers in a recessionary environment.

Figure 2.3 / Total outstanding credit and total deposits in Belarus, 2000-2015, % of GDP



Source: NBRB.

Table 2.5 / Main financial indicators of Belarusian commercial banks, %

	01.01.2009	01.01.2012	01.01.2014	01.01.2016
Regulatory capital adequacy, %	21.8	24.7	15.5	18.7
Leverage ratio (capital/assets)	0.17	0.14	0.15	0.12
Share of non-performing assets in total assets exposed to credit risk, %	1.7	4.2	4.45	6.8
Return on assets (ROA), %	1.37	1.7	1.9	1.0
Return on equity (ROE), %	9.6	14.9	13.8	8.4
Share of liquid assets in total assets, %	23.2	34.7	27.2	32.1

Source: NBRB.

Table 2.6 / Characteristics of asset quality of Belarusian commercial banks, 2012-2016

	Share of non-performing assets in claims on legal entities, %			Share of non-performing assets in claims on households, %		
	Jan 01, 2009	Jan 01, 2012	Jan 01, 2016	Jan 01, 2009	Jan 01, 2012	Jan 01, 2016
State-owned	2.3	4.0	9.1	0.1	0.1	0.1
Foreign	1.9	5.6	7.7	2.0	1.9	3.9
Private national	5.1	11.0	11.7	2.7	2.5	6.0
Total	2.2	4.6	16.9	0.6	0.5	1.0

Source: NBRB.

Furthermore, the period of rapid credit growth was combined with a high level of dollarisation in both assets and liabilities (Table 2.7). Also there was a growing term mismatch in the banks' balance sheets with an increasing share of short-run deposits on the liability side coupled with an increasing share of

long-term assets (to a large extent driven by directed lending) which was causing liquidity challenges. Also, some of the current challenges are the consequences of aggressive policy in the recent past.

Table 2.7 / Currency positions by groups of banks

	Share of forex loans in total outstanding loans, %			Share of forex deposits in total deposits, %			Net currency position, % of regulatory capital ^{*)}		
	01 Jan 2009	01 Jan 2012	01 Jan 2016	01 Jan 2009	01 Jan 2012	01 Jan 2016	01 Jan 2009	01 Jan 2012	01 Jan 2016
State-owned	23.8	29.2	48.7	28.0	51.4	62.3	6.5	2.3	4.0
Foreign	65.7	65.0	76.9	58.8	70.1	79.4	14.6	20.2	5.0
Private national	33.4	59.3	46.2	43.3	70.0	63.8	5.9	-4.6	6.6
Total	31.9	39.9	57.8	33.0	57.6	67.7	8.6	9.4	4.5

*) The net currency position illustrates the sensitivity of banks to exchange rate fluctuations. It is calculated as the sum of the net positions in each foreign currency. In turn, the latter is the difference between the corresponding assets and liabilities. The net currency position is long (with a positive sign) when assets in foreign currencies exceed liabilities; the position is short (negative sign) when assets are less than liabilities.

Source: NBRB.

Aggregated statistics, nevertheless, tends to mask some hidden problems. For instance, the trend of growing non-performing loans (NPLs) became visible in the statistics only in 2016, although anecdotal evidence and some indirect indicators (special provisions, market lending conditions, etc.) had pointed to a worsening situation much earlier. Furthermore, given the large degree of heterogeneity in the behaviour of banks, it would be more insightful to try and trace banks' performance on a more disaggregated level.

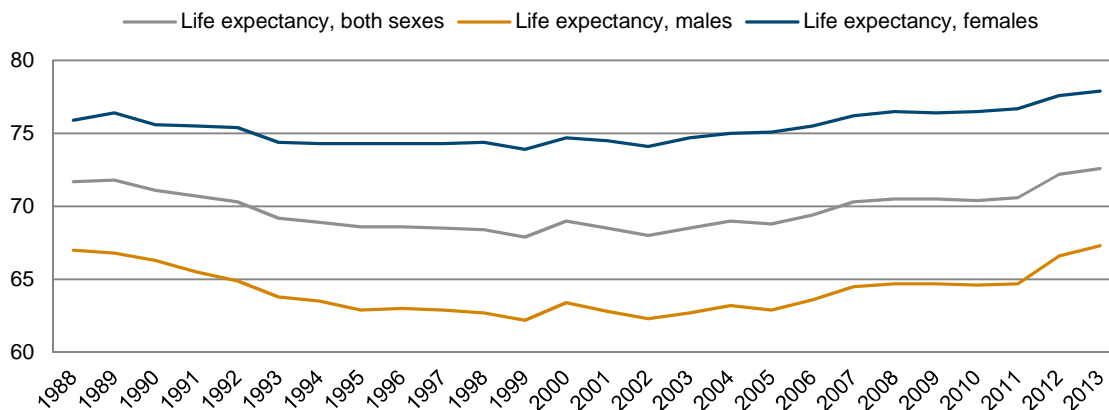
According to the available statistics, foreign banks report the worst characteristics in terms of the effect of NPLs (Table 2.6). At the same time, given the practice of poorly screened directed lending, NPLs could be expected to weigh most heavily on state-owned banks. Thus the actual quality of assets of state-owned banks might be worse than shown in the official statistics (for instance, due to government guarantees provided, whose execution is nevertheless doubtful; and some accounting tricks). Moreover, the problem of non-performing loans might be more severe for the system as a whole than it appears from the official statistics.

Another traditional source of vulnerability and potential shocks for the banking system, the macroeconomic currency risk, seems to have decreased during the last couple of years thanks to the change in monetary policy. On the other hand, dollarisation has been on the rise both on the asset and liability side of the banks' balance sheets, reinforcing the transmission channel for currency-induced credit risk. Moreover, this trend was present in all groups of banks: foreign banks, which traditionally had a preference for forex in both assets and liabilities, and state-owned banks, which shifted to a forex-oriented lending policy whereas previously they had been more likely to extend loans in national currency. From a macro perspective, the trend towards further dollarisation makes the economy more vulnerable to external shocks, while economic policies become less effective.

As many post-Soviet and European countries, Belarus is facing the problem of ageing population. Similarly to other post-Soviet countries, Belarus experienced a demographic crisis after the dissolution of the Soviet Union, combining a drop in fertility with spiking mortality. While the demographic crisis in Belarus was less profound than in other countries in the region, there was a significant drop in life

expectancy in the 1990s: in 1999 the life expectancy of males reached its minimum over the past 50 years of data – only 62.2 years (Figure 2.4). The life expectancy of females did not contract as much. As the economy rebounded, life expectancy started recovering as well: by 2013 the life expectancy reached 67.3 years for males and 77.9 years for females.⁸⁷

Figure 2.4 / Life expectancy at birth in Belarus



Source: National Statistical Committee of Belarus.

Fertility rates experienced a similar trend. In the 1990s the total fertility rate declined from 1.91 in 1990 to only 1.23 in 2003. But in the 2000s and later on fertility picked up, reaching 1.69 in 2014.⁸⁸ The improving economic conditions and expectations as well as policies promoting fertility supported this revival.⁸⁹ Despite the increase, the fertility rate is below the level needed for population replacement, let alone growth.

Measured international migration rates in Belarus are insignificant, despite the widespread public perception that a lot of Belarusians left the country in the 1990s. Many Belarusians moved to Russia for better jobs and pay in the 2000s but preserved their principal residency in Belarus.⁹⁰ According to official data on registered migration for 2013, 19,435 persons arrived in Belarus from abroad, while only 7,792 left the country.⁹¹

At present migration cannot be regarded as a remedy to the demographic problems of Belarus, at least under the strict current migration and labour laws: employers have to receive special permits for each migrant they want to hire, and have to prove that there is no Belarusian ready and able to assume that workplace. Migrants also have no access to social protection, despite the fact that since 2016 they have to pay social security contributions just as Belarusians. This is one of the reasons why Belarus does not appear to be very attractive to foreign workers.

⁸⁷ Belstat (2014).

⁸⁸ Ibid.

⁸⁹ Amialchuk et al. (2014).

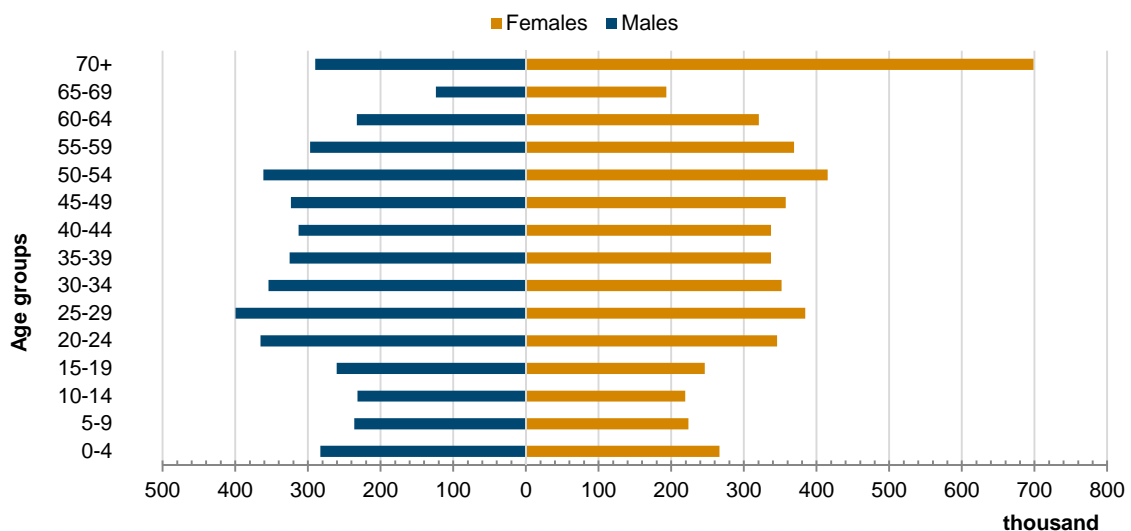
⁹⁰ Valetka (2013).

⁹¹ Belstat (2014).

Within the 20-year period between 1996 and 2016, the population of Belarus dropped by 6.7%.⁹² Given the low fertility rate, population projections are negative. The World Population Prospects forecast that by 2050 the Belarusian population will contract to 8,125 thousand people.⁹³

The demographic trends of the recent decades are also reflected in the stationary population pyramid with a very narrow base (Figure 2.5). Up until now the labour market of Belarus was not experiencing pressure from demographic challenges. People leaving the labour force for retirement represented the cohorts born during or after World War II, which were not numerous. By contrast, the cohorts entering the labour force were numerous due to a baby boom in the 1980s. However, over the coming years the situation will reverse as the trends will be exactly the opposite.

Figure 2.5 / Population pyramid of Belarus, 2013



Source: National Statistical Committee of Belarus.

A small spike in the cohort of 0-4 years old is mostly driven by the cohorts of females aged 20-24 and 25-29. However, these relatively large cohorts in childbearing age will be followed by significantly smaller cohorts born in the 1990s. Hence one can expect the number of newly born children to decrease again.

Another important demographic trend is urbanisation – the internal migration from the rural areas to the cities. While only 55.9% of the population resided in cities in 1980, by 2014 this number had risen to 76.8%.⁹⁴ All the cities-regional centres in Belarus have increased their population. The population of Minsk, for example, grew 17% between 1990 and 2013 and accounts for over 20% of the total Belarusian population.

The demographic trends pose important policy challenges as regards the labour market, the social security and the pension systems.

⁹² http://www.belstat.gov.by/ofitsialnaya-statistika/socialnaya-sfera/demografiya_2/g/chislennost-i-estestvennyi-prirost-naseleniya/

⁹³ UN (2015).

⁹⁴ Belstat (2014).

The labour market: flexible, but unprotected

The labour market in Belarus has some specific and, to some extent, unique features: on the one hand, it is characterised by flexibility in terms of the duration and conditions of the employment contracts and, on the other hand, by excessive regulation generating rigidities. Moreover, the availability of employment opportunities has been an important part of the social contract in Belarus; however, this part of the contract is unravelling at present, as the economy faces the need for painful restructuring and adjustment.

The principal declared objective of public labour market policies has been the access to jobs for everyone as well as rising personal income, in the first place through wage growth, in the absence of significant wage differentials. The main policy instrument to target the desired wage levels has been the wage scale regulating the salaries for every profession. Following this wage scale is not mandatory, and many state-owned and private enterprises only use it as a benchmark for salary formation. In this case the wage scale shapes the basic portion of the salary, while the rest is qualified as surcharge or wage bonus for work experience, good performance etc. However, given the extent of the role of the state in the economy, the wage scale still affects the wages for almost everyone.

The effects of the policy of low wage differentiation are two-fold. On the one hand, this policy contributed to low income inequality, which is atypical even of a transition economy. On the other hand, this policy has created certain disincentives for the employees as it does not motivate sufficiently self-development and promotion.

The government used the wage scale quite efficiently as a tool to increase wages even when the economic conditions were not conducive to such increases. As can be seen from Figure 1.10 in Chapter 1, real wages and labour productivity did not always go hand in hand. Election years were usually accompanied by observable effects of the political cycle: excessive wage growth which, in turn, stimulated demand and economic activity.⁹⁵ However, as already discussed, in 2009-2010 this practice led to an overheating of the economy and a currency crisis. Despite this, real wages continued growing faster than labour productivity over 2012-2014, leading to another substantial exchange rate crash in 2015. 2015 also became the first election year after 2000 when real wages actually declined.

Another part of the problem has been the fact that the authorities, at least implicitly, used to set wage targets in US dollar equivalents and those targets were among the central objectives of socio-economic development. For example, the big goal of the 2005-2010 period was to reach an average wage equivalent of USD 500. For the year 2015, the goal was even more unrealistic: the equivalent of USD 1000.⁹⁶ Of course, these goals made the government push for quick wage growth and the disproportional wage hikes were among the key reasons for macroeconomic destabilisation.

The policy desire to raise wage levels was partly related to external pressure as Belarus is part of the single labour market of the Eurasian Economic Union (see Chapter 3). In this labour market workers may move almost freely: the labour market rights of the citizens of Russia, Kazakhstan and Belarus are the same in each market, and there are no special permits or other administrative difficulties accompanying the hiring of applicants from member countries of the Union. Access to the Russian

⁹⁵ Haiduk (2007).

⁹⁶ De facto the average wage in 2015 was only USD 424.

labour market was always particularly important as it has always been ready to absorb Belarusian applicants. This arrangement was beneficial for Belarus as labour demand was asymmetric: due to wage differentials (Russian wages being traditionally higher) not many Russians wanted to come and work in Belarus. This relieved the policy concern of the Belarusian authorities as regards unemployment as the jobless could always find employment in Russia. Plus, the remittances from the labour migrants were substantial: in the peak year 2012 inward remittances reached 1.5% of GDP.⁹⁷

After the almost three-fold devaluation in 2011 the situation regarding labour migration to Russia worsened. The dollar-denominated wage differentials between Belarus and Russia grew, and in several industries it surpassed the margin of two. Many Belarusian workers, particularly those working in manufacturing, education and healthcare, sought to find jobs in Russia.⁹⁸ Thus the Belarusian government decided to counter the exodus by increasing wages in 2012-2014 which, however, fuelled inflationary pressure and macroeconomic instability. The economic crisis of 2015 hit both Russia and Belarus, forcing some of the labour migrants to return home, where they also have difficulties finding employment.

There are two types of employment contracts in Belarus: permanent and fixed-term. Most of the employers prefer the fixed-term contract, with the usual duration of one year. This contract does not carry commitments for renewal of the employment after its expiration. It also allows dismissing an employee with only three-month severance payment if the occupied position is abolished. Since the independent union movement in Belarus is hardly developed due to political reasons, the fixed term contract has become widespread.

Due to the flexibility of the labour market in terms of contracts, employment over the years has gradually shifted from less productive and low-paid jobs in agriculture and manufacturing to the emerging and rapidly growing services sector. Despite the growth in total employment from 4,444 thousand in 2000 to 4,496 thousand in 2015, employment in manufacturing over the same period fell by almost 16% and employment in agriculture by almost 36% (Table 2.8). Thanks to this flexibility in the labour market, there has been a relatively frictionless redeployment of labour from less productive industries to more productive ones.⁹⁹

Table 2.8 / Employment and unemployment in Belarus, thousands of persons, 2005-2015

	Total employment	Registered unemployment rate, %	Employed in agriculture	Employed in manufacturing
2000	4443.6	2.1	674.0	1249.3
2005	4414.1	1.5	532.2	1213.5
2010	4703.0	0.7	492.2	1182.9
2014	4550.5	0.5	430.7	1102.4
2015	4496.0	0.7	434.0	1051.0

Source: National Statistical Committee of Belarus.

⁹⁷ Valetka (2013).

⁹⁸ Akulava et al. (2013).

⁹⁹ Kruk and Bornukova (2014).

The Belarusian official statistics only report registered unemployment figures, which are traditionally low, below 1% in recent years. Obviously registration does not reflect the true extent of unemployment, especially in Belarus, where unemployment insurance is extremely low (below 10 EUR per month in Minsk in 2015), and registered unemployed are often required to perform social works (such as sweeping the streets). In 2012 the Ministry of Labour started labour force surveys following the ILO methodology; however, these estimates are rarely published as unemployment is a politically sensitive topic. Some leaked estimates show that ILO unemployment is not high either: it was around 3.5% in 2013.¹⁰⁰

In 2015, the Belarusian authorities introduced a rather unorthodox labour market instrument: a 'tax on the unemployed' according to which those who are not employed and not registered as unemployed should pay a levy. The tax is supposed to charge 'free riders' for the social services they receive from the state and counter shadow employment. Apart from its controversial nature, the timing of the introduction of this tax was rather inappropriate: in 2015 employment was negatively affected by the crisis and bankruptcies in many SOEs, and newly unemployed also faced the risk of being penalised by the new tax.

Human capital in Belarus is relatively high. The Human Development Indicator of 0.798 puts Belarus in a high human development category, in 50th place out of the 188 countries¹⁰¹ and placed above the average for Europe and Central Asia. This favourable result is largely due to the level of educational attainment: almost half of the employed persons either have a university degree (27.4% in 2013) or have graduated from a post-school professional/vocational institution (22.5%). These shares have been increasing over time and this rising trend is expected to continue as the majority of school graduates continue their studies. Despite the high average educational attainment in the labour force, employers often cite the lack of skilled labour as a barrier to growth, claiming skills mismatches between what is provided by the education system and market demand.¹⁰²

Gender equality: the heritage of the Soviet Union will not last long

The Soviet Union promoted gender equality in the workplace, and Belarus is still enjoying this legacy of the past. Female labour force participation is 62% among females aged 15-62, which corresponds to the OECD average. The Gender Equality Index produced by UNDP positions Belarus on 28th place out of 152 countries. This result is driven by the relatively good performance in two indicators: high female labour force participation and low maternal mortality. Females are also well-represented in the corporate structures, with 44% of firms having female participation in ownership.¹⁰³

On average, females have higher educational attainment than males and the ratio of girls to boys in tertiary education reaches around 140%. However, educated females tend to dominate in relatively low-paid sectors such as education, social services and health care. The rapidly growing services sector is also dominated by women, while males take the majority of jobs in manufacturing and construction.

¹⁰⁰ Valetka (2014).

¹⁰¹ UN (2015).

¹⁰² IPM (2015).

¹⁰³ World Bank (2015b).

Also, Belarus remains largely a traditional patriarchal society with the culture giving a woman the role of mother and housewife. This cultural role model is also promoted by government officials and the President in an effort to promote family values and increase fertility. Ironically, the preferential treatment of women in some social programmes also leads to their discrimination in the labour market. Thus the retirement age for women is five years earlier than for men, quoting the Minister of Labour, 'to compensate for the hard work at home'. Women are also entitled to a three-year maternity leave. These policies lead to the reluctance of employers to hire women, as they face the risk of maternity leave(s) and early retirement.

The gender wage gap in 2015 was around 24%¹⁰⁴ and it tends to grow over time. There are several possible explanations to this. First, wages are growing more rapidly in the sectors where male employment dominates, such as manufacturing. Second, in areas where females are more numerous, the higher-paid positions also tend to be occupied by males so the gender wage gap actually increases (this is particularly true for social services where the gender gap is higher than average). Third, some gender-biased policies unintendedly lead to the discrimination of women in the labour market.

The social contract in need of rethinking

Economic development and growth in Belarus during the past two decades were pro-poor, delivering some benefits of growth to everyone, decreasing poverty and preventing high inequalities in the society. The 'social contract' (see Chapter 1) was quite peculiar: the government did not rely on targeted handouts to the vulnerable groups but instead sought to provide everyone with opportunities to find a job, offered a wide range of complimentary services (such as healthcare and education) and subsidised some prices and tariffs.

Economic growth during the 2000s delivered benefits virtually to all Belarusians. The average real disposable income saw a 4-fold increase between 2000 and 2015 (Table 2.7). This rise in incomes was not accompanied by an increase in inequality (in part due to the wage controls), but resulted in a significant decrease in poverty rates. Absolute poverty contracted from 41.9% in 2000 to only 5.1% in 2015. The share of food expenditure, an indirect measure of living standards, also shows significant improvement.

Table 2.9 / Real incomes and poverty in Belarus, 2000-2015

	Real disposable income, 2000 = 100	Absolute poverty rate, % of population	Share of food in household expenditures, %
1995		38.4	60.1
2000	100.0	41.9	58.0
2005	173.2	12.7	42.4
2010	302.1	5.2	36.8
2014	426.0	4.8	39.2
2015	400.9	5.1	39.1

Source: National Statistical Committee of Belarus.

¹⁰⁴ Belstat (2016b).

At the same time attention should be drawn to another peculiarity of the social security system: Belarus is a socially-oriented state without unemployment insurance or unemployment benefits. Technically unemployment benefits for the registered unemployed do exist, but they are extremely low (around EUR 10 per month) and do not depend on the previous wage level. Moreover, to obtain the benefit the registered unemployed often have to participate in social or public works for free.

Healthcare in Belarus is complimentary, accessible and of adequate quality. There is no wide-spread health insurance system, mostly because until recently there was no need for it as most of the health services were offered for free. The World Health Organisation recently placed Belarus among the top countries in terms of access to healthcare and praised its achievements in lowering infant mortality.

Primary and secondary education in Belarus is also complimentary. Literacy levels are high as the gross enrolment ratio for primary education is 99%.¹⁰⁵ The transition rates into different forms of tertiary education are also high – over 89% of school graduates continue their education. Tertiary education is also subsidised but is not offered for free; however, tuition fees are relatively low, usually ranging between USD 500 and 1500 per year.

The government subsidises a number of services with the objective to make them accessible to lower-income people. The tariffs on utilities, public transport, culture, and many other services are subsidised as they do not cover costs. Up until 2011 the government subsidised the interest rates for loans to buy real estate. These subsidies were targeted to those with relatively low incomes and the need to improve their housing conditions. These subsidies acted as a replacement for the non-existent mortgage lending, allowing many to buy accessible apartments while (considering the inflation rates) paying negative real interest rates on the loan. As a result, Belarus has one of the best housing space indicators among the CIS countries, with 25.7 sq m per inhabitant compared to 23.4 in Russia.¹⁰⁶

However, as the economy slowed down after 2011, the government gradually decreased the social support, mainly by cutting down on subsidies, to some extent undercutting some of the building blocks of the social contract. There is an obvious need to reconsider the nature of the social policy package as the economy may be entering a prolonged period of lower growth. So far the shortage of funding has led to the retraction of social support here and there, with no safety net emerging to replace the 'subsidies for everyone' approach. The major challenge today is to create a new social contract and establish a new safety net instead of the old one.

The subsidies for real estate lending have been significantly cut: only large families now have access to it. At present there is no alternative mechanism to acquire housing as mortgage lending still does not work. Many of the advanced health services are no longer free, but there is no health insurance for those who want to mitigate health risks. The level of subsidies for tuition is declining, but there is no institution providing loans for education. Unemployment benefits are very low, but now the state cannot continue to support excessive employment and will have to restructure the SOEs, putting more people in unemployment.

¹⁰⁵ World Development Indicators (2016).

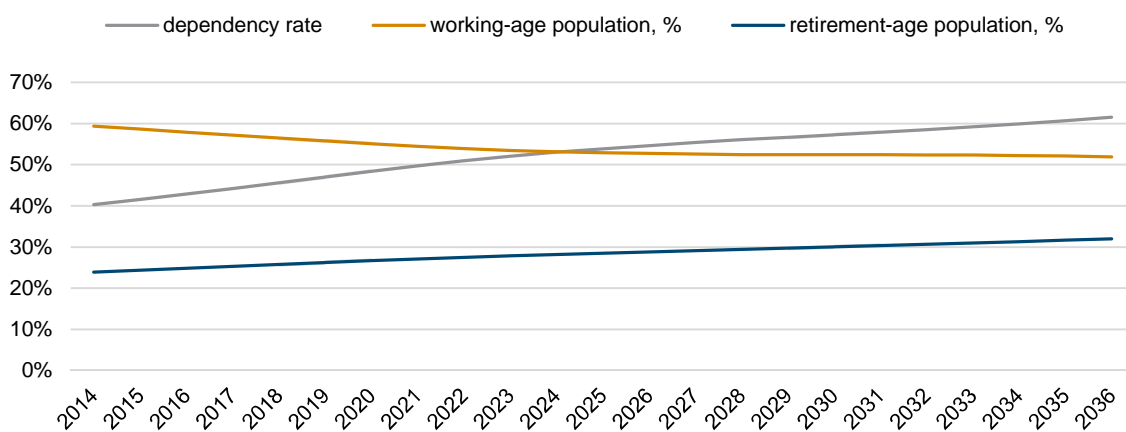
¹⁰⁶ Belstat (2015).

However, the crisis actually also presents an opportunity to revise the whole set of social policies and increase their efficiency. Subsidisation policies are obviously not efficient as they provide support for everyone instead of targeting those in need. Moreover, people with higher income and consumption levels de facto get more benefits from subsidies. Hence it might be beneficial to move from the subsidies-based social support system to a system of targeted means-tested welfare.

The process of transformation of the social system speeded up in 2015-2016 under the pressures of economic hardship and international creditors. Until then, heating tariffs for the population were heavily subsidised in Belarus, with the tariffs covering only 10-20% of total costs. Other utility tariffs are heavily subsidised as well. These subsidies are only partially covered by the budget and a significant part of the burden falls on the enterprises which have to pay higher tariffs. In 2015 and 2016, utility tariffs were gradually increased; however, estimates show that the relative burden of higher tariffs will mostly fall on low-income groups and retirees.¹⁰⁷ In particular, if heating tariffs were to be increased to 100% of the costs, households from the lowest income quintile will have to spend over 16% of their income on heating.¹⁰⁸ However, the government still has not introduced the plans of targeted social assistance in utility tariffs, despite talks about plans to introduce it.

The demographic changes and population ageing also pose important policy challenges, in particular, to the pension system. As the proportion of the working-age population in Belarus is projected to decrease, the dependency ratio (the number of persons of retirement age per 100 persons of working age) would increase from 40% at present to over 60% by 2036 despite the expected increase in the retirement age (Figure 2.6).¹⁰⁹

Figure 2.6 / Dependency rate*) and population ageing in Belarus, 2014-2036



*) Number of persons of retirement age per 100 persons of working age.

Source: Bornukova et al. (2015).

The pension system in Belarus is a standard one-pillar pay-as-you-go scheme: the current working-age population pays social security contributions that finance current pension expenditure. At present Belarus has the lowest retirement age in Europe: 55 years for females and 60 years for males. The

¹⁰⁷ Shymanovich (2015).

¹⁰⁸ Zhang and Hankinson (2015).

¹⁰⁹ Bornukova et al. (2015).

retirement age (as well as the pension system in general) did not change from that in Soviet times. The contribution rate of 29%, on the other hand, is among the highest in Eastern Europe. The pension system is quite generous: in 2013 the average pension benefit exceeded the poverty level 2.54 times, and constituted 38% of an average wage.¹¹⁰

Up until 2013 the Pension Fund was operating at a small surplus, benefiting from the favourable demographic conditions as discussed above. But after 2013 the situation started to change, as the largest cohorts started entering retirement. Several independent studies have estimated that if policies do not change the Pension Fund may incur significant deficits in the future, reaching up to 9% of GDP by 2050.¹¹¹

In response to the demographic challenges, the government has decided to increase the retirement age by three years starting from 2017. The increase will take place over six years (until 2022) in half-year increments. The increase in the retirement age is the only parametric reform at hand: the contribution rate is already quite high, while the replacement rate is low. However, the proposed raising of the retirement age will not be sufficient for the Pension Fund to break even beyond 2022; hence further increases in the retirement age can be expected in the future. A more profound pension reform would entail a transition to a fully-funded pension system and this will also need to happen at some future point.

The healthcare system will have to prepare to address a greater burden of chronic and degenerative diseases. Fewer children and further urbanisation also mean that the school structure will have to be optimised, especially in the rural areas, where the number of pupils in a class is usually very low.¹¹²

In summary, the previously existing social contract in Belarus is probably in a process of unravelling or transformation. In an effort to cut public expenditure, the state is withdrawing or reducing many types of social support, which mainly came in the form of subsidies. On the other hand, the crisis opens up a way to make the social welfare system more efficient, means-tested and evidence-based. In aggregate, the transition from subsidies to targeted means-tested support might have positive welfare effects. At the same time, there is a dire need for the fast introduction of adequate new safety nets replacing the previous subsidies which are being withdrawn. The most urgent tasks in this area are the comprehensive overhaul of unemployment insurance providing adequate coverage of the risk of job loss and a system of targeted assistance to the social groups most hurt by utility tariff increases.

¹¹⁰ Lisenkova and Bornukova (2015).

¹¹¹ Ibid, Zviniene and Biletsky (2011).

¹¹² World Bank (2013).

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3. Trade and international economic relations

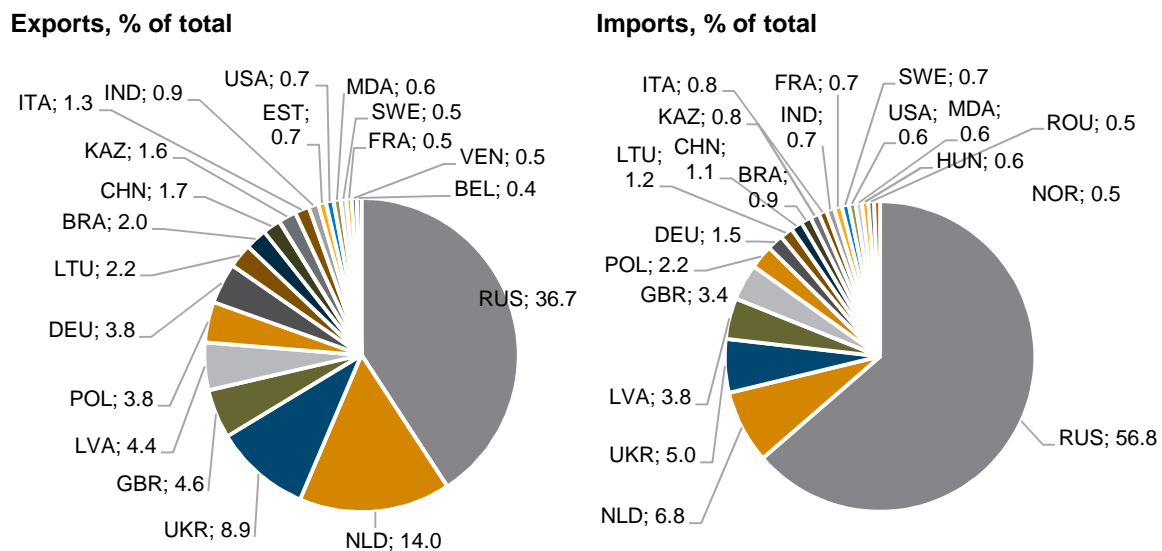
BY AMAT ADAROV, PETER HAVLIK, GÁBOR HUNYA AND OLGA PINDYUK

TRADE IN GOODS

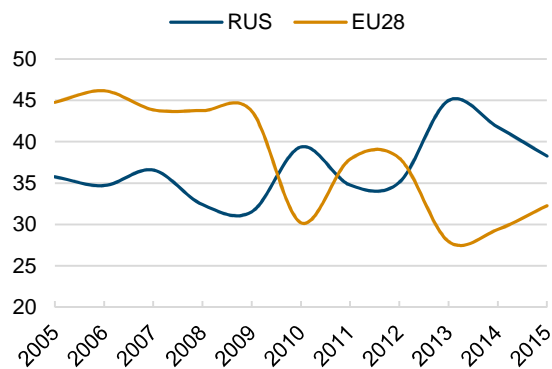
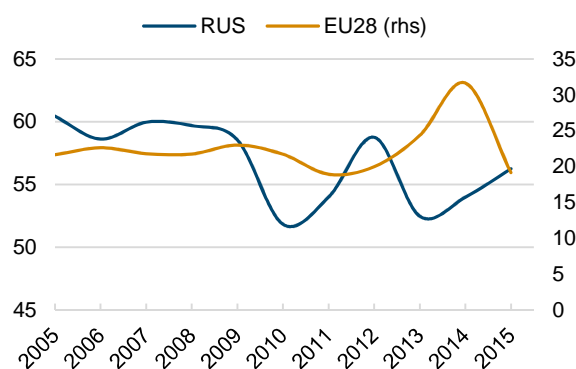
Recent developments

Historically Russia has been the most significant trading partner of Belarus (Figures 3.1 and 3.2), both in terms of exports – over a half of total, and imports – over a third of total. The EU-28 has also been prominent as a destination for exports (10-year average share amounts to 39% of total exports), as well as a significant origin of imports (22%). Asymmetries in the geographic composition of Belarus’ trade have been accompanied by disproportions in their industrial composition. While exports to Russia are relatively diverse, comprising, besides commodities and agricultural/food products, also transport equipment and machinery, imports are dominated by petroleum products. By contrast, exports from Belarus to the EU are mostly comprised of mineral fuels, while imports are formed by more advanced goods, including chemical products, machinery and transport equipment.

Figure 3.1 / Top 20 trading partners of Belarus, average 2005-2014

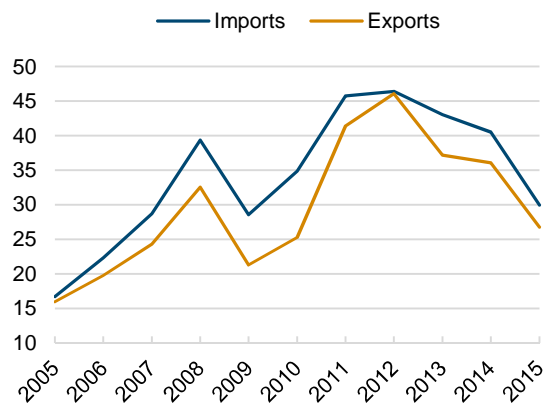


Source: wiiw calculations based on UN Comtrade data.

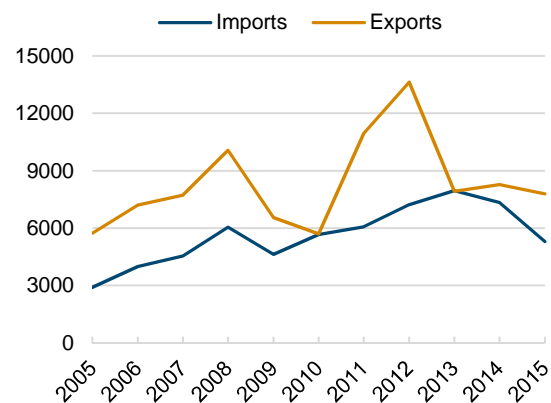
Figure 3.2 / Share of Russia and EU-28 in total trade of Belarus, 2005-2015, %**Share in total exports****Share in total imports**

Source: wiiw calculations based on UN Comtrade data.

The dynamics of Belarus' trade flows has been largely following the business cycle of Russia and that of Belarus itself. While the overall trade balance has been persistently in the negative zone, Belarus traditionally recorded a trade surplus with the EU (Figures 3.3 and 3.4).

Figure 3.3 / Foreign trade of Belarus, 2005-2015, billion USD

Source: UN Comtrade.

Figure 3.4 / Foreign trade of Belarus with the EU, 2005-2015, million EUR

Source: Eurostat Comext.

Trade with Russia was already largely liberalised prior to the inception of the Eurasian Customs Union (see below) and Eurasian integration did not have much impact on trade volumes. Yet, as a result of the global economic and financial crisis as well as trade diversion effects pertaining to the customs union, the share of Russia in total exports has exceeded that of the EU in recent years (in general, there is a marked negative relation between the two) (Figure 3.2). High dependence on the Russian market intensified by the Eurasian integration represents a double-edged sword for the Belarusian economy. Close integration with Russia served Belarus well during the 2000s when high and rising oil prices boosted growth in Russia, and Belarus benefited from its robust import demand. However, as Russia slipped into a deep recession in 2015 on account of sharp oil price declines complemented by an array

of Western sanctions and rising geopolitical risks, the economy of Belarus suffered a strong negative shock.

As a result of the severe weakening of the Russian rouble in late 2014 (the currency lost half of its value), Russian producers gained a competitive edge vis-à-vis other partners in the Eurasian Economic Union (EAEU) squeezing Belarusian producers even in the domestic markets. In response, and unable to withstand pressures on foreign exchange reserves, Belarus also devalued sharply its currency, thus regaining price competitiveness, and attempted to move to a more flexible currency regime – consistent with the EAEU strategy to facilitate cross-country coordination of macroeconomic policies.

According to the official statistics, Belarus' total trade turnover in 2015 amounted to USD 56.8 billion (exports = USD 26.6 billion, imports = USD 30.1 billion)¹¹³ and declined by more than 25% relative to 2014. Both nominal exports and imports declined by about a quarter over the year, and the trade balance remained negative. Yet, in real terms, whereas imports declined in 2015 by 11.3% relative to 2014, exports actually increased by 2.4% owing to terms-of-trade adjustments (export prices dropped by 27.8%, import prices declined by 15.6%)¹¹⁴.

The trade balance with CIS countries turned negative in 2015 (– USD 3.1 billion) and that with non-CIS countries was positive (+ USD 0.8 billion), due to import contraction outpacing reduction of exports in nominal terms. Trade with Russia also declined significantly: exports by 31.6%, imports by 23.4%, the overall trade balance being negative. In contrast, trade with the EU remained in surplus (EUR 2 billion in 2015).

Composition of trade flows and international competitiveness of Belarusian industries

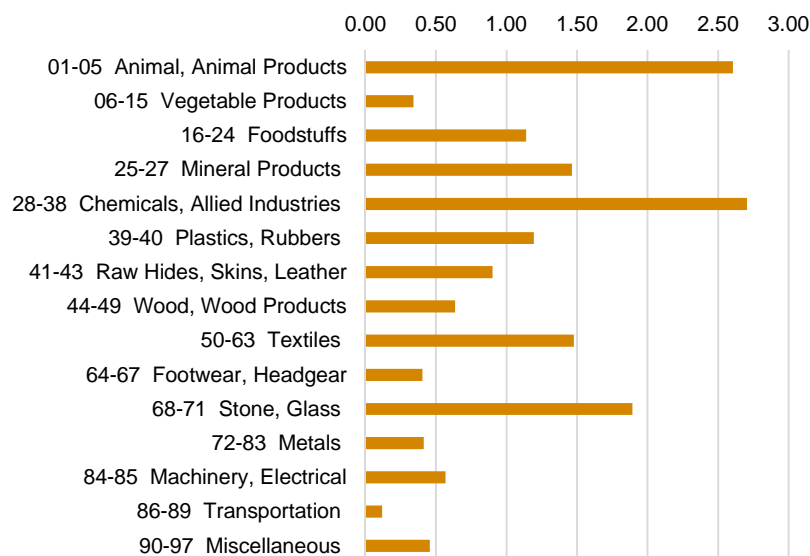
Belarus' exports are mostly concentrated in the extractive sectors, agriculture/food processing and some manufacturing sectors (see Annex Table 3). HS industry 27 (Mineral fuels) has traditionally dominated both exports and imports as the key commodity group, constituting over a third of the country's total trade with a wide gap from other products. Belarus inherited large oil refineries from the Soviet Union and processes crude oil coming from Russia into refined fuels, gasoline, etc., to be further exported to the EU. While fertilisers rank second in exports, some more advanced industries – machinery and transportation equipment – are also in the top 5 most important products both in terms of export and import shares.

Over time, the share of primary commodities in Belarusian exports has been gradually increasing and squeezing the share of manufacturing exports that could only find a market niche predominantly in the CIS region. The global competitiveness of Belarusian industries (as measured by the widely used index of revealed comparative advantage, see Figure 3.5) is mostly concentrated in agricultural and food products, as well as chemicals.

¹¹³ State Customs Committee of Belarus, http://gtk.gov.by/ru/stats/itogi_vnesh_torgovli2015/

¹¹⁴ Belstat, http://www.belstat.gov.by/ofitsialnaya-statistika/makroekonomika-i-okruzhayushchaya-sreda/vneshnyaya-torgovlya_2/operativnye-dannye_5/ob-itogakh-vneshney-torgovli-tovarami/

Figure 3.5 / International competitiveness of Belarusian industries: revealed comparative advantage index¹¹⁵



Source: Own calculations based on the UN Comtrade data.

The textiles and stone/glass commodity groups also appear to be rather competitive, although this is mostly the result of exports to Russia and the rest of the CIS. Belarus can boast a relatively more diversified industrial structure within the EAEU with much of the manufacturing capacity retained from the Soviet era. However, over the course of the recent decade, the competitiveness of the relatively more advanced sectors has been deteriorating despite protectionist measures imposed under the EAEU framework, as well as targeted state interventions to support high value added sectors. In this respect, Belarus is a case in point against the 'infant industry' argument, particularly relevant in the context of the EAEU bonding countries with similar development bottlenecks associated with insufficient modernisation of industries, weak infrastructure and institutions. Essentially, the dichotomy in the specialisation patterns of Belarusian trade with Russia on the one hand and the EU on the other hand did not change much during the last decade.¹¹⁶

TRADE IN SERVICES

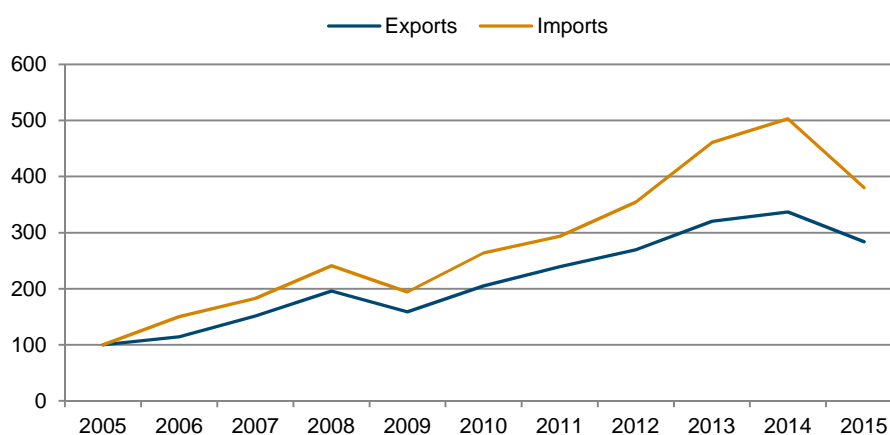
Services trade in Belarus has been accounting for an increasing share in total foreign trade: according to NBRB data, during 2005-2015, the share of services in total exports increased by almost 7 p.p. to 20.2%; as regards imports, the share of services in total imports increased by 6.6 p.p. to 13.3%. Both exports and imports of services have been growing steadily during the whole period with a drop in trade only taking place in the crisis year of 2009 and more recently in 2015 (Figure 3.6). Services imports have outpaced exports in terms of their growth rate, but in value terms, exports are still about 50% larger than

¹¹⁵ The RCA index, based on Balassa (1986), measures the comparative advantage of country *c* in industry *i* in year *t*, and is constructed as follows: $RCA_i = \frac{x^{(i)c}/X_c}{x^{(i)w}/X_w}$, where *x*(*i*) is the value of exports of industry *i*, and *X* is the total value of exports from country *c* or from the world (*W*). A country reveals a comparative advantage in a particular industry *i* if its RCA index in that industry is greater than unity. (Balassa, 1986.)

¹¹⁶ See Havlik et al. (2012) and Havlik (2007).

imports (see Annex Table 1). The positive balance in services trade contributes significantly to decreasing the current account deficit that the country has been running since 2006.

Figure 3.6 / Dynamics of Belarus' total trade in services, 2005-2015, index of nominal change, %, 2005 = 100



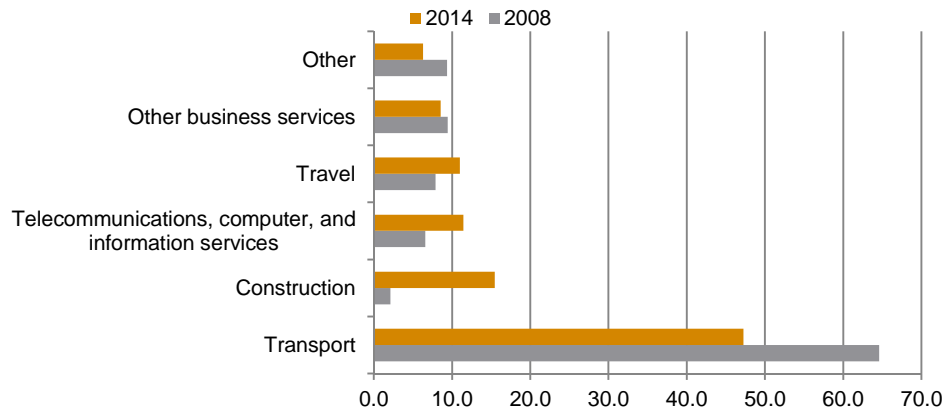
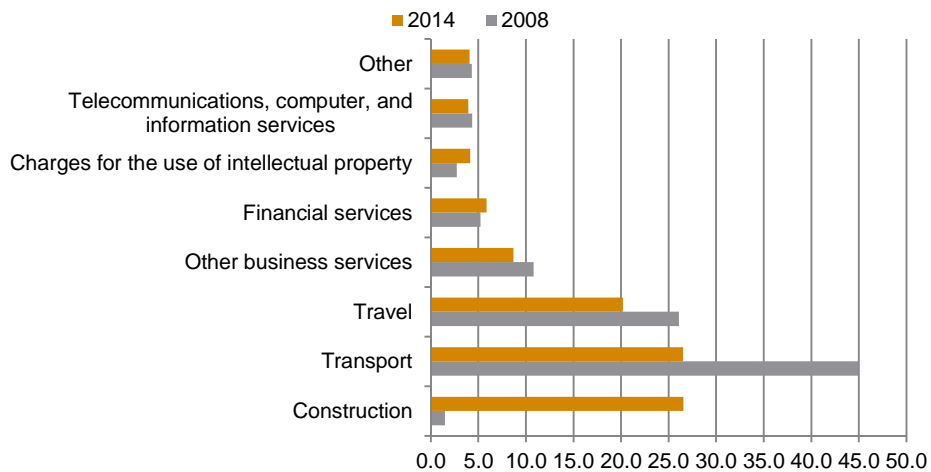
Source: National Bank of Belarus.

In terms of their composition, services exports are dominated by the transports sector, with freight transportation via railway, motor transport and pipelines being the key modes of transport. The importance of transportation has however decreased over time, and its share in total services exports fell from 64.6% in 2008 to 47.2% in 2014 (see Figure 3.7a). Instead, the country has increased its relative specialisation in construction services – with the exports share growing from about 2% in 2008 to more than 15% in 2014. Also, the ICT and travel sectors increased their shares in total services exports to double-digit levels in 2014.

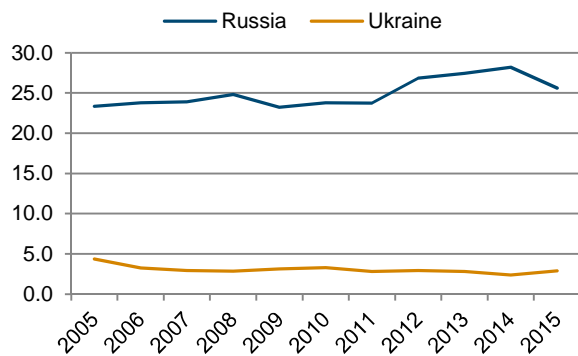
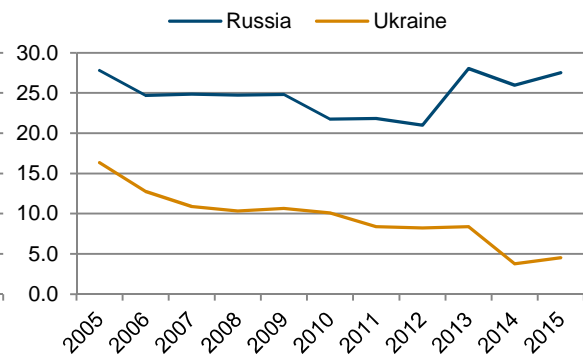
Construction services have become quite significant also on the import side; the sector accounted for the highest share in services imports in 2014 – 26.6% (Figure 3.7b). The two other top sectors in terms of import shares are transport and travel, their shares however decreased noticeably during 2008-2014 – by 18.5 p.p. to 26.5% and by 5.9 p.p. to 20.2%, respectively. Imports of financial services and charges for intellectual property slightly grew in terms of shares, but the sectors are still accounting for rather small shares in total services imports.

Data on the geographic structure of Belarus' services trade are rather scarce, but the available data point to a lower importance of the EAEU as a source of or destination for the country's services trade as compared to goods trade. Available data from the UN Services Trade database¹¹⁷ show that in 2011 the EU accounted for the bulk of Belarus' exports and imports of services, with the neighbouring countries Lithuania and Poland being the top trading partners.

¹¹⁷ <http://unstats.un.org/unsd/servicetrade/default.aspx>.

Figure 3.7 / Sectoral composition of Belarus' trade in services, 2008 and 2014**a. Exports****b. Imports**

Source: National Bank of Belarus.

Figure 3.8 / Shares of Russia and Ukraine in Belarus' trade in services, %, 2005-2015**Exports****Imports**

Source: National Bank of Belarus.

Figure 3.8 shows the dynamics Belarus' trade in services with Russia (Ukraine is also shown for comparison). Russia has been accounting for about 25-30% of both exports and imports of services during 2005-2015, and these shares did not change much over time. In 2015, Russia accounted for 95.2% of Belarus' services exports directed to the EAEU, for imports the figure was 97.6%.

Ukraine is a relatively minor market for Belarus' services exporters, accounting for less than 5% of exports. The situation was different with respect to imports of services, where Ukraine's share exceeded 16% in 2005, but it was steadily declining and was below 5% in 2015.

FOREIGN DIRECT INVESTMENT

The Belarus economy has been based on state ownership and over-regulated conditions for private investors. But since 2007 the authorities have undertaken some liberalisation measures and have given space for the development of the private sector. This was also the starting point when foreign investors were provided with basic freedom and security standards. 2008 marked the beginning of a new privatisation phase; investment incentives were introduced and the network of free economic zones expanded.¹¹⁸ The new privatisation programme targeted foreign investors and the golden share rule was removed so that private investors could get control over former state-owned enterprises (SOEs). Economic difficulties and deepening recession have deterred FDI in the past two years despite increasing government efforts.

The FDI statistics methodology improved after 2007 and data are now available based on the IMF Balance of Payments Manual Revision 6 (BPM6) from 2008 onwards¹¹⁹ (Table 3.1; for longer time series and outward FDI see Annex Table 4).

Table 3.1 / FDI inflow and inward FDI stock in Belarus, 2008-2015

FDI inflow

	2008	2009	2010	2011	2012	2013	2014	2015
EUR million	1544	1321	1041	2787	1110	1690	1418	1444
EUR per capita	162	139	110	294	117	179	150	152
in % of GDP	3.6	3.8	2.5	7.6	2.3	3.1	2.4	3.0
in % of GFCF	10.9	10.7	6.4	19.8	6.7	8.2	7.1	10.4

Inward FDI stock

EUR million	4778	5952	7479	10048	11011	12120	14617	16440
EUR per capita	502	627	789	1062	1164	1280	1542	1731
in % of GDP	11.2	17.3	18.2	27.2	22.4	22.1	24.8	33.7

Note: BPM6, directional principle.

Source: wiiw FDI Database relying on national sources.

FDI inflow in Belarus was marginal before 2007, but since 2008 annual inflows have been fairly stable, amounting to about EUR 1.5 billion per year. Lower inflows were reported in 2010 and 2012 but were

¹¹⁸ UNCTAD (2009).

¹¹⁹ wiiw FDI Database. Official Belarus sources usually quote data on gross FDI in USD terms; <http://www.economy.gov.by/en/investors/lqoty-preferencii/FIGURES>.

levelled out by higher sums in 2011. After controlling for the size of the country, Belarus has received more FDI than Moldova and Ukraine but less than the new EU Member States. The inflow of about EUR 160 per capita in Belarus is three times higher than in Moldova and two times higher than in Ukraine; but it is lower than in its Western neighbours Lithuania (EUR 185) and Poland (EUR 200). However, the FDI inflow per GDP or per GFCF has been higher in Belarus than in Lithuania or Poland.

Due to the relatively short history of FDI, FDI stocks have reached lower levels than in countries with a longer FDI history. The FDI stock per capita in Belarus (EUR 1,751 in 2015) amounted to less than 40% of the Polish and Lithuanian level while the difference in terms of FDI stock per GDP is only 15%. The poorer Southern peers, Moldova and Ukraine, have much higher FDI stocks per GDP than Belarus. One may conclude that the dependence of the Belarus economy on FDI is still smaller than in the case of its neighbours.

Table 3.2 / FDI inward stock by country of origin, 2009 and 2014

		2009	2014	2009	2014
		EUR mn	EUR mn	% of total	% of total
1	Russia	3455.6	8359.9	58.1	57.2
2	Cyprus	503.0	2322.3	8.5	15.9
3	Austria	147.4	507.4	2.5	3.5
4	Netherlands	153.3	363.3	2.6	2.5
5	Germany	141.7	250.7	2.4	1.7
6	United Kingdom	120.1	241.9	2.0	1.7
7	Switzerland	39.8	228.1	0.7	1.6
8	Iran	34.4	205.4	0.6	1.4
9	Italy	12.1	169.0	0.2	1.2
10	China	1.9	139.0	0.0	1.0
11	Estonia	81.7	136.8	1.4	0.9
12	Latvia	67.0	119.1	1.1	0.8
13	United States	86.6	116.9	1.5	0.8
14	Poland	40.5	116.1	0.7	0.8
15	Lithuania	46.4	99.6	0.8	0.7
16	Finland	19.3	85.7	0.3	0.6
17	Lebanon	39.3	77.0	0.7	0.5
18	Ukraine	31.9	66.6	0.5	0.5
	Other	930.1	1011.9	15.6	6.9

Note: Countries with at least 0.5% of FDI stock, BPM6, directional principle.

Source: wiiw FDI Database relying on national sources.

FDI in Belarus is mainly of Russian origin. FDI from this country amounted to 57-58% of the stocks in both 2009 and 2014 (the earliest and latest years for which data are available, respectively). In addition, FDI from Cyprus is also in all likelihood of Russian origin, thus the direct and indirect FDI dependence on Russia is probably greater. The concentration of flows is even higher in outward FDI: 80% of the EUR 521 million outward FDI stock is located in Russia. The Russian connection constitutes the most important difference between Belarus and its peers. Neither Ukraine nor Moldova, not to mention the EU members, have any similar rate of Russian FDI flows and stocks.

The second most important investor by a large distance to Russia is Austria, which accounts for only 3.5% of the FDI stocks. One of the largest investment projects in the country is the Telekom Austria Group's acquisition of the local mobile telecom provider Velcom in November 2007. There are also other greenfield projects producing mainly for the local market (see Annex Table 4).

Some Western companies are finding their way to Belarus also through Russia.¹²⁰ Two major franchise chains, McDonald's and TGI Friday's, opened restaurants through their Russian franchise partner. The owner of the TGI Friday's franchise, the Russian company 'Rosinter Restaurants Holding', also owns the KFC franchise in Belarus. The franchise of Burger King in Russia called 'Burger Rus' operates the Burger King restaurants in Belarus.

A significant part of FDI has taken place in the framework of large privatisation transactions; joint ventures with state-owned enterprises and greenfield investments are rare. The sale of a 50% stake of the national gas transportation company Beltransgaz to the Russian Gazprom brought USD 2.5 billion to the FDI stock in four annual instalments through February 2010.

A major part of Belarus' industry is still state-owned. In 2016 the government announced public sales and tenders for shares in 60 state-owned companies. The list published by the State Property Committee includes 56 open joint stock companies and four enterprises as asset complexes. None of the economy's 'white elephant' enterprises are on the list and most such companies require financial support.¹²¹

Greenfield investment projects

The genuine foreign investment enterprises are those that start as greenfield investment projects. The low number of such projects (Table 3.3) is telling proof of the difficult business conditions in the country. According to the statistics, 2008-2013 were the years when Belarus was more attractive to foreign greenfield investment projects than before or thereafter. The number of projects fell in 2014-2015 when also the overall economic performance of the country deteriorated. The amount of pledged investments has fluctuated with no definite pattern (these data are also not very reliable as they are to a large extent estimated).

Table 3.3 / Greenfield FDI projects in Belarus

	Projects	Capex, million EUR	Jobs created
2015	11	688.2	3191
2014	7	263.3	1064
2013	22	808.7	3793
2012	16	521.9	1631
2011	29	874.9	3304
2010	36	1511.3	4872
2009	22	945.2	4905
2008	28	846.7	5054
2007	16	332.2	1592
2006	15	708.7	1566
2005	11	681.7	3624
2004	10	192.1	466
2003	15	755.1	1750
Total	238	9130.2	36812

Capex = investment capital pledged.

Note: Capex and job data include estimated values.

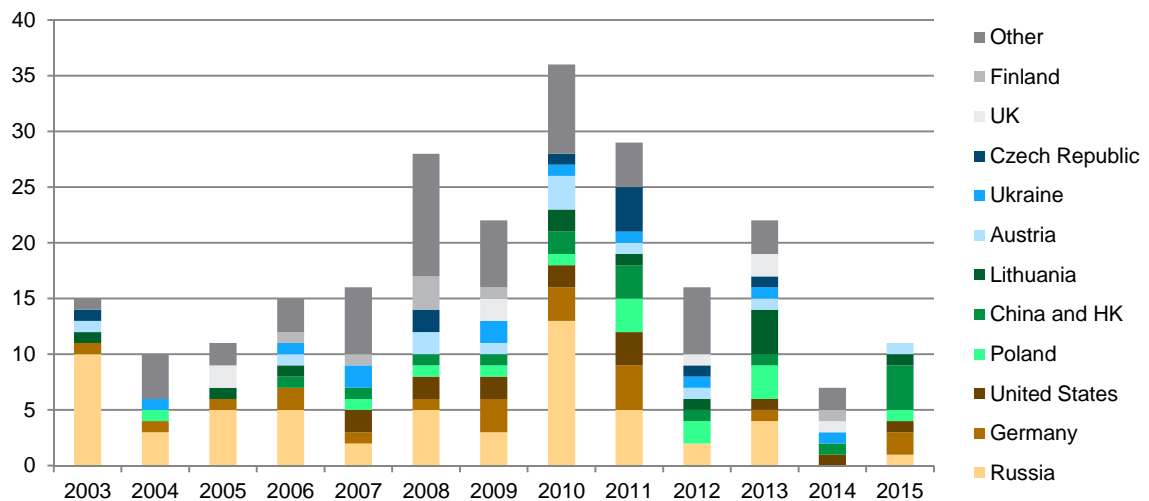
Source: fDi Intelligence, from the Financial Times Ltd 2016.

¹²⁰ <http://belarusdigest.com/story/investment-climate-belarus-room-growth-22914>

¹²¹ <http://www.financialobserver.eu/cse-and-cis/belarus/belarus-kick-starts-privatization-as-economy-stumbles/>

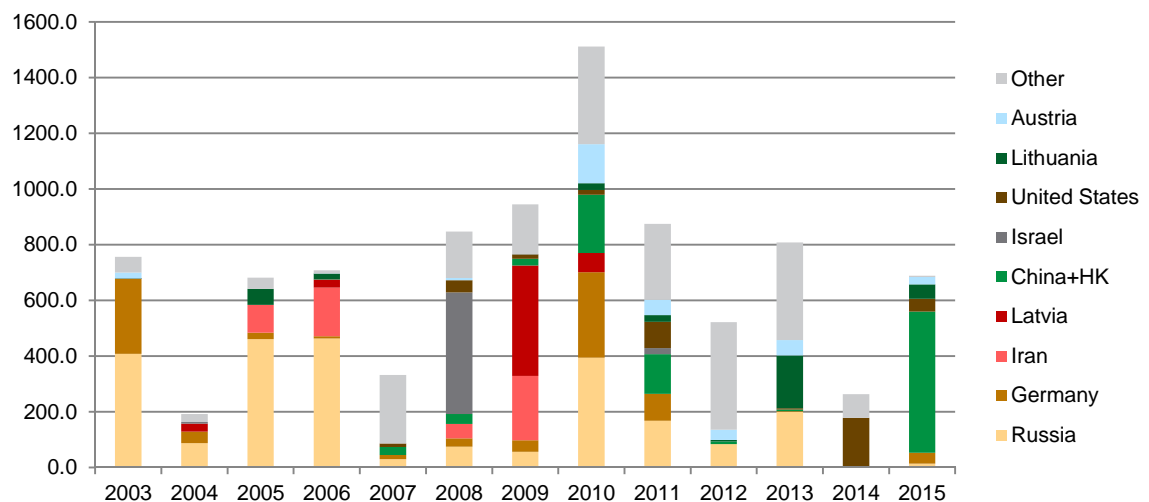
As to the greenfield investing countries, there has been some diversification in recent years away from the Russian dominance. More projects have been initiated by investors from Germany, the United States, Poland, China and Hong Kong (HK), Lithuania and Austria (Figures 3.9 and 3.10).

Figure 3.9 / Number of greenfield FDI projects by main investing countries



Source: fDi Intelligence, from the Financial Times Ltd 2016.

Figure 3.10 / Capital investment pledged in greenfield FDI projects by main investing country, million EUR

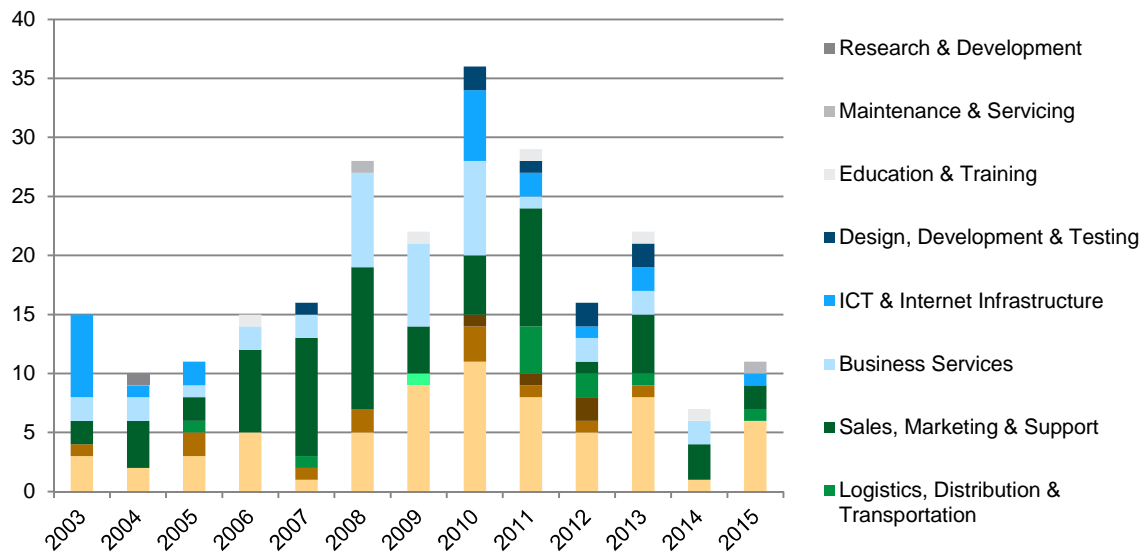


Source: fDi Intelligence, from the Financial Times Ltd 2016.

Manufacturing as well as sales and marketing are the most important business activities of greenfield investments. Modern services such as business services and five other categories (the top segments of the bars in Figures 3.11 and 3.12) comprise also important categories. These include domestic market telecom services as well as export-oriented IT development companies. Such ventures, which are less capital intensive by their nature, are usually under-represented in statistics based on investment value

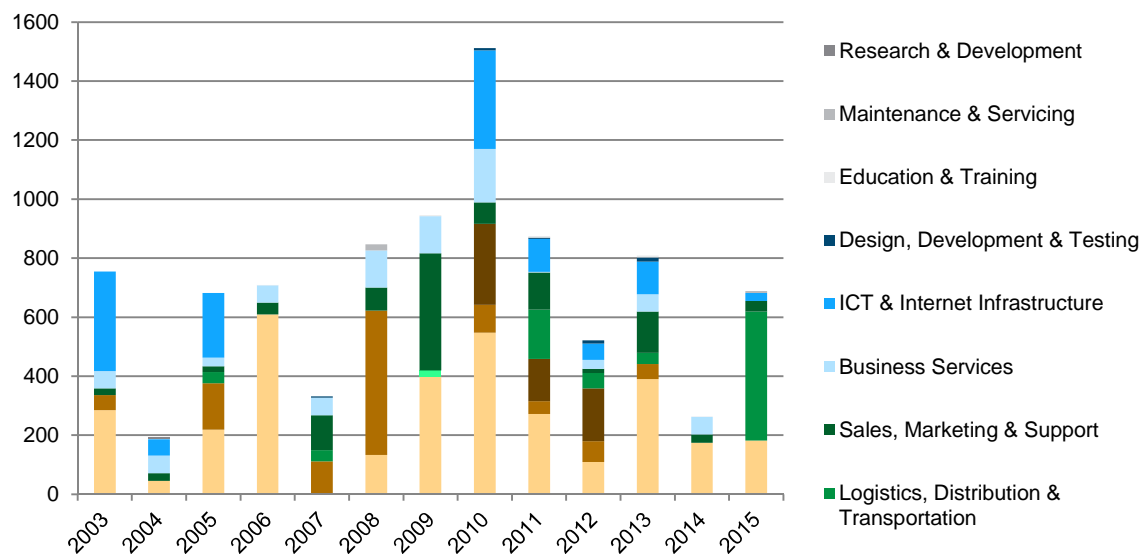
and show up in statistics by project number or employment. 2014 and 2015 were poor years in terms of greenfield FDI, especially in the services sectors, which probably suggests that potential investors have been deterred by the deteriorating economic situation in the country. A new feature for both Russia and Belarus is the growing interest of Chinese investors at least in terms of investment intentions if not in terms of completed and operational projects.

Figure 3.11 / Number of greenfield FDI projects by business activity



Source: fDi Intelligence, from the Financial Times Ltd 2016.

Figure 3.12 / Capital investment pledged in greenfield FDI projects by business activity, million EUR



Source: fDi Intelligence, from the Financial Times Ltd 2016.

Specific features of Belarus' FDI policy

A peculiarity of the FDI practice in Belarus is that state-owned companies usually form joint ventures (JVs) with foreign investors. As of 1 January 2015, there were 7,099 registered companies with foreign capital in the country of which 4,052 were JVs, 3,018 were foreign enterprises and 29 others.¹²² The total contribution of foreign investors in the statutory capital of enterprises with foreign capital amounted to USD 2,648.0 million (USD 1,267.8 million in joint ventures, USD 1,377.0 million in foreign enterprises and USD 3.2 million in others). Thus about the half of the registered foreign capital was in JVs. This FDI entry mode used to be favoured in transition economies in the first years of economic and political transformation, when the legal framework was in the course of being established and a dominant share of the economy was still under state ownership. JV is a somewhat vague concept and does not represent a specific corporate form. It is supported by the authorities in Belarus and China where one of the participants in the JV is the local government or an SOE.

A recent example of a joint venture entry is in car production. Chevrolet (Opel) will be assembled in Belarus by General Motors and Unison which itself was established as a Belarusian-British joint project.¹²³ Unison has been assembling Peugeot and Citroën as well as Chinese cars. Later the automaker Iran Khodro joined the JV whose small transporters were assembled in the factory. Further partners in the JV are the Belarus government and the Russian company Fenox Lada. General Motors announced in June 2015 its intention to transfer part of its Russian production capacity to Belarus after demand for Opel cars fell in Russia.¹²⁴

Most of the greenfield FDI projects are located in special economic zones. Three such forms exist in Belarus: six free economic zones (FEZ), a Chinese-Belarus industrial park and the Belarusian High-Technology Park. Special zones can be useful vehicles of FDI policy especially in countries with risky business environment and vague property rights. In these circumstances, proper conditions for investments can be established at least in a limited geographic area. The authorities can also attach special rights and incentives to such zones which is the case in Poland and also in Belarus.

The FEZ legislation provides companies settling in their territories with a number of incentives and special regulations.¹²⁵ They attract mainly export processing firms and storage facilities. Companies set up in the FEZ are exempted from profit tax for five years and pay half of the statutory rate for another five years. They enjoy a 50% discount on VAT on import-substituting goods manufactured within the FEZ. They are also exempted from a number of smaller taxes as well as from customs duties on raw materials and equipment. By 2014 close to 270 foreign businesses had taken advantage of these opportunities.¹²⁶

The Chinese-Belarus industrial park 'Great Stone' is a recently established territorial entity of 91,5 sq. km with a special legal status for the provision of comfortable conditions for doing business.¹²⁷

¹²² <http://www.economy.gov.by/en/investors/lgoty-preferencii/FIGURES>

¹²³ http://www.belarus.by/en/business/business-news/general-motors-to-assemble-chevrolet-or-opel-cars-in-belarus_i_0000010654.html

¹²⁴ <http://wardsauto.com/industry/general-motors-shifts-russian-production-belarus>

¹²⁵ <http://www.belarus.by/en/invest/investment-climate/free-economic-zones>

¹²⁶ Ibid.

¹²⁷ <http://www.economy.gov.by/en/investors/China-Belarus-Industrial-Park>

According to the master plan developed by Belarusian and Chinese institutions, production and living areas, offices and shopping malls, financial and research centres are to be located on the territory of the Park. Any company, regardless of the country of capital origin, can act as a resident of the industrial park.

The High-Technology Park is not confined to territory but provides a special status for high-tech companies. Eligible companies can be located anywhere in Belarus. The first residents were registered in 2006; by mid-2016, 152 companies had become Park residents. Half of these are foreign companies or joint ventures employing local IT specialists at relatively low (by international standards) wages. Technology companies that become 'residents of the High-Technology Park' are free from all taxes, including VAT, profit tax, and customs duties.¹²⁸ Individual income tax is fixed at 9% for the employees of resident companies. All these favourable conditions are to be effective at least until 2020. The IT industry is mostly export-oriented, exporting to the United States, the EU and Russia. In 2015 the exports of High-Tech Park residents reached USD 800 million, or 12% of total services export of Belarus.¹²⁹

INTERNATIONAL ECONOMIC COOPERATION AND INTEGRATION

Trade regime under the Eurasian Economic Union framework

Traditionally, external economic developments of Belarus have been closely associated with its strong economic linkages and relations with Russia and, more recently, their evolution in the context of the Russia-led Eurasian integration project. Eurasian economic integration has been progressing very fast formally, starting from the formation in 2010 of the Eurasian Customs Union by Belarus, Russia and Kazakhstan. Only two years later the bloc was replaced by the Eurasian Customs Union–Single Economic Space, and in 2015 by the Eurasian Economic Union (EAEU). The latter also expanded geographically and now includes, besides the three founding members, Armenia and Kyrgyzstan.

While the customs union arrangement dealt only with the liberalisation of mutual trade in goods via elimination of tariffs and introduction of a common external tariff (CET), the EAEU will seek to bring integration to a qualitatively new state reaching beyond trade-related matters, and also facilitating the so-called 'four freedoms' – a common market for goods, services, capital and labour, as well as coordination of economic policies, which is envisioned to be accomplished by 2025 (for details on the Eurasian Economic integration and its history see Box 3.1).

¹²⁸ <http://www.belarus.by/en/invest/investment-climate/high-technology-park>

¹²⁹ <http://www.park.by/post-1204/>

BOX 3.1 / EURASIAN ECONOMIC INTEGRATION IN BRIEF

Eurasian economic integration remains the most successful attempt so far to reintegrate the economies of the post-Soviet space. After repeated fruitless efforts to facilitate multilateral economic cooperation within a broader pool of countries from the Commonwealth of Independent States (CIS), Belarus, Kazakhstan and Russia were the only ones that managed to reach a consensus and establish a customs union in 2010 (*Eurasian Customs Union, EACU*).

As with other customs unions, at the core of the Eurasian Customs Union were the following proposed key arrangements: (1) free movement of goods across the member states, (2) a common customs territory for the member states, (3) unified commodity classification, (4) a common external tariff applied to non-member trading partners, and (5) harmonised non-tariff measures and procedures. The common external tariff (CET) to be applied by each member state to imports from non-bloc trading partners followed predominantly the existing structure of Russian import duties, with a range of temporary exclusions negotiated and granted to the member states on certain 'sensitive' products. In 2012, the three member states moved on with the integration process by establishing the *Eurasian Customs Union–Single Economic Space (EACU-SES)*, which declared as its ultimate objective the achievement of a common market not only for goods, but also for services, capital and labour. The launch of the new format was also accompanied by the formation of the Eurasian Economic Commission (EEC), a supranational organisation explicitly charged with oversight of the integration process and regulatory competencies in certain areas, including customs, sanitary and phytosanitary (SPS) measures and technical regulations.¹³⁰

With the formation of the *Eurasian Economic Union (EAEU)* in January 2015, the member states crafted further plans to deepen economic ties by implementing a framework to coordinate and harmonise economic policies and by restating their commitment to facilitate the free movement of goods and factors of production. The multitude of regulations and intentions were meticulously summarised in the Treaty on the Eurasian Economic Union – a document comprising over a thousand articles, grouped into four sections, proposing multiple directions along which integration should proceed, including: trade, technical regulation, SPS measures, consumer protection, macroeconomic policy, financial markets, taxes, competition and natural monopolies, energy, transport, procurement and migration.¹³¹ While in many respects the provisions reiterate the previously stated goals and regulations, among the notable features the union will attempt to eliminate the remaining barriers to mutual trade in goods (mostly related to discrepancies in technical requirements and SPS regulations).

The treaty also provides a framework for a common energy market (oil, gas, electricity), which has been one of the most controversial matters within the bloc, although the common market is expected to be achieved only by 2025. The member states will have to implement national treatment in the provision of services and equal access to the labour market across the union. The treaty also proclaims the need for coordination of economic policies, which should potentially lead to closer financial integration. The intention is to establish a common supranational authority to oversee financial markets (envisaged for 2025).

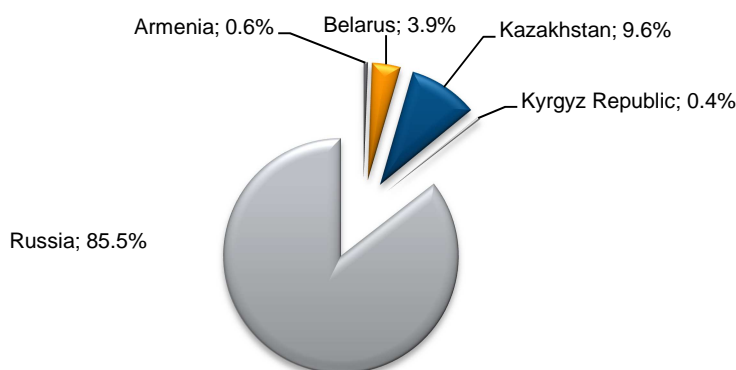
Source: Adarov (2015b).

¹³⁰ See the website of the EEC: www.eurasiancommission.org/en

¹³¹ The document is accessible at <https://docs.eaeunion.org/ru-ru/Pages/DisplayDocument.aspx?s=bef9c798-3978-42f3-9ef2-d0fb3d53b75f&w=632c7868-4ee2-4b21-bc64-1995328e6ef3&l=540294ae-c3c9-4511-9bf8-aaf5d6e0d169&EntityID=3610>

The EAEU represents a relatively large market with a population of more than 180 million and an aggregate output of USD 2 trillion¹³², although it is less than 20% of the total GDP of the EU (in PPP terms). Importantly, the composition of the Eurasian market is highly asymmetric: over 80% of its total GDP is attributed to Russia, whereas the economy of Belarus constitutes only a small fraction of the EAEU — less than 4% (see Figure 3.13). Therefore, merely from the perspective of access to the much larger market of Russia, Belarus appears to be a beneficiary of the Eurasian integration endeavour, especially in the light of its low competitiveness in other markets and strong traditional trade and value-added linkages to Russia in a number of industries (not taking into account the long-run structural consequences of such dependence).

Figure 3.13 / Composition of the EAEU market, GDP shares at PPP, 2014

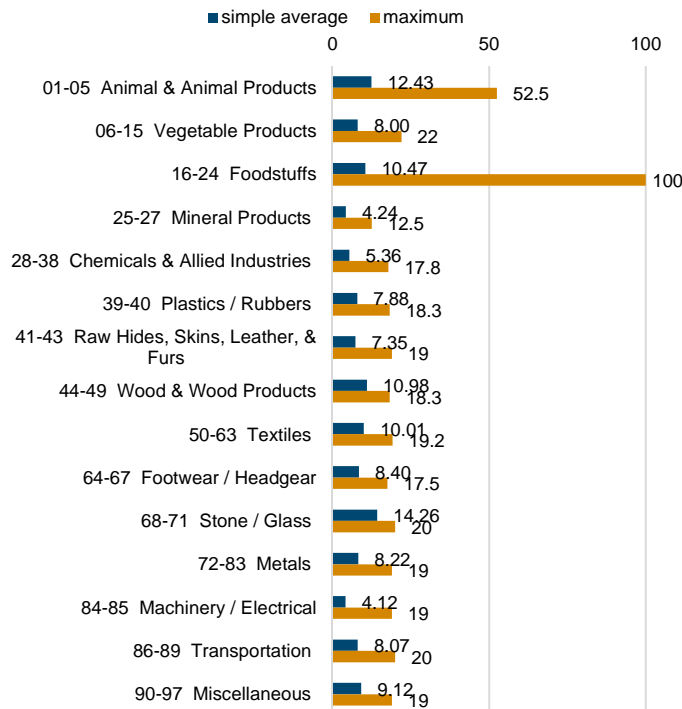
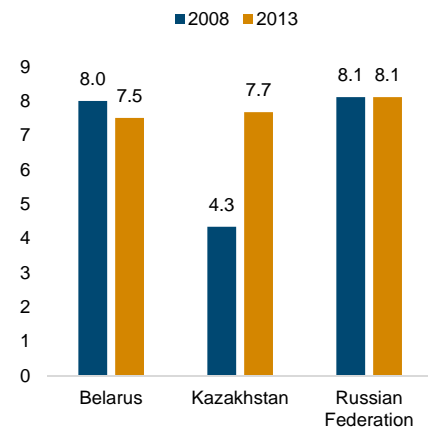


Source: Calculations based on IMF WEO data.

The customs-related arrangements of the EAEU provide relatively strong protection for the domestic producers in Belarus. The common external tariff (CET) introduced in 2010 in the Eurasian Customs Union was largely based on the Russian import duty structure in line with its WTO commitments (Figure 3.14). The import tariff structure of Belarus, however, was already rather similar to that of Russia, and the adoption of the CET did not induce major changes in its tariff structure (as opposed to Kazakhstan, which had a more liberal trade regime prior to joining the EACU, see Figure 3.15). Besides this, tariff rate quotas (caps on the maximum quantity of goods that can be imported under reduced tariff rates, but not limiting the overall quantity of imports) introduced by Belarus on the imports of certain meat products, and a range of non-tariff measures (sanitary and phytosanitary standards, technical regulations, etc.) also shield the domestic market from non-EAEU competitors.

As regards trade-related matters, besides the EAEU, Belarus is also a member of the Commonwealth of Independent States Free Trade Area (CISFTA). So far, the CISFTA has entered into force for Armenia, Belarus, Kazakhstan, Moldova, Russia and Ukraine. In addition, bilateral free trade agreements exist between Belarus and other CIS members, as well as Serbia. However, in comparison with the regulatory implications and trade flows within the EAEU, these arrangements have only a marginal impact on the external trade of Belarus.

¹³² At current USD, as of 2014 (World Bank's WDI); in terms of PPP, the combined GDP of the EAEU amounts to 4.4 trillion current international USD.

Figure 3.14 / Import tariff structure of Belarus, 2014, %**Figure 3.15 / Average applied import tariff rate change after CET implementation, %**

Note: MFN applied rates with ad valorem equivalents based on the UNCTAD method, mean and maximum over the sector based on HS 6-digit product line tariff data aggregated to broad industry groups for readability (corresponding 2-digit HS codes next to industry labels).
Source: Own calculations based on World Bank WITS data.

Source: World Bank's WDI.

WTO membership, non-tariff barriers and other trade-related challenges for Belarus

Concurrent membership of the EAEU members in the WTO represents another new challenge for the bloc.¹³³ Belarus remains the only country within the bloc that is not a WTO member, and among the very few countries in the world still not in the WTO. At the same time, it has to indirectly adhere to WTO rules via commitments of its EAEU partners. Prior to 2015, Russia was the only country of the Eurasian bloc that was also a WTO member (having joined in 2012) and thus its obligations were internalised in the regulations of the Eurasian Customs Union. In contrast to earlier Eurasian integration frameworks (EACU, EACU-SES), the situation in the newly formed EAEU is rather different: the newly admitted members of the bloc had already been WTO members for a long time (Armenia joined the WTO in 2003 and Kyrgyzstan already in 1998). With Kazakhstan completing its accession negotiations in 2015, Belarus remains the only non-WTO country of the bloc.

¹³³ See Adarov (2015a).

The fact that each of the EAEU members joined the WTO independently and under rather different terms represents a regulatory challenge for the harmonisation of EAEU trade-related rules – not to mention numerous sensitive political issues. The exemptions and control over rules of origin are thus likely to inhibit mutual trade and prompt the re-establishment of some degree of internal border controls. Belarus itself still appears to be rather far from satisfying the original demands expressed by the WTO related to agricultural subsidies and the high level of government involvement in the economy. Accession negotiations have been dragging on for years with the Working Party on the accession of Belarus established in 1993.¹³⁴

Although the EAEU member countries declared their commitment to an economic union arrangement, barriers still exist even with regard to trade in goods. The Eurasian Economic Commission, the supra-national body governing the Eurasian integration, itself identified 603 barriers, exclusions and various restrictions to trade in goods and services, and the movement of labour and capital.¹³⁵ The elimination of the existing non-tariff barriers that are still significant in the EAEU (by some accounts they might add up to 15-30% to the costs of exports within the EAEU) may provide an important remedy to the currently stagnating intra-bloc trade, particularly important for Belarus given its significant exposure to Russia.¹³⁶

The intentions spelled out in the Treaty on the EAEU – the cornerstone regulatory document of the union – and repeatedly proclaimed by the officials of the member states and the Eurasian Economic Commission no doubt provide a pathway for deeper and multifaceted integration. However, the ability of the member states to fully commit and implement them effectively raises concerns. The issues in this regard were reiterated at the recent summit of the heads of the EAEU member states held in Astana in May 2016, noting the falling trade turnover, barriers to mutual trade, repeated trade-related disputes, and other impediments.

Related to this, the unilateral introduction of an embargo by Russia on selected European (including Ukrainian) agro-food imports as a response to Western sanctions undermines the credibility of the Eurasian integration and the EEC, which is supposed to be the ultimate authority in the design and implementation of joint trade-related policies of the bloc. In the light of the imperfect track record of compliance and trade disputes within the Eurasian bloc, this hardly looks surprising. The disputes between Russia and Belarus have been especially notorious: to mention some of the earlier disputes, the 'solvents scheme' dispute in 2012¹³⁷, or the politically charged bans imposed by Russia on milk and dairy products imported from Belarus in 2009. More recently, in 2014 and 2015, meat and seafood product bans were imposed by Russia on imports from Belarus following accusations of re-exports of sanctioned western food products, which also led to customs border checks by the Russian authorities, effectively hindering mutual trade flows. As a related matter, the import substitution agenda that has been cultivated recently in Russia may also hurt Belarusian producers not only via market share losses, but also by preventing the formation of cross-border production chains, usually viewed as an essential aspect of economic integration.

¹³⁴ See more at www.wto.org/english/thewto_e/acc_e/a1_belarus_e.htm. For some earlier background analysis of Belarus' stance towards WTO and related challenges see: Kurilionak et al. (2007).

¹³⁵ A detailed account of non-tariff barriers to movement of goods, services, and factors of production is available in EEC (2015).

¹³⁶ See also Pelipas et al. (2014).

¹³⁷ Russia exposed the scheme used by Belarus to export gasoline and other processed oil products refined from imported Russian crude oil, disguised as 'solvents', to avoid paying customs duties to Russia.

For Belarus, one of the important aspects of Eurasian integration is also related to the imports of fuels. Negotiations over the 'fair' price for oil and gas purchased from Russia have long been a point of discontent in the bilateral relations and subject to political bargaining.¹³⁸ The much hoped-for by Belarus common Eurasian petroleum market is expected to be launched in 2024 at best, and at the moment the overall strategy regarding energy market integration is also subject to intense debates between the EAEU members, all either directly or indirectly dependent upon external trade in energy commodities, with a lack of consensus on such issues as price setting mechanism, oil standards and infrastructure.

Overall, there are vast asymmetries in Belarus' foreign trade both in terms of industrial composition of trade (dominated by mineral products) and geographic orientation (heavily concentrated on the Russian market). While some headway has been made in easing existing barriers to trade under the EAEU framework, many issues still persist and are even more difficult to address nowadays given the deteriorating macroeconomic outlook of Russia spilling over to Belarus, as well as deep-rooted structural issues in Belarus that hinder the transformation of the economy into a more competitive state.

Trade relations with the EU

Traditionally, Belarus' relations with the EU have been strained and the EU criticised Belarus' human rights record and, generally, the slow progress in economic reforms. The ratification of an EU-Belarus Partnership and Cooperation Agreement (negotiated in 1995) has been frozen since 1997 in response to the political situation in the country: the violations of electoral standards and crackdowns on civil society, political opposition and independent media.¹³⁹ Despite occasional EU sanctions, Belarus has been included in the EU Eastern Partnership initiative (together with Armenia, Azerbaijan, Georgia, Moldova and Ukraine). President A. Lukashenka has managed relatively successfully to manoeuvre between Russia and the EU (e.g. by not recognising South Ossetia and Abkhazia independence, the Russian annexation of Crimea, etc.), most recently offering mediation in the Russia-Ukraine conflict in Minsk, etc. As a sign of a possible shift in attitude, the EU partly lifted the existing sanctions on Belarus – despite hardly any visible change in Belarus' internal policies which had led to their imposition in the first place.

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¹³⁸ In addition to membership in the EAEU, there has been a 'Union State of Belarus and Russia' since 2000 with a highly ambitious integration agenda between the two countries, including political and economic cooperation, common currency, etc. These plans seem to have been shelved some time ago.

¹³⁹ See http://eeas.europa.eu/belarus/index_en.htm. More on EU's relations with Belarus is available at http://eeas.europa.eu/enp/pdf/financing-the-enp/belarus_2014_2017_programming_document_en.pdf.

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4. The current macroeconomic environment: policy dilemmas

BY DZMITRY KRUK

SOFT BUDGET CONSTRAINTS AND QUASI-FISCAL OPERATIONS IN THE BELARUSIAN ECONOMY

The Belarusian economy is a special case among all transition economies both for its institutional framework (domination of state property, direct government intervention into the economy and its individual sectors, see Chapter 1) and its specific policies (discussed later in this chapter). These two foundations are bonded through a system of quasi-fiscal activities (QFA) including the practice of soft budget constraints (SBC) on state-owned firms and banks. The prevalence of QFAs is backed by the obscurity of the system of economic management and the absence of proper accountability. Moreover, evaluating the effect of quasi-fiscal activities is also problematic and much depends on the mechanisms and instruments used. A number of research and policy studies focus on selected areas of the QFA-SBC system in Belarus: for instance, QFA in the energy sector¹⁴⁰, SBC for agriculture¹⁴¹ and manufacturing¹⁴² or selected instruments of it such as directed lending¹⁴³. One study that tried to address and assess the effect of QFA-SBC more systematically was performed by the World Bank¹⁴⁴. But even this study mostly seeks to trace the effects of QFA on budget performance and does not provide evidence about the economy-wide scope and effects of QFA-SBC system.

The QFA-SBC system is extremely important for understanding the Belarusian economy as the scope of its effects and impact covers the economy thoroughly, from micro-level incentives to macro indicators, from the supply to the demand side of the economy. On the supply side, it seeks to provide a relocation of resources as desired by the authorities and to secure support to selected industries/enterprises. In this respect, QFA may be treated as an instrument for pursuing institutional objectives and priorities. On the demand side, the intensity of QFA and SBC affect the pattern of capital investments (and final consumption to a smaller extent). Through this, one may treat such operations as the part of the policy mix that may directly influence the business cycle.

According to the IMF classification of QFA¹⁴⁵, two functional groups of QFA instruments are actively used in Belarus: those related to the financial system and those concerning the sector of commercial enterprises.¹⁴⁶

¹⁴⁰ Tochitskaya (2007).

¹⁴¹ World Bank (2009).

¹⁴² World Bank (2010).

¹⁴³ Kruk and Haiduk (2013).

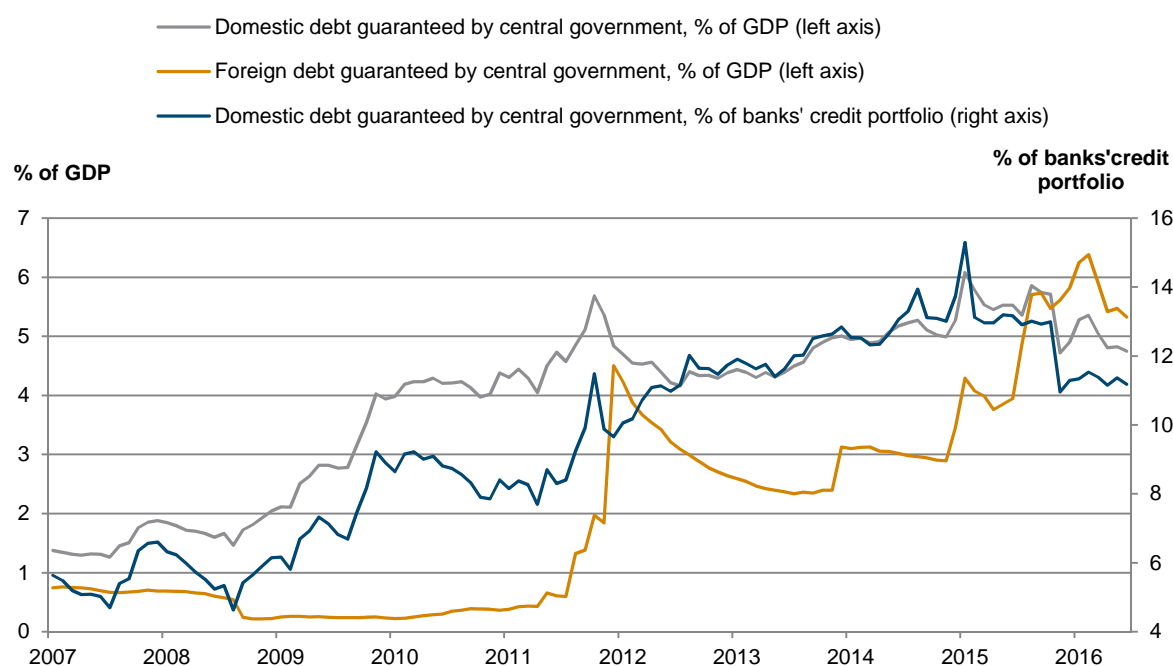
¹⁴⁴ World Bank (2011).

¹⁴⁵ IMF (2007), Box 19, p. 80.

During the last two decades *operations related to the financial system* were mainly represented by directed (subsidised) lending (see Chapter 1 for more details). By the beginning of 2016, the amount of outstanding directed loans reached roughly 18% of GDP or 40% of banks' assets.¹⁴⁷

More recently, a number of additional financial QFA have proliferated: the provision of implicit government guarantees and rescue (bail-out) operations for state-owned enterprises.¹⁴⁸ In the past, government guarantees were mostly an optional supplement to directed lending. However, in recent years there has been a general trend of restricting new open directed loans (both in terms of volume and lending conditions). Instead, the practice of providing government guarantees for bank credit extended to SOEs has become more wide-spread, partially as a compensating measure for cuts in directed lending. Hence, in recent years government guarantees have become an important component of the QFA system, in some cases not supplementing (as before), but substituting directed lending. At present, the amount of outstanding central government credit guarantees has reached roughly 10% of GDP (Figure 4.1).

Figure 4.1 / Credit guarantees by the central government, 2007-2016



Source: Ministry of Finance; Belstat; author's calculations.

¹⁴⁶ Historically, instruments related to exchange rate and trade operations were employed as well (for instance, non-tariff barriers and multiple exchange rates). However, the usage of these instruments was quite weak in terms of intensity and regularity. Moreover, in recent years (after the currency crisis of 2011, and especially that of 2014) these instruments were basically abandoned by the authorities in their efforts to enhance transparency in exchange rate issues.

¹⁴⁷ Murin (2016).

¹⁴⁸ The latter is discussed in the next section of this chapter.

Apart from the central government, local governments are extending similar credit guarantees to SOEs.¹⁴⁹ The amount of outstanding guarantees by local authorities in 2015 and 2016 is estimated to be in the range of 3.5-4.0% of GDP (or 8-9% of banks' credit portfolio¹⁵⁰). So, the total amount of outstanding guarantees¹⁵¹ by both the central and local governments has reached roughly 14% of GDP.

Overall, QFA related to the financial system (represented by directed lending and government guarantees) have become instruments for sheltering a large spectrum of beneficiaries under soft budget constraints. Hence, it has formed the most substantial part of the 'quasi-fiscal overhang' for the economy.¹⁵²

Operations related to the commercial enterprise sector are mainly represented by 'charging less than commercial prices'.¹⁵³ The purpose and the practice of using this instrument depend on the sector where it is applied. There are two major sectors through which such quasi-fiscal impulses are induced and later on are extended throughout the economy – energy and agriculture (see Box 4.1).

BOX 4.1 / SUBSIDIES AND QUASI-FISCAL OPERATIONS IN THE SECTORS OF ENERGY AND AGRICULTURE

Energy. Energy production and distribution has traditionally been a sector through which the government provides subsidies to economy-wide beneficiaries. In the 1990s this practice was common for many post-Soviet countries¹⁵⁴, given the access to relatively cheap energy thanks to either political agreements with Russia, or the availability of own energy resources. In the majority of non-energy-rich CIS countries, the scope of quasi-fiscal activities was contracting throughout the 2000s, as the sources for such subsidies were drying out. Belarus, in contrast, stuck to the policy of energy subsidies as a factor of its competitiveness. Hence, the authorities engaged in intense political and economic manoeuvring to secure an 'energy grant' from Russia (either direct reductions of the market price and/or some additional preferences in terms and the conditions of gas and oil purchases). Thus, the Belarusian bilateral agreements with Russia, membership in the Unions (Customs and later Eurasian Economic Union), the agreement to sell its gas pipeline to Russian Gazprom, etc. all were justified to a large extent by the desire to secure 'energy grants'.

As regards quasi-fiscal activity, the 'energy grant' from Russia (Figure 4.2) should be divided between gas and oil grants. The 'gas grant' may be treated as a direct source of subsequent quasi-fiscal operations in the domestic energy sector. As for the 'oil grant', the situation was more complex and unstable over the years. Partially it was also used directly as a source of economy-wide quasi-fiscal operations, but partially it was absorbed either by individual firms or the budget, without being further transmitted to the economy.

¹⁴⁹ The 'division of labour' between central and local governments is set depending on the status and size of the enterprise-beneficiary of a guarantee.

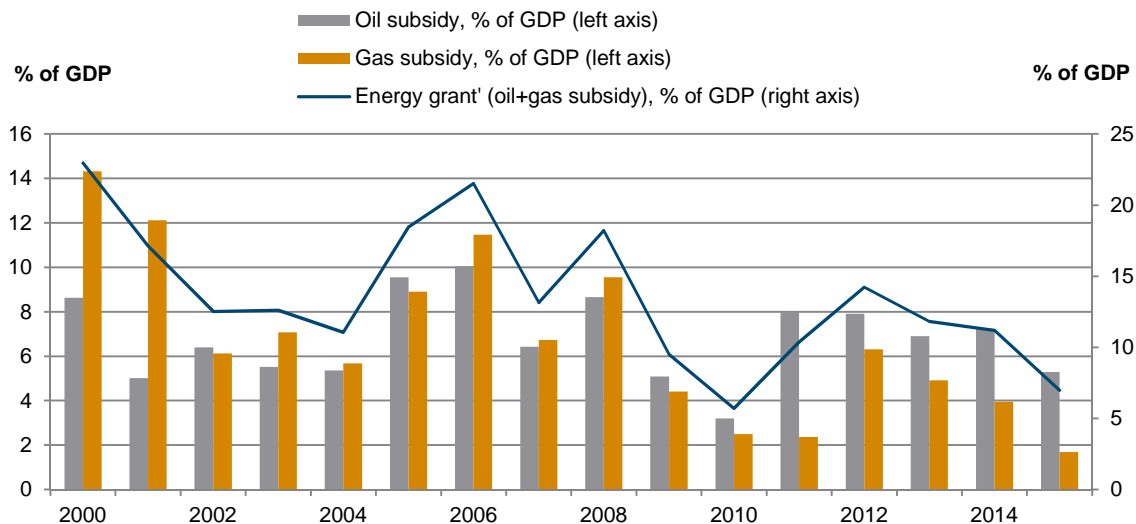
¹⁵⁰ Data on guarantees provided by local governments are available only since 2015.

¹⁵¹ Domestic and foreign guarantees by the central government (Figure 4.1) and domestic guarantees by local governments.

¹⁵² Individual assessments of outstanding directed lending and government guarantees cannot be summed up as these two activities overlap.

¹⁵³ According to IMF (2007).

¹⁵⁴ Petri, Taube and Tsyvinski (2002).

Figure 4.2 / 'Energy grant' from Russia, % of GDP

Source: Belstat; IFS database; author's calculations.

The policy objective of carrying out quasi-fiscal operations in the energy sector was to make firms more competitive, hence triggering positive externalities in the economy. Moreover, the government could vary subsidies for individual sectors, according to either long-term or short-term priorities. Furthermore, the QFA in energy have become a powerful tool for direct redistribution of wealth between firms and households, through cross-subsidised utilities tariffs: in Belarus, energy tariffs for households have traditionally been lower than those for firms.¹⁵⁵

There are three main QFA instruments in energy: tariffs below cost recovery level; non-payments and arrears to energy companies; and excessive losses and theft (the latter are of lesser significance).¹⁵⁶ The intensity of these QFA operations mainly depends on the size of the input 'energy grant' from Russia, the current policy priorities within the sector and at the macro level in general. During the two last decades, the total volume of energy sector QFA was quite close to the level of the gas 'energy grant' from Russia. For instance, the estimates of these QFA in the mid-2000s vary between 3.7% and 4.7% of GDP.¹⁵⁷

The combination of different QFA instruments varied mainly depending on the general macroeconomic situation. Reduced tariffs traditionally have been the most influential tool providing implicit subsidies up to 3.6% of GDP.¹⁵⁸ The accumulated firm energy arrears by the mid-2000s amounted to some 3.5% of GDP.¹⁵⁹ However, after 2006 energy arrears declined and in 2013-2014 fell to a historic minimum of 0.13-0.14% of

¹⁵⁵ Some convergence in tariffs was achieved in 2016 because of a noticeable increase in utility tariffs for households. Nevertheless, the tariffs for households and legal entities still differ. At the same time, the tariff system assumes a number of reductions for firms, depending on the type of their activity.

¹⁵⁶ Tochitskaya (2007).

¹⁵⁷ Ibid.

¹⁵⁸ Ibid.

¹⁵⁹ Ibid.

GDP. With the recession and some increase in tariffs, energy arrears rose again, reaching 1.1% of GDP by the end of the first half of 2016.¹⁶⁰

Agriculture. Agriculture is sometimes referred to as the ‘black hole’ of the Belarusian economy. By different estimates Belarus is a clear-cut leader in direct and implicit fiscal support to agriculture in comparison both to neighbouring emerging markets and to developed EU countries.¹⁶¹ The level of direct fiscal support has been fluctuating between 3.5% and 4.5% of GDP.¹⁶² When some secondary fiscal tools (tax credit, tax benefits, tax arrears) are taken into account, the level of fiscal support rises to some 5-5.5% of GDP.¹⁶³ Furthermore, agriculture is among the main beneficiaries of subsidies through directed lending QFA.¹⁶⁴

The massive subsidies for agriculture are not fully absorbed by the industry itself, and a large fraction is further transmitted to the economy through price regulations. Price regulations tend to secure purchasing prices for agricultural products which are lower than in neighbouring countries.¹⁶⁵ This price gap forms an important advantage for food producers, which can rely on actually reduced prices on intermediary inputs. Further, the government sets minimum export prices for agricultural goods and foodstuffs in order to avoid obtaining gains from reduced agricultural inputs outside the country. Alongside that, it keeps the right to regulate domestic consumer prices for foodstuffs.¹⁶⁶

Distorted prices actually trim down the profit margin of agricultural firms which de facto operate around break-even point. Ultimately, similarly to tariffs in the energy sector, this mechanism operates as an instrument for wealth transfer to households.

One of the most important features of Belarusian QFA practices is that instruments in different spheres do not exist independently of each other. On the contrary, instruments are designed and managed in a way to provide systemic interactions and trigger expected positive externalities for the economy. In this manner the authorities intend(ed) to secure strengthening growth and shaping it according to the desired trajectory and political/social priorities.

However, reality turned out to be different and the success in triggering positive externalities has been doubtful. There is no evidence that QFA mechanisms in Belarus have been successful in generating social returns exceeding the corresponding injections. But there is plenty of evidence of adverse structural effects associated with numerous distortions: capital and labour misallocations, distorted

¹⁶⁰ Own assessment based on Belstat data on overdue payments.

¹⁶¹ World Bank (2009).

¹⁶² World Bank (2011, 2009).

¹⁶³ World Bank (2011) provides corresponding estimates for 2005-2009. As the instruments of direct fiscal support of agriculture have not been changed significantly, one can expect that the current level of direct fiscal support has remained roughly the same.

¹⁶⁴ According to the approach by Kruk and Haiduk (2013) the share of agriculture in directed loans outstanding is roughly 50%. But in this study directed loans to manufacturing are ignored, which means that the actual share of agricultural borrowers in the stock of directed loans is lower than 50%. In recent years (when the statistics on newly granted directed loans have become more transparent), the share of agriculture in the flow of new directed loans was roughly 40%.

¹⁶⁵ Tochitskaya and Kruk (2010). However, in recent years Russian producers (especially those of dairy products) try to lobby a compulsory coordination of purchasing prices for raw agricultural goods within the Eurasian Union.

¹⁶⁶ Current legislation stipulates a limit of 90 days of price regulation throughout the year.

incentives, misleading price signals, underinvestment, discouraged savings, and extra losses in financial intermediation.¹⁶⁷

Overall, the QFA system (see Table 4.1 for a simplified snapshot) has become very complex and ambiguous in terms of long-term economic effects. Despite this, for a long time it has been treated as an indispensable cornerstone of the Belarusian economy. Most probably, both the beliefs that it can nevertheless secure long-term growth and its political acceptability have been the justification for its existence.

Table 4.1 / Specific subsidies and related quasi-fiscal operations in Belarus: a summary

	General (through directed lending)	Sectoral (QFA)	
		Energy	Agriculture
Intended purpose	To trigger positive externalities and/or provide liquidity for subsequent transmission of positive impulses to the economy		
Financial sources	Budget (compensation of interest rates, provision of funds for new loans, bank recapitalisation) Households and firms through wealth transfers due to inflation tax	Russian 'energy grant'	Budget Directed lending
Beneficiaries	Agriculture Manufacturing Households	All economic agents (with differentiated effect)	Food manufacturing Households
Long-term economic effects	Losses in efficiency due to resource misallocation Underinvestment and distorted incentives of firms Losses in financial intermediation and discouraging savings ¹⁶⁸	Rising energy costs Misleading price signals Lack of incentives to increase energy efficiency	Promotion of food exports Financially fragile agriculture Misleading price signals
Short-term economic effects	Exchange rate overhang Current account deficit Price overhang	Output sensitivity to changes in the size of the 'energy grant'	Food market sensitivity to sudden shocks (XR depreciation, changes in global prices, etc.)

Source: Author's synopsis.

The QFA-SBC system de facto gained a dominating status in the hierarchy of Belarusian economic policies. The macroeconomic policy mix (i.e. 'conventional' monetary and fiscal instruments) was in effect subordinated to the QFA-SBC design. In the case of conflicting objectives¹⁶⁹, the authorities (at least before 2015) would sacrifice macroeconomic stability rather than revise the QFA-SBC system itself. This has had serious implications for macroeconomic and price stability in the country.

Some signs of an intended downsizing of the QFA-SBC system appeared in 2015-2016. However, it is not clear whether these new policies will be continued; moreover, most of the elements of the QFA-SBC system are still in place.

¹⁶⁷ Kruk and Haiduk (2013); Tochitskaya (2007); Petre, Taube and Tsyvinski (2002).

¹⁶⁸ Kruk and Haiduk (2013); Fry (1995).

¹⁶⁹ Miksjuk, Pranovich, and Ouliaris (2015).

CHANGING MACROECONOMIC POLICY OBJECTIVES AND INSTRUMENTS

The recent evolution in the macroeconomic policy mix in Belarus mirrors the deep-seated changes in economic fundamentals during the past decade or so.

The period of 2003-2008, featuring an average growth rate of 9.5%, is often characterised as the 'golden age' or 'fat years' of Belarus. In the expansionary environment that prevailed for quite some time, the authorities were not so much concerned with growth-supporting policies but rather with those fine-tuning the desired trajectory. QFA-SBC instruments were actively put in place in order to secure this trajectory. In turn, monetary, fiscal and some other specific policy tools were considered as additional support for the desired characteristics of the growth path. For instance, the authorities paid much attention to the structure of domestic demand, i.e. the relationship between consumer and investment demand, and that between domestic and foreign demand.

Exchange rate stability and disinflation were considered as other important attributes of the desired growth path given the fact that Belarus had experienced a couple of waves of hyperinflation in the 1990s. This was one of the reasons why Belarus opted for an exchange rate peg as an effective tool for enhancing more nominal stability. In addition, some positive external shocks – increasing prices for commodities (e.g. oil and potash), strong rebound in Russia's import demand, improving terms of trade – facilitated the introduction of the peg.

This background determined in 2003-2007 a policy mix combining: (i) exchange rate peg; (ii) monetary stimulation; (iii) direct wage stimulation (see Chapter 2); and (iv) fiscal stimuli (directed at the stimulation of both consumer and investment demand). The combination of these instruments and their intensity was changing over the years.

It is sometimes claimed that it was this policy mix that triggered the path of high growth. However, the causation was likely the opposite: the favourable growth environment created an environment conducive to pursuing such policies.

Importantly, this constellation was not without its problems even during the period of high growth. While GDP grew robustly, this was not driven by productivity gains whereas capital accumulation played a prominent role.¹⁷⁰ Low productivity entailed a deterioration in international competitiveness after 2005-2006 as evidenced by different measures such as the share in foreign markets, revealed comparative advantages, index of export specialisation or export basket diversification.¹⁷¹ Consequently, the current account balance worsened considerably after 2006 (Annex Table 1).

Further negative changes in the macro environment started emerging after 2007. A number of empirical studies¹⁷² suggest a persistent tendency towards a declining rate of trend output growth in Belarus

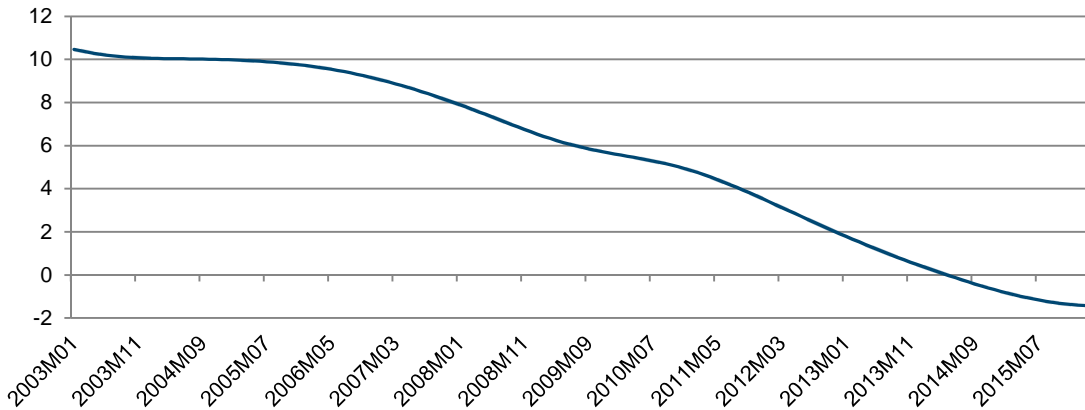
¹⁷⁰ Kruk and Bornukova (2014).

¹⁷¹ Kruk (2009); Kruk, Tochitskaya and Shymanovich (2009).

¹⁷² Kruk and Bornukova (2014); Mironchik, Sudnik, and Katcherskaya (2016).

(Figure 4.3).¹⁷³ Concomitantly, the terms of trade deteriorated considerably during the global financial crisis.

Figure 4.3 / Trend GDP growth rate, % per annum

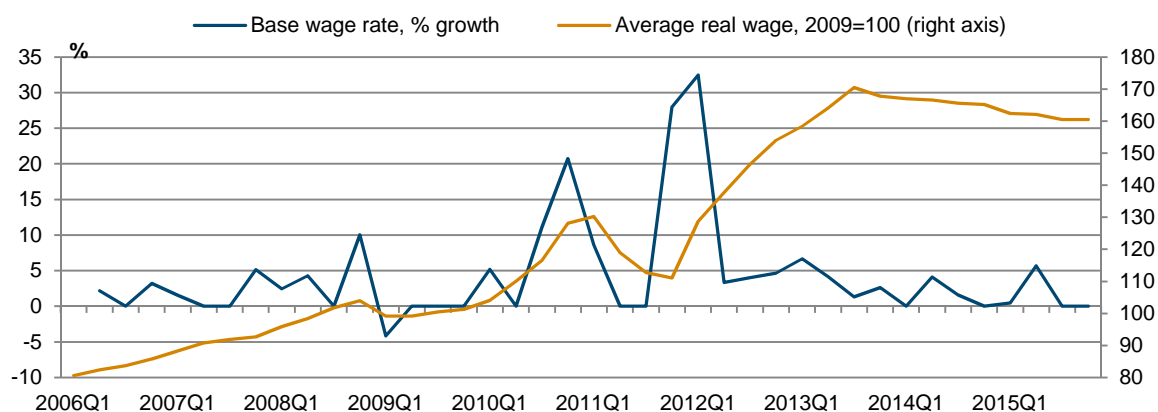


Source: Belstat; author's calculations.

Note: The estimation is produced using a Hodrick-Prescott filter.

Nevertheless, the exchange rate peg was still considered as an indispensable guarantee of price stability. Furthermore, the government started actively pursuing demand stimulation policies with a view to achieving its output growth targets. In effect, after 2007 the authorities apparently switched to a different policy regime and assigned the macroeconomic policy mix with a more proactive role by seeking to boost economic growth through policy tools. However, due to the built-in inconsistencies in the policy mix, these proactive policies turned out to be a source of instability. The rapid accumulation of macroeconomic imbalances resulted in a series of currency crises: in 2009, 2011 and 2014-2015.

Figure 4.4 / Base wage rate and real wages in the Belarusian economy, % change and index, 2006-2015



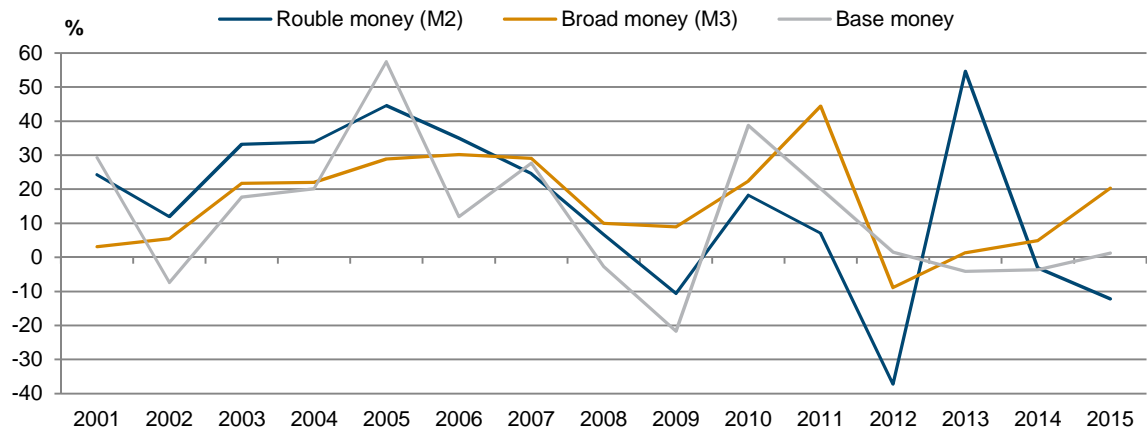
Source: Belstat; author's calculations.

Note: The 'base wage rate' is the notion for '1st category wage rate', which is set by the government (see Chapter 2).

¹⁷³ The majority of statistical filters suggest that by 2015 potential growth has faded, having achieved zero level. Alongside with weakening growth, one can argue about increased amplitude and frequency of business cycle fluctuations.

The year 2010 highlights the growing inconsistency of the policy mix: the sharp growth in wages (Figure 4.4) coupled with radical monetary softening (Figure 4.5) did produce a cyclical output upturn: GDP bounced back, increasing by 7.7% that year.

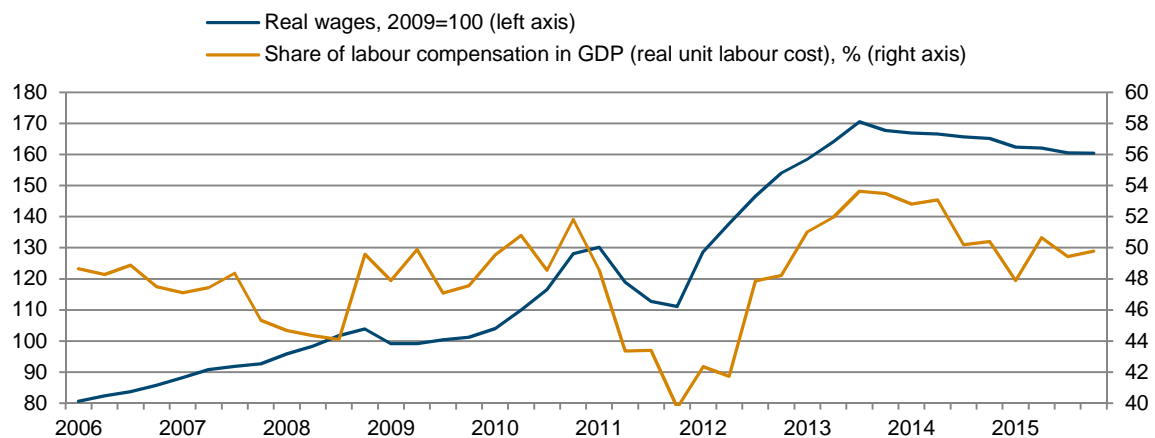
Figure 4.5 / Dynamics of monetary aggregates in real terms (CPI-deflated), percentage change over the year (at year end), %, 2001-2015



Source: NBRB; Belstat; author's calculations.

This output rebound, however, was achieved at the expense of mounting macroeconomic imbalances. First, the gap between wages and productivity rose (Figure 4.6), leading to deteriorating competitiveness in foreign trade. Second, the periods of active monetary interventions resulted in a price overhang¹⁷⁴ and, respectively, high inflation. Coupled with the exchange rate peg this caused a steady appreciation of the real effective exchange rate and a mounting external imbalance (Annex Table 1). A significant gap emerged between the actual and the equilibrium real effective exchange rate (Figure 4.7).

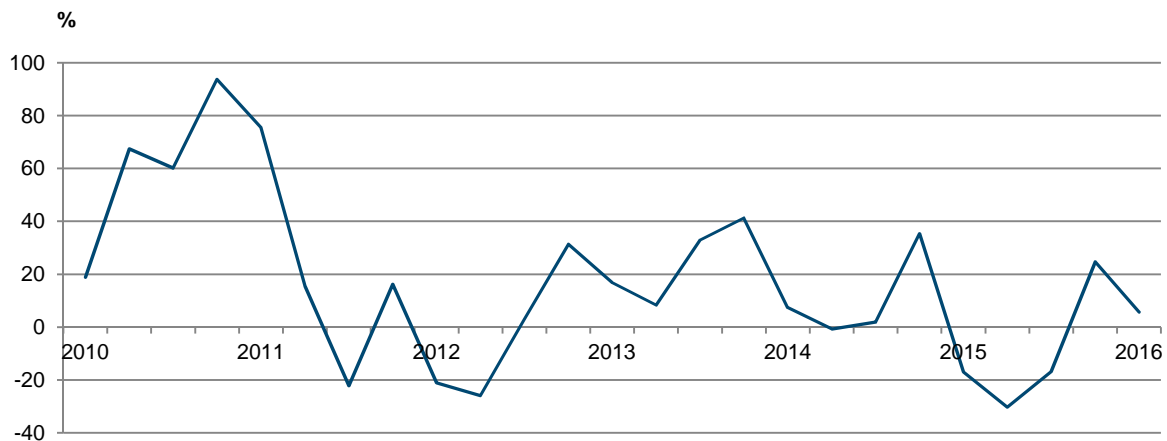
Figure 4.6 / Real wages and real unit labour cost, index and % of GDP, 2006-2015



Source: Belstat; author's calculations.

¹⁷⁴ Bezborodova (2015).

Figure 4.7 / Gap between actual and equilibrium real effective exchange rate, % of actual level, 2010-2015

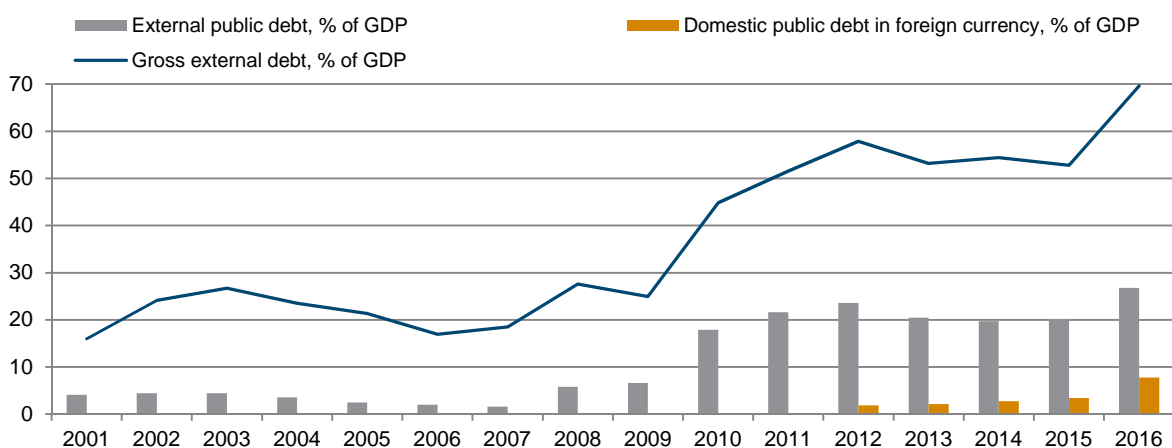


Source: NBRB; Belstat; author's calculations.

Note: The estimations are based on Zaretski, Kruk and Kirchner (2011).

Trying to mitigate the chronic pressure in the currency market, the authorities resorted to active external borrowings; this happened against the background of a considerable gap between the equilibrium exchange rate and the actual one. Moreover, when possible, the government tried to avoid sovereign borrowing, but rather promoted borrowing by business entities. This was done through 'recommendations' to banks and SOEs. Therefore, there was a sharp rise in external borrowings after 2008 (Figure 4.8). At the same time, the authorities introduced episodically some temporary restrictions on foreign exchange transaction and more capital controls.

Figure 4.8 / Gross external and public debt of Belarus, 2001-2016 (as of 1 January), % of GDP.



Source: Ministry of Finance; Belstat; author's calculations.

Given the initially low level of the debt-to-GDP ratio, foreign borrowing was considered by the authorities as an effective tool for achieving their policy objectives including the defence of the currency peg. Moreover, attracting foreign borrowings was even used as a policy target for different government

bodies and state-owned banks. The terms 'financing gap' and 'financing deficit' (i.e. the difference between the planned amount of borrowings associated with the projected deficit of the current account, on the one hand, and the actual amount of funds available for borrowing, on the other hand) were widely circulated in the economic policy agenda.

Thanks to intensive foreign borrowings¹⁷⁵ the authorities managed to mask the underlying macroeconomic imbalances in 2009-2011. However, the drying out of external funding sources served as a trigger for the currency crisis of 2011. In terms of the extent of nominal exchange rate adjustment, this currency crisis was the most severe: the Belarusian rouble depreciated roughly by a margin of three; over the period 2011-2012, CPI more than doubled (Annex Table 1).

At the same time, the rapid crisis-driven macroeconomic adjustment contributed to rebalancing the economy: there was a significant downward adjustment in real wages (Figure 4.6) which contributed to a notable contraction in the current account deficit. From this perspective, in principle the crisis provided important lessons for possible reconsideration of the macroeconomic policy design. In late 2011-2012, the options of abandoning demand stimulation practices and the exchange rate peg were considered by the government. At that point probably for the first time the government acknowledged that the weakening growth could not be offset by excessive demand stimulation policies.

But despite such debates, the macroeconomic policy setup did not change considerably. While arguing about the necessity of more flexibility of the exchange rate, actually a return to a currency peg to a single currency (the US dollar) took place. The demand stimulation policies persisted, although their intensity weakened somehow: some monetary stimuli were abandoned (Figure 4.5) alongside with the reduction of new directed lending inflows (Chapter 1, Figure 1.7). But de facto, the old policy setup was fully restored by late 2012.

There were probably two main reasons for ignoring the lessons of the 2011 currency crisis in its immediate aftermath. First, the authorities were anxious about the social and political consequences and sought options of rapid recovery in real disposable income. The practice of wage policy since the early 2000s assumed setting (implicit) wage targets in US dollars. On the one hand, the government justified this practice by the dollarised macro environment. On the other hand, this practice contributed to progressing real dollarisation itself. Finally, this contributed to the reincarnation of both an active wage policy and the exchange rate peg to the US dollar.

Second, the authorities probably believed that they had uncovered a new tool that could play simultaneously the role of a growth driver and liquidity supporter. In 2012, thanks to a new phase under the Eurasian integration framework, Belarus was awarded a new contract with Russia for the supply of natural gas, which assumed roughly a 40% price discount. Some improvements also took place in the terms and conditions of oil trade. Moreover, in late 2011 and throughout 2012, Belarus enjoyed a specific scheme of trade in 'thinners and solvents' (see Chapter 2), which secured extra currency revenues on the net basis thus providing a positive push on output. In hindsight, this understanding of

¹⁷⁵ Apart from borrowing mirrored in the debt statistics, a large amount of forex funds in 2010 (about USD 3.7 billion, or about 7.5% of GDP) were rechannelled to international reserves from the holdings of commercial banks (mainly subsidiaries of Russian banks) through currency swaps. Although these funds were not reported as debt according to statistical methodology, de-facto they can be treated as debt.

the situation was unjustified: cheaper energy did not help in strengthening growth while the extra currency revenues were not sufficient to cover the financing needs.

The 2011 currency crisis gave rise to new threats to macroeconomic instability such as high and volatile inflation expectations¹⁷⁶ and a sharp increase in dollarisation.¹⁷⁷ By instigating macroeconomic instability, the crisis likely contributed to a further reduction in trend output growth. However, the authorities were not prepared to address these threats through structural reforms, preferring to consider the exchange rate peg as a buffer against them.

So, during the period 2013-2014, the policy setup survived again, but its internal inconsistencies became more evident.¹⁷⁸ For instance, more emphasis on demand stimulation now led not only to price overhang and delayed impact on the real exchange rate, but also to direct pressure on prices and the exchange rate through less demand for national currency and more for hard currency.

These inconsistencies further reduced the effectiveness of the policy efforts to boost output. The contribution to output growth by domestic demand and net exports became roughly equal with opposite signs. The appreciation of the real effective exchange rate through 2013 and 2014 led to a widening of the current account deficit while the attempts to stimulate growth through more domestic demand were offset by a further worsening of net exports. Ultimately, there was only meagre GDP growth in 2013 and 2014 – in the range of 1-2 per cent annually.

During these last two years of the 'traditional' policy setup it was becoming increasingly difficult to justify it. It was problematic to put forward reasonable explanation for the accumulating distortions and imbalances. Furthermore, the increasing dollarisation and resurgent inflation undermined the confidence in the currency peg which de facto was no longer perceived as a credible nominal anchor. The currency crisis of 2014-2015 made an exit from the traditional policy setup inevitable.

2015: A TURNING POINT?

Institutional changes and shrinking quasi-fiscal activities: illusory or real?

Numerous macroeconomic challenges became evident at the turn of 2014-2015 (even before the currency crisis) when the effects of the lasting weakening of growth were coupled with external shocks and drying-out of the sources of foreign funding.

Poor progress in institutional and structural reforms was largely responsible for the weakening of growth. In the years preceding the crisis (2012-2014) the government had actually recognised the necessity of at least some selective reforms. A number of programmes and action plans adopted in this period declared the intention for institutional reforms such as state property management, SOE management by independent boards, improvement of the mechanisms of state support and lending within the framework of state programmes, motivation of and incentives for SOE managers, and facilitating the development

¹⁷⁶ Kruk (2016).

¹⁷⁷ Kruk (2015).

¹⁷⁸ Miksjuk, Pranovich, and Ouliaris (2015).

of investment funds. In 2014 the government opened a dialogue with the World Bank on the development of a roadmap for structural reforms in Belarus. This formed an environment of expectation of such reforms in the near future. In some cases, the authorities explicitly proclaimed the year 2015 as the preparatory stage for deep reforms, announcing the start of reforms themselves in 2016 (associated with a new electoral cycle). But in reality, even what was called 'preparatory measures' were limited in practice.

By the end of 2015, it became clear that there was no political will to introduce the expected reforms. After the presidential elections, Mr. Lukashenka circulated a personal public address stating that no dramatic changes would be taking place in the operation of the national economy. At the same time, some measures that were probably inevitable, such as raising transport fares and utility tariffs, and an increase in the pension age, were presented by the authorities as structural reforms. Moreover, some promising legal acts were adopted (for instance, the strategy of reforms in the system of state finance¹⁷⁹); however, up until now they have remained mainly declarative. By 2016, this ambiguity allowed authorities arguing that deep reforms in Belarus had been started and were ongoing, but without using the term 'structural reforms' for that process.

Some evidence in support of this statement is the progress in reducing the scope and size of the QFA-SBC system, in particular, directed lending, throughout 2014-2015 which was probably the biggest policy change in the last couple of years.

However, the outcomes of this intention were ambiguous: while directed lending by commercial banks was reduced (both in nominal and real terms, mainly due to housing loans that almost halved even in nominal terms) the lending activity of the Development Bank partially compensated the latter. In 2015, the aggregate (commercial banks plus Development Bank) amount of directed loans granted remained roughly unchanged in nominal terms from the year 2014, although it did drop in real terms. But, what is probably more important, the stock of outstanding directed loans remained roughly unchanged throughout 2014-2015. The procedures for granting and obtaining such loans changed very little (although some novelties were announced, including a competitive basis for funds allocation): for the time being, funds are still simply granted to borrowers from the list approved by the government.

So, on the one hand, there are signs of willingness to reduce, if not dismantle the QFA-SBC system. On the other hand, these signs are too weak and leave doubts in respect to the future outcomes. Actually, this trade-off mirrors a more systemic challenge that the government is faced with: while the scope of accumulated distortions due to the QFA-SBC system is too high, a rapid exit from it will be painful. So, even in the case of strong political will for change, its speed might be restrained by concomitant concerns. And if the will for QFA-SBC dismantlement is not strong enough, the 'reform' period may take ages.

The outcomes of the attempts to restrict directed lending for a number of woodworking and machine-building SOEs provide evidence of this challenge. The relatively modest restrictions in directed lending coincided with shrinking foreign demand for these industries' products, and this resulted in a marked deterioration in the financial state of the affected SOEs in 2015. Many of them could hardly service their

¹⁷⁹ At the year end of 2015, the government adopted a corresponding Resolution. However, the document contains no direct action measures, and mainly postulates objectives of future activities without mentioning any measures that could help achieve the declared objectives.

debts, even those granted at preferential rates. The government responded by another unconventional intervention: the Ministry of Finance de facto purchased from the respective banks the debts of some machine-building and woodworking companies in exchange for state bonds, and the original debts of the state-owned enterprises were restructured and extended. The ministry used the scheme to purchase and restructure more than USD 1.5 billion worth of enterprise debt.¹⁸⁰

Through this step the ministry addressed two challenges: (a) it supported large manufacturers and helped maintain the number of jobs (which is almost identical to the purposes of directed lending) and (b) bailed out the affected banks helping them get rid of low-quality assets. So, while formally restricting directed lending, the government introduced a new tool of granting soft budget constraints. Hence the measures that were initially considered effective did not hit the actual target, preserving the environment of soft budget constraints under which the state-owned sector operates.

In the case of smaller SOEs, the restrictions in directed lending became even more painful, since the authorities were unable to provide sufficient support for all SOEs. Hence many companies initiated bankruptcy procedures on their own or had their lenders do it. In 2015, the number of bankruptcy cases filed with economic courts increased by 25% year on year. At the end of the year, the list of companies under bankruptcy procedures included several large manufacturing SOEs, which had been subject to a bankruptcy 'taboo' in previous years. This evidence strengthened voices (especially in the sphere of SOEs' management) against attempts to reform the QFA-SBC system.

The attempt of retuning QFA also affects the future macroeconomic development. If the government restricts its quasi-fiscal injections, it directly questions the viability of SOEs. The expected upshots are losses in output in the SOEs and a deterioration in the banks' financial stance due to the increase in non-performing loans (NPLs). If the authorities shift the responsibility for corresponding QFA from the state-owned banks to the government itself, this may buy some time but will just postpone the challenge for the future. Essentially the government would put its own future solvency at risk. The effectiveness of this policy will depend on whether beneficiaries will be able to restore their capacity to pay in the future and hence pay back their debt to the government. If not, the government will have to take all the responsibility (in financial and moral respect) as quasi-fiscal liabilities would transform into open public debt.

So, having a large inheritance of QFA overhang leaves no chance for easy solutions. The government has to balance between output losses, accumulation of NPLs and public debt. Thus, the future perspective has become the hostage of past mistakes.

Finally, the trade-offs in transforming the QFA-SBC system generate similar challenges for macroeconomic policy design. On the one hand, there is a broad public request for macroeconomic and financial stability, given the fresh memory of extremely high inflation, depreciation and other financial turbulences. On the other hand, fiscal and monetary restrictions may propagate output losses associated with adjustments in the QFA-SBC system.

So, the same diagnosis of the current stance of the economy may lead to different recommendations in respect to the macroeconomic policy mix. One may argue that, while exiting the QFA-SBC system is

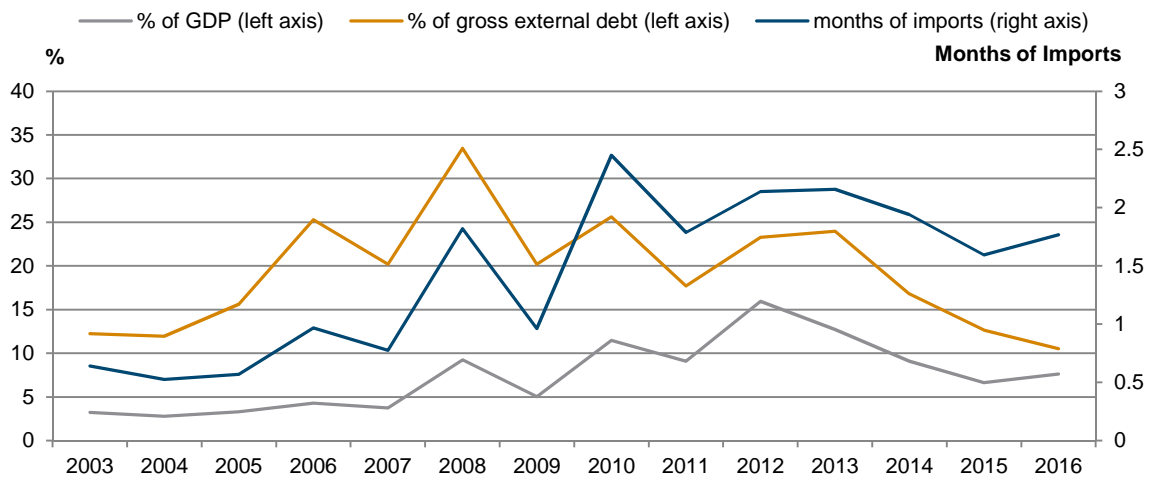
¹⁸⁰ The debts restructured were mainly nominated in foreign currency.

inevitably painful, it is worth paying this price in order to get rid of the associated distortions. However, it can be challenged by the opposite vision – that changes in the QFA-SBC system and in the macroeconomic policy mix should be cautious and taken by small steps to minimise output losses. In 2015-2016, Belarus seems to be still in a limbo, having got stuck in this trade-off.

Towards a new macroeconomic policy model

At the turn of 2014, it became evident that the currency peg could no longer be sustained. The authorities took a range of administrative measures to address the new currency crisis, including currency restrictions, direct price controls, and new taxes and charges on foreign exchange transactions. However, drawing on the experience of the financial crisis of 2011, they realised that if such measures were protracted, financial contagion would spread. So a couple of days after introducing administrative controls, the NBRB announced a complete overhaul of the country's monetary policy. In the first place, the currency peg was abandoned and a floating exchange rate regime was adopted. At par with the change in the exchange rate regime, monetary targeting was announced as the NBRB policy framework with rather restrictive targets for 2015. In turn, the government declared its intention to abolish or curb some of the demand stimulation tools. These radical policy changes were vindicated by a concern that the currency crisis might escalate into a full-fledged financial crisis, especially given the thin international reserves (Figure 4.9).

Figure 4.9 / Evolution of international reserves, 2008-2016 (beginning of the year)



Source: NBRB; Belstat; author's calculations.

Ever since, the macroeconomic policy setup in Belarus could be summarised as follows: (i) floating exchange rate framework; (ii) monetary targeting with tight intermediary goals; (iii) fiscal policy tightening; and (iv) less intensive usage of unconventional demand stimulation tools (QFA-SBC mechanisms, wage stimulation, etc.). The need for such a major policy shift had been building during quite a long period preceding the latest crisis; the latter was merely the trigger ('regime switcher') of the policy overhaul.

The floating exchange rate framework helped restore external equilibrium very rapidly. In 2015, even against the background of substantial negative external real shocks,¹⁸¹ this helped in bringing the current account deficit to acceptable levels (-3.8% of GDP¹⁸²), mostly due to large downward adjustments in imports.

The floating exchange rate so far also confirmed its effectiveness as a shock-absorber. Under the policy model of 2003-2014, real wages had been more volatile, and shocks in the real exchange rate triggered co-directed adjustments in real wages (Figure 4.10)¹⁸³ which is in line with theoretical conclusions.¹⁸⁴ In the case of Belarus this was amplified by the dollarisation and the high pass-through from exchange rate to prices which was reinforced by the pegged exchange rate regime.¹⁸⁵ During the currency crisis of 2014-2015, this relationship seems to have weakened which may be partly related to the shift away from the peg.

Figure 4.10 / Dynamics of the real effective exchange rate and real wage, percentage change over the year, %, 2006-2016



Source: NBRB; Belstat; author's calculations.

Note: CPI deflated series of real effective exchange rate distributed by the NBRB is used.

On the other hand, there are a number of risks associated with a floating exchange rate framework. However, the majority of them are not pitfalls of the regime itself but the consequences of introducing it in a fragile and weak macro environment (see Box 4.2).

¹⁸¹ A sharp drop in import demand from Russia (due to the plunge in oil prices) and other CIS countries.

¹⁸² According to the BOP methodology, outflow of primary income captures incomes and profits of foreign investors, even if there were no actual outflow of these funds. In the latter case, they are mirrored as the inflow in the financial account as reinvested earnings. This effect is relevant for Belarus, as a larger part of foreign investors' income is reinvested, and actually does not leave the country. From the view of macroeconomic policy, this effect may be interpreted as overestimating the current account deficit (and, respectively, the financial inflows). If netting this effect, the current account deficit in 2015 was roughly zero.

¹⁸³ Moreover, rough causality analysis suggests one-way Granger causality from real effective exchange rate to real wages.

¹⁸⁴ Obstfeld and Rogoff (1995); Edwards and Levy Yeyati (2005).

¹⁸⁵ Kruk (2011).

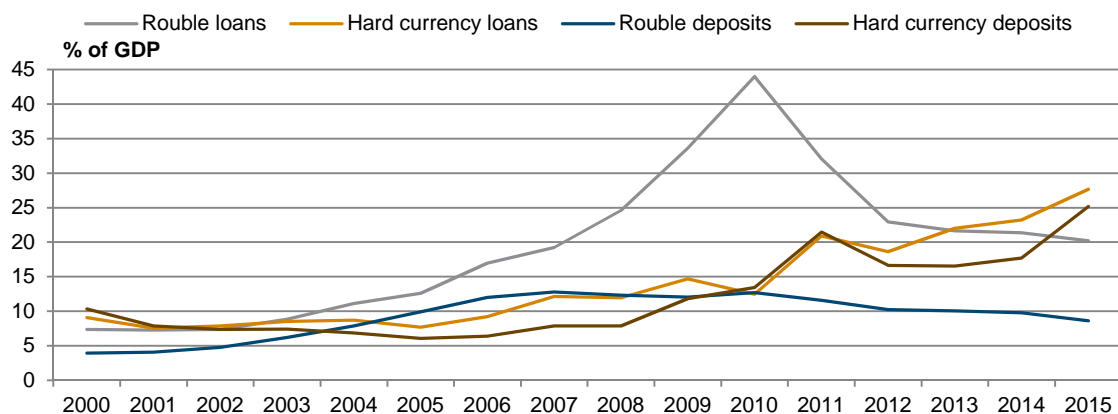
BOX 4.2 / FLOATING EXCHANGE RATE REGIME: WHAT ARE THE RISKS FOR BELARUS?

Among the downsides of the floating exchange rate regime – both on theoretical and/or empirical grounds – the following ones are probably most relevant for Belarus: (i) an effect equivalent to a sudden stop in financial flows¹⁸⁶; and (ii) the currency-induced credit risk¹⁸⁷.

The introduction of a floating exchange rate after the peg, when the latter was associated with a substantial overvaluation overhang, has much in common with the sudden stop crisis mechanism. Both of them cause rapid improvements in the current account largely due to the curbing of imports. While this may be favourable from the viewpoint of restoring the external balance, it might be too costly in terms of the domestic balance. Restraining imports of intermediate goods will impact negatively on domestic producers and will ultimately curb aggregate output. Empirically sudden stops are argued to be among the most painful types of shocks in terms of output losses and duration, especially for emerging markets.¹⁸⁸ Such a line of argumentation is applicable to Belarus as the 2015 adjustment had much in common with the sudden stop effect. Hence, one may expect output losses of prolonged duration associated with this effect. On the other hand, part of the sudden stop effect may be due to overvaluation rather than to the shift to a floating regime. From this perspective, despite being painful, such an effect is more likely to be interpreted as a ‘back to fundamentals’ adjustment.

As to the currency-induced credit risk, one should take into account that due to the high real interest rates after 2011¹⁸⁹, many Belarusian firms resorted to more active borrowing in foreign currency (Figure 4.11), even those that could not match repayment with stable currency revenues. In this case, the introduction of a floating exchange rate (given the exchange rate overhang fortified by the peg) becomes a trigger for non-payments by such borrowers. Again, this problem has become vital for Belarus. However, such aspects are not directly associated with monetary/exchange rate policy, but rather need to be addressed by banking regulation and supervision as well as proper credit screening by commercial banks.¹⁹⁰

Figure 4.11 / Currency structure of loans and deposits, % of GDP, 2000-2016



Source: NBRB; Belstat; author's calculations.

¹⁸⁶ Becker and Mauro (2006).

¹⁸⁷ Cayazzo et al. (2006).

¹⁸⁸ Becker and Mauro (2006).

¹⁸⁹ Kruk (2012).

¹⁹⁰ Cayazzo et al. (2006).

On balance, the introduction of the floating exchange rate regime so far has brought about positive macroeconomic outcomes by helping restore equilibrium and serving as a more effective shock-absorber. At the same time, it breeds some new risks that need to be addressed by policy.

The regime of monetary targeting with tight intermediary goals is the other key component of the new monetary framework. The re-orientation to low and stable inflation as the primary goal (instead of the exchange rate) of monetary policy has become the most prominent step forward.

When pondering over the new monetary policy regime, the logic of ‘imperfect environment’ and ‘scarce options to choose from’ was still prevailing in Belarus. In early 2015, the authorities aimed at answering the question ‘which monetary policy framework can immediately substitute for exchange rate targeting (given the failure of the latter), securing acceptable outcomes in terms of price and financial stability against the background of a fragile institutional framework?’. In the crisis-type environment of early 2015 such a choice could be treated as reasonable. However, from a longer-term perspective, one could still pose the question whether this was the right choice (for a discussion see Box 4.3).

The line of argumentation for adopting monetary targeting as a policy framework for the medium-term perspective by the NBRB looks as follows:¹⁹¹ (a) the NBRB has direct control over base money (operational target); (b) base money drives and defines broad money supply (intermediate target); and (c) broad money is the root cause of inflation (primary goal). The justification for monetary targeting was supported by econometric analysis on various aspects of the expected impact undertaken both by the NBRB and by independent analysts¹⁹². In other words, this was a type of justification claiming that ‘this regime is employed as it is feasible’, but not ‘this regime is the best choice among alternatives’.

Clearly, there are potential pitfalls (Box 4.3) associated with the monetary targeting framework in the case of the Belarusian macroeconomic environment. At some point, the authorities will probably seek for a more effective policy regime at par with the necessary institutional changes to support it. At present there are a number of studies pointing to the advantages of inflation targeting in the case of Belarus.¹⁹³

BOX 4.3 / CAVEATS ASSOCIATED WITH MONETARY TARGETING IN BELARUS

There are a number of arguments to support (with some caution) the introduction of monetary targeting in Belarus. At the same time there are reasons to suspect its low effectiveness as a monetary framework.

First, by definition this regime almost fully ignores the impact of expectations on the monetary environment. However, for Belarus the issue of inflation expectations emerged after the 2011 crisis and up until now inflation expectations are high and volatile, contributing a lot to the actual inflation dynamics.¹⁹⁴

¹⁹¹ Officially the NBRB assumes a gradual shift to the inflation targeting framework in the longer term. However, there is no schedule (even indicative) and road-map for such transformation, which means that in the foreseeable perspective (2-3 years) it will not occur, barring any emergency.

¹⁹² Mironchik and Bezborodova (2015); Pelipas and Kirchner (2015).

¹⁹³ Zaretski (2012).

¹⁹⁴ Kruk (2016).

Second, this regime is mainly backward looking. Its operational and intermediary targets are mainly formulated based on historic data, and can hardly take into account real-time data on a regular basis which may contain the impact of unexpected shocks. Hence, the policy regime is suffering from lack of flexibility.

Third (partially associated with the previous item), monetary targeting overemphasises the long-term context of monetary policy, while restricting the possibilities of inciting a short-term economic impetus. The latter means that this framework can hardly realise the dual mandate of monetary policy – price stability and output smoothing, and is likely to focus on price stability only. For Belarus, given the coincidence of an adverse external shock and slowdown in the business cycle, both goals seem to be important.

Fourth, there is a traditional objection to monetary targeting: the inherent instability in the money demand function and, respectively, difficulties in forecasting it. Available research is ambiguous whether or not this objection will be relevant in the case of Belarus.¹⁹⁵

Fifth, some specifics in the relations between the NBRB and commercial banks give rise to doubts about the full control of the NBRB over base money. Since 2010, when the NBRB undertook large-scale swap deals, a great part of its liabilities has been accounted for outside base money. Moreover, in the last couple of years, commercial banks have held large amounts (in comparison to base money) of liquidity in deposits at the NBRB and in NBRB bonds.¹⁹⁶ Hence, base money is affected not only by NBRB interventions but by commercial banks' operations as well.

Sixth, monetary targeting tends to breed some conflicts between the setting of base money as a monetary target and the interest rate as a policy instrument. Too high real interest rates and a distorted yield curve lead the monetary authorities into the temptation of direct control over interest rates. Such practices were widely used in previous years under the exchange rate peg, and persisted even under the monetary targeting framework.¹⁹⁷ However, a steady adherence to direct interest rate control and commitments on monetary aggregates may induce contradictory signals.

Seventh, broad money can hardly be treated as a proper anchor in many respects. For instance, knowing, understanding and perceiving this indicator as the nominal anchor by the public is doubtful. Moreover, given the very high dollarisation ratio, in case of significant exchange rate fluctuations the NBRB may face problems in meeting either broad money targets or the inflation target. A similar situation took place in 2015 when the NBRB formulated a target of 30% growth for broad money. But some unexpectedly large fluctuations took place during the year, which caused a 40.9% growth of broad money by the year end. Despite this, the inflation (primary) target was hit, while the intermediary one was not. So, the anchor is sensitive to the factors outside the NBRB's control, which may be a challenge in meeting its commitments.

A relative *tightening of fiscal policy* accompanied the dramatic changes in the monetary sphere. Unlike monetary policy, this was not an immediate decision. The fiscal authorities have been facing pressure from increasing obligations on debt repayments since 2012 (Figure 4.12). It included both debt service

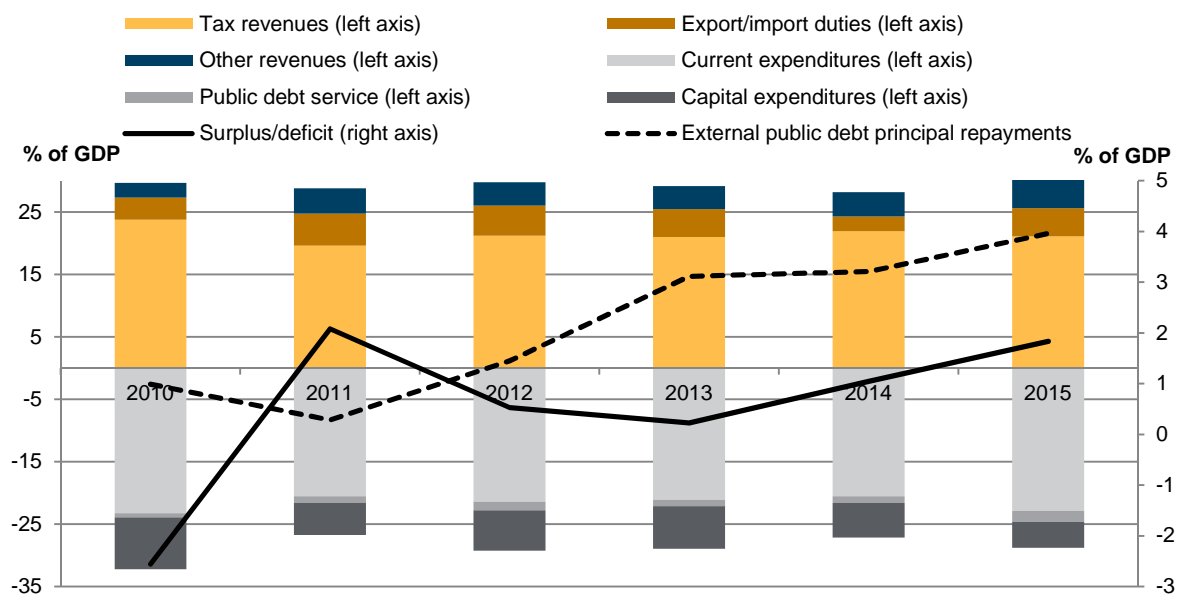
¹⁹⁵ Pelipas and Kirchner (2015), Mironchik and Bezborodova (2015), Kruk (2011).

¹⁹⁶ During last year the larger part of funds from 2010 swap deals was repackaged into NBRB's bonds.

¹⁹⁷ Murin (2016).

(where the increase was more or less gradual) and principal payments (in which case the increase was quite sharp). Overall, this did not cause radical adjustments in fiscal expenditures.

Figure 4.12 / Budget performance (revenue '+', expenditure '-') and external debt repayment, 2010-2015, % of GDP



Source: Ministry of Finance; Belstat; author's calculations.

In 2012-2014, the government cushioned the challenge mainly through debt refinancing, thus postponing the problem for later periods. This solution was chosen as the share of budget revenue denominated in foreign currency was much lower than its forex obligations. Moreover, revenues from export/import duties (the major component of forex revenues) were shrinking further due to unfavourable conditions in export markets. Given the mismatch between foreign currency obligations and expenditures, debt service would have either led to additional foreign currency demand by the government at the domestic market (which was considered highly undesirable) or would have required painful adjustments in expenditures. Thus, the government opted for debt refinancing but, nevertheless, gave rise to some restrictive trends in expenditures.

Some downward adjustment in public expenditure also did take place. Within current expenditure, the most profound reduction occurred in the public procurement of goods and services, and budget transfers (which include both social transfers and subsidies to firms). The cuts in these two items taken together contributed to a reduction in expenditures roughly by 0.8 percentage points of GDP. Furthermore, there were significant cuts in public capital expenditures: by 0.9 percentage points of GDP over the period 2012-2014. It may be interpreted that the savings generated by these cuts were directed towards debt repayments.¹⁹⁸

In 2015 the fiscal stance remained roughly the same, with a few new elements. A new deal with Russia (in respect to oil duties) was the most influential one. It secured an increase in public revenues roughly

¹⁹⁸ Repayments on debt principal are accounted in the budget 'under the line'.

by 2.5% of GDP. Moreover, these funds were forex-denominated, which made it possible to use them directly for debt repayment.

Technically this resulted in a larger headline fiscal surplus, as oil duties increased the revenue side but did not affect the expenditure side, as debt repayment is accounted 'under the line'.

Furthermore, additional internal restructuring of expenditure and revenue cushioned to some extent the real contraction of the most sensitive items of budget expenditures such as wages in the public sector and social transfers. Thus there were further cuts in public capital expenditure: in relative terms they reached a historical low in 2015 (4.2% of GDP vs. an average value of 6.4% in 2010-2014 and about 10% of GDP in previous decade). In addition, the authorities sought sources of additional revenue and targeted two groups of taxpayers: households and profitable state-owned enterprises. The rate on personal income tax was raised in 2015 from 12% to 13%. Hence, this tax was the only one that secured higher revenues. As regards profitable SOEs, a number of new regulations increased budget revenues due to higher than usual charges on their profits. In addition, the tax administration tightened tax and penalty collection, which contributed to an increase in non-tax revenues to 5.0% of GDP (3.6% of GDP in 2010-2014, and about 2.5% in previous decade).

Overall, fiscal policy was not used as a counter-cyclical tool during the recession in 2015 and even acquired some pro-cyclical features. The fiscal challenges directly impacted on the demand stimulation measures. Thus the authorities abstained from significant adjustment of the nominal 'base wage rate' which resulted in a reduction by some 7.5% in real terms (Figure 4.4). Furthermore, the government recommended to link wage and salary increases more closely to the labour productivity dynamics.¹⁹⁹

Reflecting all these policy changes, the macro environment in Belarus also changed. Before 2015, the stylised macroeconomic picture was a combination of low unemployment and GDP growth (albeit low and weakening during the last years), on the one hand, and substantial foreign trade deficit, exchange rate overhang and high inflation, on the other hand. Since 2015, the picture has changed to the reverse: the actual exchange rate roughly corresponds to the equilibrium rate, the current account deficit is close to its estimated mid-term equilibrium of around 3% of GDP²⁰⁰ with signs of disinflation; however, all of this is coupled with output contraction and growing unemployment.

In terms of output performance, 2015 turned out to be the worst year in the past two decades. GDP fell by 3.9% year on year; gross fixed capital formation dropped by 15.9% (and made a negative contribution to GDP growth of -5.9 percentage points), real consumption expenditures by households and state organisations fell by 2.4% (and made a negative contribution to GDP growth of -1.6 percentage points). The only component that made a positive contribution to GDP (+5.3 percentage points) was net exports. However, the positive effect of net exports can be attributed to the fact that real imports dropped more than real exports. On the supply side, all major industries were in recession. Construction output fell by 9.5% year on year while the manufacturing sector reported a 6.2% contraction in output.

In 2015, average real wages dropped by 3.1%, and real disposable incomes decreased by 5.6%. Rising unemployment became an important new characteristic of the economic status of households. Official

¹⁹⁹ This practice was introduced in the second half of 2014 by a special Resolution of the government.

²⁰⁰ IMF (2010) estimates the mid-term equilibrium level of the current account deficit at about -2.7% of GDP.

unemployment statistics (1.1%) only cover registered unemployed individuals and cannot shed light on the real scope of the problem. The significant decline in employment (the number of jobholders fell by 80,500 people in the period from December 2014 to December 2015) is a better indicator of the deteriorating situation in the labour market.

In foreign trade, Belarus reported a surplus for goods and services for the first time in many years (USD 174.3 million²⁰¹). This outcome can be attributed to the depreciation of the national currency and the ongoing recession.

In the monetary sphere, the results of the year 2015 were ambiguous. The authorities managed to avoid a full-fledged financial crisis and the NBRB was successful in pursuing disinflation. The average annual inflation (CPI) rate slowed to 13.5%, which was a progress compared to the past. Disinflation was not only the result of restrictive monetary policy. The contraction in demand (in particular, private consumption) lowered inflationary pressures and contributed to disinflation. The significant depreciation of the national currency (by 37.6% to the basket and 56% to the US dollar) was mostly caused by external shocks and did not translate into immediate financial shocks thanks to the change in the exchange rate regime.

At the same time, the tight monetary policy under the monetary targeting framework probably exerted a pro-cyclical effect, reinforcing the cyclical slowdown. Furthermore, the growing amount of non-performing loans has become an increasing concern for the banking system, giving rise to doubts about the stability of banks in the new economic reality.

Finally, external indebtedness became a more acute issue. While gross external debt in absolute terms went down by USD 1.8 billion, due to the exchange rate depreciation it hiked in relative terms, to 69.7% of GDP in 2015 from 52.8% a year earlier; government external debt rose to 26.8% of GDP from 20.1% (Figure 4.6).

Overall, macroeconomic performance in 2015 was disappointing. The country faced the first recession in 20 years and was reminded of the problem of unemployment. Despite the relative price stabilisation, the risks for the financial system and its overall fragility are still on the agenda.

In 2015, both the authorities and the general public were more or less ready to face these challenges. At the same time, there was an expectation of an upcoming rapid recovery. But this did not materialise in 2016 as the recessionary environment persisted. Questions like 'why is the recession so persistent' and 'what are the right priorities for economic policy' resurged on the agenda. The consolidated position of the authorities on the obvious restrictions in respect to both the QFA-SBC system and the macro incentives (as in the first half of 2015) began to erode. So, in 2016, the uncertainty about the future policy course and the direction of macroeconomic performance has resurged.

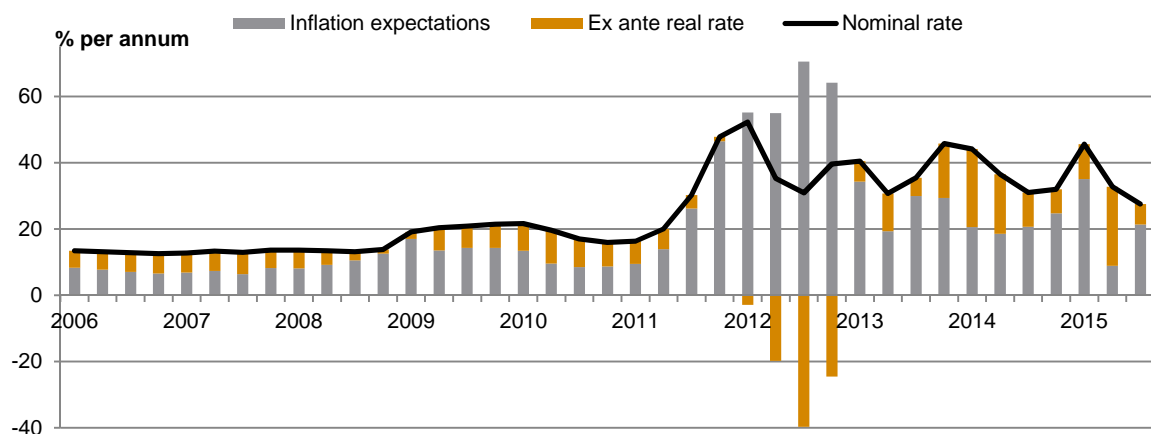
²⁰¹ FOB-FOB prices.

The roots of the recessionary environment

In the current macroeconomic environment, Belarus needs to find new impetuses to invigorate growth. The question is whether and how policy can contribute to such impetuses.

A 'big picture' of the macro environment in Belarus is somewhat similar to the interpretation of the current slowdown in developed countries as secular stagnation: the natural interest rate is below the actual level of the interest rate, which causes a downturn/slowdown in the business cycle.²⁰² However, for the developed market economies this situation is considered to be consequent to the problem of the zero lower bound, which is not the case for Belarus. For Belarus the steady overhang in real interest rates seems to be associated with the high and volatile inflation expectations after the currency crisis of 2011 (Figure 4.13).

Figure 4.13 / Decomposition of the nominal interbank interest rate, 2005-2015, %



Source: Own estimations based on Kruk (2016).

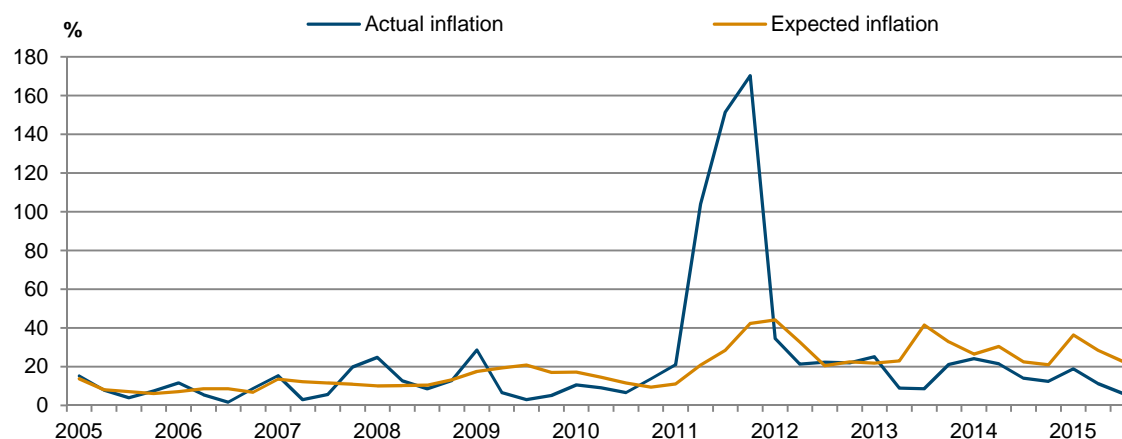
In 2011, Belarus experienced an upsurge of very high inflation associated with the currency crash. While this adjustment helped in easing (albeit temporarily) the macroeconomic imbalance, it also destroyed the confidence in the monetary policy and induced a spike in inflation expectations.

The estimated series of inflation expectations²⁰³ suggests that the level of expected inflation has tended to be steadily higher than actual inflation. It suggests that economic agents probably still do not have enough confidence in the declared commitments of the NBRB and tend to consider the inflation threat as a long-lasting process (Figure 4.14).

²⁰² Summers (2014).

²⁰³ Kruk (2016).

Figure 4.14 / Actual inflation (CPI) and inflation expectations, quarterly change (annualised rate), %, 2005-2015



Source: Own estimations based on Kruk (2016).

BOX 4.4 / MONETARY POLICY CHALLENGES UNDER HIGH INFLATION EXPECTATIONS

Propagating inflation through expectations may be considered as a separate channel within the monetary transmission mechanism (along with interest rate, exchange rate and bank-lending channels). In other words, even in the absence of underlying fundamental preconditions, inflation expectations may become a self-fulfilling prophecy.²⁰⁴ In order to suppress propagation through such channel, the authorities may need to tighten the policy stance more intensively than it would be the case in the absence of this channel, in particular, by raising interest rates. On the one hand, such a level of nominal interest rate may already be factored in the inflation expectations and the real ex ante interest rate; i.e., the current level of nominal interest rates will equalise the ex post real rate with the ex ante real rate if the actual inflation rate has been as high as current inflation expectations. On the other hand, if actual inflation is much lower than the expected one, the ex post real rate will be much higher than the ex ante one.

This creates something of a trap for the monetary authorities. If they keep interest rates high, based on the expected inflation, the impact of expectations on actual inflation will be mitigated, but the losses in terms of foregone output will be high as well, due to high ex post real interest rates. If they pursue a rapid reduction of nominal interest rates, current nominal rates will not guarantee ex ante real interest taking into account the high inflation expectations, which will constitute a shock for the money market. This constellation may set the stage of the mechanism of the self-fulfilling prophecy.

Furthermore, an increase in absolute value and in the volatility of the ex ante real rate (and high probability of an even higher ex post real rate in national currency) might also be a point of concern (Figure 4.13). Given the high inflation expectations, depositors might require higher 'guaranteed' interest on national currency, i.e. a higher ex ante real rate on savings in national currency. If such a premium is not secured, the depositors tend to shift more to foreign currency deposits (Figure 4.11), thus reducing the demand for national currency. Here, the NBRB again faces a dilemma that does not allow for a good solution: ignoring increasing deposit dollarisation means accepting less control over monetary aggregates and higher sensitivity to shocks; otherwise, interest rate should be maintained high, which leads to dampening output.

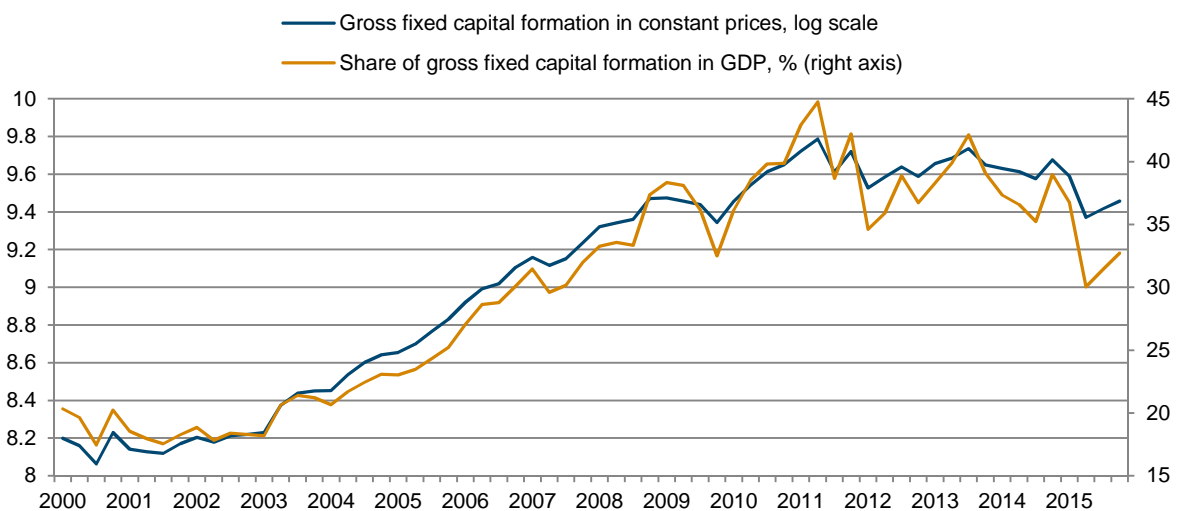
²⁰⁴ Christiano, Trabandt and Walentin (2011).

Inflation expectations have become a challenge for the monetary authorities in many respects (see Box 4.4). Persistent high inflation expectations are thus a challenge for monetary policy, effectively reducing its room for manoeuvre. Thus suppressing inflation expectations should probably be regarded as one of the priority goals of monetary policy and macroeconomic policy as a whole. In this regard, although the monetary targeting regime is probably superior to the exchange rate peg in terms of reducing the risks of currency crises, it does not help in addressing the problem of high and persistent inflation expectations.

From the point of view of the macro environment, the danger of high and volatile inflation expectations is primarily associated with their role in driving up real interest rates, which gives rise to a sustainable gap between actual and natural interest rate.

Firms may be reluctant to invest, having in mind the poor growth potential and the low expected returns on investments even in the case of an improving external environment.²⁰⁵ This predefines the environment for declining capital investments and a lowering natural interest rate. But the gap between the natural interest rate and the actual level of the interest rates in the Belarusian financial market amplifies the reluctance to invest. Finally, it leads to a depression investment environment. While in the past fixed investment was an important growth driver, since 2011 it has been stagnating and even decreasing both in absolute terms and, especially, in relation to GDP (Figure 4.15).

Figure 4.15 / The dynamics of gross fixed capital formation, 2000-2015



Source: Belstat; author's calculations.

In terms of the long-term environment, weakened fixed investments may be treated as the reflection of structural weaknesses and the erosion of the previous growth engines. In other words, this structural trend facilitates the adjustment of the capital stock to a more reasonable lower level, given the excessive and unproductive building of capital in previous years.

²⁰⁵ The view is empirically supported through estimations of the natural interest rate for Belarus according to the Laubach-Williams methodology (Laubach and Williams, 2003, 2015). The corresponding exercise exhibits a gradual decrease of the natural interest rate in Belarus from about 7.5% per annum in the mid-2000s to about 2% per annum by the end of 2015.

Breaking the current constellation of ‘dampened capital investments’ requires numerous changes relating both to structural and short-term issues. Structural consolidation can secure a trend of increasing natural interest rate. However, a stable monetary environment is not less important. Instability in expectations causes an obvious conflict between the price stability and output smoothing goals for the NBRB. From this viewpoint, prioritisation of price and financial stability leads to a tough stance of monetary policy in terms of output, which dampens business activity.

The outlook for the near future is that this stance will be continued, with the actual real interest rate exceeding the natural interest rate.²⁰⁶ Hence, the situation with dampened fixed investments is likely to continue in the near future, deferring the recovery from the cyclical recession. Furthermore, as the weakened fixed investment is more a structural issue rather than a cyclical one, the preconditions for a return of the previous model of investment-driven growth in the medium term seems unlikely as well.

Risks to financial stability

The emphasis of the authorities on price and financial stability since 2015 nevertheless has not eliminated the risks to financial stability. Numerous traditional financial weaknesses – due to the high level of dollarisation and the unstable inflation expectations – are still on the agenda. But nowadays this list of threats has been supplemented by debt issues. The level and quality of both public and business sector debts pose risks for future macroeconomic stability. Each challenge may be amplified by quasi-fiscal liabilities, while it is still unclear which strategy will be used for eliminating them (if any).

There were several reasons for the deterioration of the quality of debt in the business sector. During the decade of the ‘lending binge’, many non-financial companies were actively changing the structure of their capital base by increasing the share of borrowed funds. Over the past ten years, the equity-assets ratio in the economy decreased from 79.4% to 57.3%.²⁰⁷ Moreover, the policy push for ‘modernisation’, which was intensified after 2012, aggravated the debt challenge in the state-owned enterprises.²⁰⁸

The cost of borrowing is another attribute of the debt burden challenge, especially given that real interest rates in recent years have increased dramatically. Furthermore, in 2013-2014, many companies were taking forex loans seeking to alleviate the debt burden while taking an excessive exchange rate risk. In many cases, loans in foreign currency were taken by businesses that had no currency earnings. As a result, the quality of debts became highly dependent on exchange rate fluctuations.

Two groups of firms – state-owned enterprises (in the first place, the beneficiaries of directed lending) and foreign currency borrowers lacking sufficient export revenues – were the most affected with respect to debt sustainability.

²⁰⁶ World Bank (2016); IPM (2016).

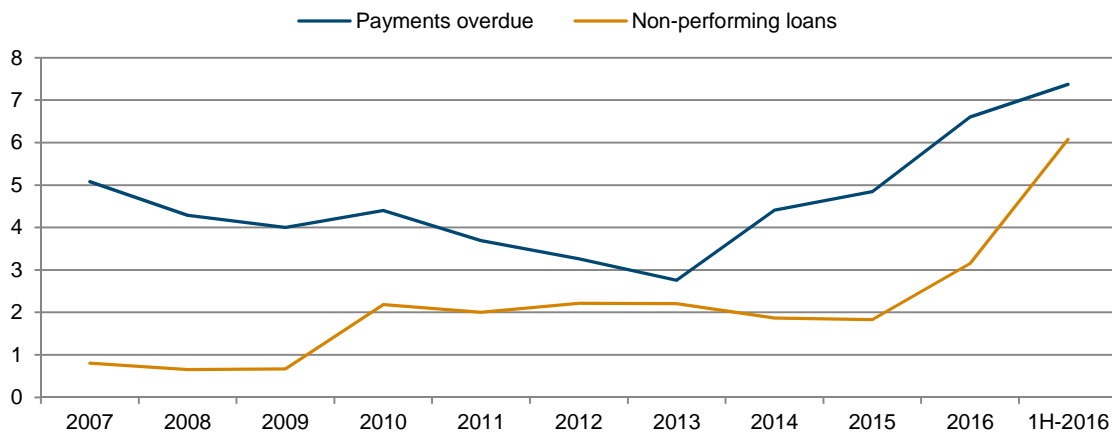
²⁰⁷ According to NBRB estimations, by the end of the first quarter of 2016, private debt was roughly 4 times higher than average monthly revenues. This indicator has roughly doubled during the last three years. The most general approach to assessing the debt quality threshold using the latter assumes the value of 3.

²⁰⁸ Having adopted modernisation plans, SOEs had to secure financial sources for implementing those plans. Most often the bulk of funds for purchasing new equipment was borrowed, given the lack of own sources for capital investments. Furthermore, the modernisation campaign contributed to a growing share of loans denominated in foreign currency, as imported equipment was mainly purchased with foreign currency and many SOEs preferred to obtain forex loans at lower interest rates.

The recession of 2015 and the significant depreciation throughout the year reinforced the debt service problems, especially in indebted SOEs. The wood processing industry provides a case in point for these problems. During the period 2008-2014, large financial resources were channelled into the SOEs in this sector through directed lending for the modernisation of their production facilities.²⁰⁹ However, the business plans that justified this campaign turned out to be unduly optimistic: real demand in the targeted markets contracted, the international prices for final goods actually halved, revenues in the domestic market also fell below expectations. By 2015, the majority of these SOEs de facto were insolvent: their debt service liabilities exceeded their revenues which triggered a debt swap intervention by the government.

The changed environment brought also problems for the businesses borrowing at market rates when the business model proved to be ineffective in the new conditions, for instance for firms depending on imports or dealing with real estate. In the first case, firms suffered competitiveness losses due to the depreciation which exceeded considerably the adjustment in domestic prices. In the sphere of real estate, changes in relative domestic prices led to a tightening in lending conditions (requirements for additional collateral, requirement for advance repayments, restricting refinancing, etc.). Plus, all debt holders who had originally borrowed in foreign exchange and had no (or very few) sources of revenues in foreign currency also experienced problems with debt servicing.

Figure 4.16 / The dynamics of overdue payments and non-performing loans, % of GDP, 2007-2016



Source: Belstat; author's calculations.

So, Belarus is de facto already facing a debt problem; however, its extent is still not clear. Publicly available financial statements of enterprises do not contain sufficient information to estimate the acuteness of the problem at the firm level. For instance, a number of accounting practices can mask the actual financial condition of a firm and its ability to service and repay debts. Moreover, in some cases financial statements (for the SOEs that are still not corporatised) are unavailable. From the available statistics, a rapid increase in overdue payments and NPLs might be a good evidence for the mounting challenge (Figure 4.16).

²⁰⁹ There is lack of official statistics on directed lending, especially concerning a breakdown by sector or by enterprise. However, a couple of times officials mentioned a figure of about USD 3 billion that have been injected into woodworking during the modernisation campaign.

On the part of the banks, there are publicly available data on the share of non-performing loans in their portfolios. Banking statistics report a gradual increase in the share of non-performing loans throughout 2015 and a sharp increase since the beginning of 2016 up to roughly 13% of the total portfolio by the end of the first quarter of 2016. However, if not for the debt swap of 2015, the level of NPLs would have amounted to roughly 17% of the total portfolio.

The current share of NPLs, which has already reached an alarming level, still may underestimate the real situation. First, state-owned banks that were mostly engaged in directed lending could be expected to exhibit high shares of NPLs. However, the level of NPLs reported by such banks is regularly lower than that in private banks. The most probable explanation is that there are state guarantees which allow classifying potentially fragile loans as belonging to the categories of 'good' assets. However, the ability of the government (central and local) to deliver on their guarantees is at least questionable, given that the bulk of such guarantees do not have an explicit source of financing. So, financial risks to state-owned banks due to NPLs might be underestimated.

Second, Belarusian legislation and banking practice allow for assessing collateral according to its book value, not fair-market value. Given some significant recent price corrections in many markets (real estate is a point in case), the gap between the accounting value of the collateral and its fair-market value may have increased. Respectively, the actual quality of such loans may have deteriorated, which would not be reflected in the statistics.

Third, in some cases banks may be reluctant to disclose the real situation with non-performing loans, as it could further hamper their own financial situation. For instance, the counterparts at the interbank market could become reluctant to provide liquidity to banks with a high share of NPLs; savers could withdraw their deposits.

The implications of the debt burden could be damaging for the national economy in many respects. The companies encountering debt problems are to give up or downsize their investment plans. If this is not sufficient to stabilise their financial situation, they will have to cut costs further and consider downsizing or even phasing down their activities. Banks that are burdened with non-performing loans are forced to provision, which affects their lending capacity and reduces borrowing opportunities, which ultimately impacts negatively on economic activity. In turn, substandard bank portfolios affect banks' operations; further significant deterioration may be a threat to their solvency, potentially creating risks for the banking system as a whole.

The authorities seem to be aware of the risks associated with increasing levels of indebtedness in the corporate and banking sector. Banks facing deteriorating quality of assets have been advised to seek recapitalisation; however, this recommendation may be difficult to implement, especially for state-owned banks. Recapitalising them will generate significant new claims on public resources which may be a threat to public debt sustainability. Given this challenge, the authorities seem to be undecided about the possible options in respect to large state-owned banks. As concerns the smaller state-owned bank – Belinvestbank – they opted for a traditional scheme of direct recapitalisation (alongside with the transfer of some its assets to the Development Bank), as this is not so burdensome for the economy as a whole. Besides, there are not many alternative options. In the past, the authorities have reverted to other bank bailout options, such as liquidity injections into banks by the NBRB, which is equivalent to outright printing of money. At present the NBRB has been resisting the repeat of such interventions, at least for

the time being. However, if there are credible threats of a full-fledged banking crisis, its attitude may change.

Other possible options of addressing indebtedness in the corporate and banking sectors that are being discussed include: provision of additional collateral against outstanding debt and accelerated repayments of outstanding debt. But again, the implementation of these solutions may be problematic. In many cases, it may require initiating bankruptcy procedures of borrowers, which may be highly undesirable considering the impact on employment, social stability, controllability, etc.

This trade-off mirrors the underlying conflict between distortions stemming from the QFA-SBC system and the desire to secure macroeconomic stability. The QFA-SBC system (not banks themselves) has become the primary source generating NPLs. Hence, the key to a successful solution of the problem must include responses not only in respect to banks, but also in respect to the fundamentals of the QFA-SBC system and the accumulated overhang of quasi-fiscal liabilities. The latter means that policy needs to address two issues: (i) which mechanisms of financial intermediation would secure efficient allocation of capital in the future, and (ii) how to absorb the losses stemming from the past.

In this context, the option of establishing a special agency for managing non-performing loans has been considered by the government as a sort of an intermediary to find individual solutions between banks and borrowers in each case.

In the second half of 2016, the authorities established the 'Agency on Assets Management', with a mandate to restructure and manage loans granted to agricultural firms. This new body is due to accelerate the process of Belagroprombank restructuring rather than to provide a systemic response to the NPL challenge in the entire banking system. But even in respect to agriculture, it is still unclear whether the agency will manage to perform a radical overhaul of the outstanding loans, the system of loan granting and, more broadly, the SBC system in agriculture as a whole. In principle, the formal powers delegated to the agency might allow it to do so.²¹⁰ However, the respective regulations do not provide clear clues as to 'who should absorb the losses'. They envisage numerous sources of funds for purchasing non-performing assets, but the issuance of bonds by local authorities is likely to become the dominating one. The actual functioning of the Agency should provide more evidence for understanding its role and assignments in respect to NPLs by agricultural firms.

At present the government does not seem to have a clear strategy for dealing with the accumulated QFA overhang. International experience and conventional wisdom assume that in a broad sense there might be three major options for addressing the challenge: (i) triggering bankruptcy of insolvent borrowers (or conciliation procedures with additional enforcements in banks' powers); (ii) supporting borrowers with simultaneous restructuring/recapitalisation of banks; and (iii) 'rebooting' the system after absorbing the losses by the government (i.e. by increasing public debt). The first option seems to be unacceptable for the government because of social and political considerations. The second and third options will actually mean that the QFA overhang is going to be transformed into open public debt. This is undesirable as well, as it will pose threats to the sustainability of public debt, which has already materialised as a medium-term risk.

²¹⁰ President's Edict No. 268 of 14 July 2016.

As of today, the risks to public debt sustainability are mainly associated with the currency structure of the debt, where hard currency obligations are dominating. Even in the case of a relatively stable absolute amount of public debt, the debt to GDP ratio is already approaching alarming levels²¹¹ and may increase further at par with possible further depreciation of the rouble. Furthermore, while the level of future forex debt service will be rising, the amount of future forex revenue of the government is uncertain; the level of international reserves is also quite low. Thus the government will need to solicit new forex borrowings in order to service its forex obligations or roll over old debt. Hence, public debt sustainability (more specifically, its forex component) may become questionable if new borrowings become unavailable, or if the debt burden continues to rise. If problems with sovereign debt emerge, these may be rather damaging for the economy, probably even more so than a private debt crisis, as it entails major risks both to macroeconomic and financial stability.

Apparently the authorities are fully aware of these risks. Recently a Council of Financial Stability has been established, with the principal mission of monitoring and counteracting systemic risks to financial stability.²¹² Its mandate mainly envisages the coordination of the activities and the development of joint action plans of three economic bodies – NBRB, Ministry of Economy and Ministry of Finance. While it does not have instruments of direct intervention, the Council might become important in terms of macroprudential regulation, as it is aimed to secure coordination and synchronisation of activities of the above-mentioned governmental bodies. A high level of representativeness in the Council – NBRB chair and vice-chairs, deputy prime minister, ministers and deputy ministers of finance and economy – is to secure high priority of financial stability considerations. However, it remains to be seen how effective the Council will be in its real life functioning.

BELARUS AND THE INTERNATIONAL FINANCIAL INSTITUTIONS

The history of Belarus' relations with the two main international financial institutions (IMF and World Bank) is not very rich. Two stand-by arrangements with the IMF were agreed in the 1990s (1993 and 1995) but subsequently were scaled down on the initiative of the Belarusian side, due to contradictions between IMF conditionality and national policy priorities. Later on, and until 2009, cooperation between Belarus and the IMF took place only at the level of technical assistance programmes. As regards the World Bank, cooperation was more intense. A number of projects were implemented (e.g. in healthcare, environment, infrastructure), but they were relatively insignificant in terms of scale and scope. Relations with the EBRD were of a similar pattern, but with a greater financial engagement of the Bank in the country's business sector. Overall, the period before the financial crisis was a period of semi self-isolation of Belarus vis-à-vis the international financial institutions. The Belarusian authorities were even somewhat suspicious of these bodies as being too focused on the promotion of undesirable standards and practices. In turn, the IMF, the World Bank and the EBRD treated Belarus as an outlier from the common patterns in other countries and were not ready to adjust their agenda to the country's specifics.

The global financial crisis of 2008-2009 and the urgent need by Belarus of external finance to support the currency peg opened the way for a new phase in bilateral relations. In 2008 Belarus applied for IMF financial assistance through a stand-by arrangement. Stabilising the balance of payments in the face of

²¹¹ Due to considerable depreciation during the past years and real GDP contraction, which together resulted in a rapid decline of GDP measured in US dollars.

²¹² Resolution of the Council of Ministers and NBRB No. 454/16 of 13 June 2016.

a sudden and sharp deterioration of the current account was the primary official goal of the programme. Given the very short duration of the negotiation process – Belarus applied for financing in mid-October 2008, and the programme was approved by the end of December of the same year – the two sides needed much flexibility vis-à-vis their traditional positions in respect to each other.

The Belarusian side was aware of the lack of alternative sources of emergency finance. Russia, which had been considered as the source of finance by default, at that same moment was itself in the midst of a deep crisis and was unlikely to lend the needed amount at acceptable terms and conditions. Moreover, just before the global crisis (at the turn of 2007-2008) Belarus was shyly 'reopening' (in both the political and economic dimensions) to the world outside Russia. Belarusian banks started borrowing from abroad and international banks became more active in the Belarusian market. Furthermore, the authorities adopted and promoted (without external pressure) a number of structural reform programmes that envisaged (although in rather ambiguous terms) privatisation, developing the infrastructure of the financial system (including the establishment of a stock market), attraction of foreign investors into the banking sector, etc.

In this environment, the Belarusian authorities were more flexible in the negotiations with the IMF. They undertook a number of commitments not only with respect to short-term macroeconomic indicators, but also as regards a number of structural issues, which earlier had been considered as a taboo in the negotiations with international financial institutions. The IMF, in turn, took a more flexible stance with respect to structural issues, which in the past had been considered as a starting point for negotiations with Belarus.

The overall emphasis of the programme was on immediate stabilisation policies, accompanied by elements of structural reforms (see Box 4.5). The successful implementation of stabilisation policies was expected to become the basis for subsequent more deep and systemic structural reforms. The programme envisaged the extension of five tranches of funding totalling SDR 1.6 billion,²¹³ which was about 420% of Belarus' quota in the Fund. The first tranche was scheduled for January 2009, the last one for February 2010.

The core stabilisation measures within the approved programme envisaged: (i) single-shot devaluation by rough 20% and shifting the peg from the US dollar to a currency basket; (ii) tightening of monetary policy as measured by base money growth; (iii) abolishment of the interest rate ceilings on loans; (iv) abolishment of non-market and preferential refinancing for state-owned banks; (v) recapitalisation of banks and introduction of a new deposit-insurance scheme; (vi) introduction of standards on special provisioning based on international good practices; (vii) balancing the central government budget; (ix) a temporary freeze in the nominal wage rate set by the government; (x) restricting the capital expenditures in the consolidated budget; (xi) increase in utility tariffs; and (xii) reserving more funds for social protection and improving the mechanisms of social security.²¹⁴

Throughout 2009 Belarus abided strictly by the IMF conditionality. The majority of the stabilisation measures were implemented without major caveats. The parties seemed to be happy with the process of programme implementations. However, the situation changed in 2010. The Belarusian authorities

²¹³ About USD 2.3 billion at that time.

²¹⁴ IMF (2008).

were keen to achieve rapid economic recovery and return to the habitual growth rates of output and incomes before the presidential elections. They considered restoring the practice of domestic demand stimulation as a safe option for this. Thus, just after having received the last tranche according to the programme, they returned to the policy design that had been prevailing before the crisis.

As regards the agreed structural adjustment measures (Box 4.5), their implementation was piecemeal and partial.

BOX 4.5 / STRUCTURAL ADJUSTMENT MEASURES AGREED UPON IN THE MEMORANDUM TO THE 2008 STAND-BY AGREEMENT BETWEEN BELARUS AND THE IMF²¹⁵ AND THEIR IMPLEMENTATION

- › *Abolishment of directed loans financed through government deposits in state-owned banks; abolishment of direct financing of the government programmes by the NBRB through non-financial organisations.*

Before 2009, the bulk of directed loans had been financed through this mechanism. This condition was rather painful for the authorities, as besides the structural context, it also affected the investment demand. Given this trade-off the authorities found a rather simple solution. Throughout 2009 and the larger part of 2010 government deposits in commercial banks indeed were frozen. The government began accumulating its deposits almost exclusively at the NBRB. However, at the same time the NBRB intensified liquidity injections to banks, thus compensating for (and even exceeding²¹⁶) the funds usually available for directed lending. So, de jure the commitment was fulfilled, but de facto the harmful practice targeted for abolition within the programme was not reduced and even expanded.

- › *Narrowing the practices of direct price regulations.*

The government took the commitments to abstain from the practice of setting 'a ceiling for price index growth' on a monthly basis for each industry. This commitment was fulfilled both formally and informally. However, temporary returns to the practice of comprehensive direct price regulations took place during the currency crises in 2011 and 2014-2015.

- › *Privatisation of state-owned banks.*

The authorities committed to: (i) find strategic investors for the state-owned Belinvestbank and BPS-bank; and (ii) put up for sale minority stakes in the two largest state-owned banks – Belarusbank and Belagroprombank. Later on, the programme was supplemented by the idea of establishing a specialised agency for non-performing loans which would acquire the majority of directed loans from the banks' balance sheets. The only commitment that was fulfilled in this field refers to the BPS-Bank: in late 2009 it was sold to Russia's Sberbank. Nevertheless, the idea of privatising both BPS-Bank and Belinvestbank was in principle appreciated by the authorities. The government did its best to strike a deal on Belinvestbank as well and was close to success in the negotiations with a large German bank. However, the environment of the global crisis dissuaded the German counterpart, which decided to abstain from the purchase.

²¹⁵ Ibid.

²¹⁶ Over 2009-2010, the share of government deposits in banks' liabilities decreased by 6.8 percentage points, down to 12.1%. The share of the NBRB's funds increased from 5.1% to 19.2%.

The sale of minority stocks in the two largest banks contradicted the plans of the authorities for actively engaging them in directed lending. Hence, from the very beginning they were reluctant to make progress in this respect. Thus, after a couple of rounds of declarations, preparations and discussion, the initiative was abandoned.

The idea of a special agency for non-performing loans was meant to prevent a further expansion of directed lending, which contradicted the general logic of the programme. Again, after a couple of rounds of discussions, the authorities rejected the initial idea by the IMF. As a kind of compromise, they suggested establishing the Development Bank with a wider mandate, which nevertheless was expected to absorb directed loans from commercial banks' balance sheets. A final decision was made only in 2011, and the Development Bank began its operations in 2012. However, so far the initial idea for its establishment has only been partially implemented: state-owned banks are still burdened with non-performing loans and perform some directed lending.

› *Privatisation of state-owned enterprises.*

The government took commitments on promoting the privatisation of 147 large and medium-sized enterprises. Later on, this was reduced to the commitment to conduct public privatisation tenders on five state-owned enterprises from the list of the largest ones. This was envisaged as a pilot with a view to providing experience on the conduct of such deals to further facilitate the privatisation process. In 2009 and the first part of 2010, some preparatory steps were made. However, the selection of enterprises for privatisation gave rise to doubts about the actual willingness of the government to deliver on this commitment. The selected enterprises were not among the 'largest state-owned enterprises' and were not too attractive to investors. Moreover, the requirements to potential investors were formulated in a way as if they were meant to discourage them. Nevertheless, the tenders were opened; however, no bids were submitted. So, formally the government again fulfilled its commitment, but failed it informally.

By 2015 Belarus had repaid the IMF loan and the programme was officially closed. The experience of this programme was ambiguous. On the one hand, it demonstrated (mainly referring to the experience of 2009) that Fund-supported stabilisation policies may have a favourable effect for enhancing macroeconomic stability. On the other hand, both parties were dissatisfied. The prevailing perception within the Belarusian authorities was that IMF loans were too heavily conditioned. Actually, the authorities sought to bypass some of those aspects of the programme that conflicted with their own policy priorities and were just trying to report some degree of formally meeting the requirements. The latter caused disappointment and reduced trust on the side of the IMF. An eventual new IMF-supported programme would thus require rebuilding trust and a credible commitment at the highest level.

Furthermore, based on the experience of the previous programme, the IMF is increasing the focus on structural issues in Belarus. In its assessments, the IMF highlights that minor adjustments have shown to be reversible, unless being anchored in 'deep and thorough structural reforms'. The Fund has hinted that it could consider a new programme for Belarus, which should be addressing structural weaknesses and promoting long-run growth. In 2012-2013, the IMF formulated its vision of the priorities for structural reforms in Belarus:²¹⁷ (i) financial sector reform, emphasising reduction in directed lending;

²¹⁷ IMF (2013).

(ii) elimination of excessive direct regulations in commodity and labour markets; (iii) liberalisation of trade, with emphasis on WTO accession; (iv) privatisation and thorough reform of state-owned enterprises; and (v) consolidating the social protection system.

At the same time the IMF continues to provide technical assistance to Belarus. Thus it supported the NBRB in launching a campaign of assets quality assessment in the Belarusian banking system in 2015. The majority of banks are to accomplish this procedure by the end of the first half of 2016. Furthermore, in April 2016 the IMF-World Bank FSAP²¹⁸ mission conducted some assessments and surveys. The results of these assessments (if publicly available, at least partially) will shed some light on the actual situation in respect to debt quality in the banking system and the degree of risk for financial stability.

Aversion of the IMF agenda and availability of other sources of external finance (first of all, the Eurasian Fund for Stabilisation and Development, EFSD) made the Belarusian side reluctant to seek a new IMF-supported programme in 2011-2015. The EFSD, established in 2009, provides to governments of member state of the Eurasian Development Bank financial credits to support stabilisation programmes aimed at making their economies more resilient to external and domestic shocks. Soon after that – in 2011, during the currency crisis – Belarus applied for a stabilisation loan. Presumably the Belarusian authorities approached EFSD with the implicit expectation that, on the one hand, its conditionality would clash less with their policy objectives and, on the other hand, that ESFD monitoring may be subject to political pressure.

The stabilisation programme of 2011 was of a short-term nature and almost entirely focused on macroeconomic policy. Stabilisation measures mainly aimed at the tightening of monetary and fiscal policies, which was expected to mitigate the domestic demand overhang. These commitments were represented in the form of targets in selected macroeconomic indicators (net foreign assets of monetary authorities, fiscal balance, tariffs on utilities and transport).

In the sphere of structural reforms, privatisation and some restrictions in directed lending were the only issues that were touched upon by the programme. Privatisation commitments assumed that in 2011-2013 the government would raise some USD 2.5 billion annually in privatisation as revenue. With respect to directed lending, threshold values were set for the NBRB's claims on banks, the net disbursement on directed lending, and the government deposits in commercial banks.²¹⁹ The programme assumed that the loan of USD 3.0 billion would be extended in six tranches.

In implementing this programme, the Belarusian authorities were not as strict as in the case of the IMF-supported programme of 2008, even with respect to formal criteria. Within every phase between two consecutive tranches, at least some target parameters were not met. As to the privatisation commitment, the authorities ignored it altogether during the whole period of programme implementation. Despite this, subsequent tranches were usually granted, which reasonably was expected by the authorities as a politically motivated decision. Violation of programme commitments became the reason for suspending only the last tranche at the end of 2013.²²⁰ By that time Belarus had received some USD 2.6 billion, and the need for the last tranche was not that urgent.

²¹⁸ Financial sector assessment programme.

²¹⁹ After the end of the 2008 IMF programme, the government resumed this practice of reserving funds for directed lending.

²²⁰ The last tranche was not granted at long last, after two suspensions of decisions on it.

The experience of the EFSD-supported programme seems to have matched the expectations of the authorities that cooperation with EFSD would not be a compelling constraint on continuing with their desired course of economic policies. Moreover, in subsequent years Belarus was apparently trying to play a strategic game with the IMF and EFSD, probably seeking to instigate a kind of 'competition' among them with the goal of getting access to cheaper and less conditioned borrowings. According to this logic, the best solution for Belarus would be to borrow from both institutions.

In early 2015, the situation changed. First, the need for new borrowings became more urgent, while such borrowings were not readily available either from Russia or from the EFSD. Second, in early 2015, expectations were that President Lukashenka would approve the start of deeper structural reforms. The severe recession was sometimes considered as a possible trigger of these reforms.

In fact the Belarusian government developed a draft 'roadmap' of structural reforms in partnership with the World Bank.²²¹ It envisages the following priorities for reforms: (i) ensuring an even playing field in the access to finance for state-owned and private firms; (ii) eliminating various form of financial support to SOEs; (iii) strengthening state property management mechanisms; (iv) reducing excessive administrative regulations in the labour market; and (v) fine-tuning of social protection for the unemployed. The authorities consider this document as the framework for the negotiation of a new IMF-supported programme. Based on this, they made an official request for IMF financing. However, the Fund came up with supplementary requirements that were aimed at making reforms irreversible and this put the negotiations in limbo. Furthermore, the approval of an EFSD financing programme in early 2016 reduced the urgency of IMF funding for the Belarusian side and this probably affected their negotiation stance. Hence, the negotiations that started in 2015 are still ongoing and their outcome is uncertain.

In turn, the approval of the EFSD programme in March 2016 has become, in a sense, a pleasant surprise for the authorities, given the rejection of the sixth tranche under previous financing programme, and the financial difficulties in Russia, the main donor of the EFSD. The Belarusian side had applied for a new financing programme with the EFSD in March 2015, most probably relying on a politically motivated loan similar to the previous one.

In the course of 2015, the EFSD team insisted on numerous amendments and improvements to the draft programme. According to their official position, they wanted 'to develop additional mechanisms that would reduce risks of programme failure'. So, the decision of the EFSD to approve a new programme came somehow unexpected, especially given that the Belarusian side did not undertake any new serious commitments in favour of Russia and/or the project of Eurasian integration.

Two interpretations of the EFSD have been put forward. The first one looks at the political background, in particular the desire of the Russian side to prevent a new funding programme with the IMF by installing an EFSD programme. The second one looks at the new deal as an instrument of refinancing previous debts from the EFSD and Russia. Moreover, the new programme contributes to more economic stability within the Eurasian Union, which is important for Russia both economically and politically.

²²¹ <http://www.worldbank.org/en/news/press-release/2015/11/03/policies-for-higher-productivity-and-sustainable-growth>.

Finally, the design of the EFSD programme has become rather 'light'. Although mentioning the importance of structural changes, it does not focus too much on concrete measures. It mainly includes the steps that have already been implemented (or are being implemented) by the Belarusian authorities – such as raising utility tariffs, abolition of directive 'volume' indicators for SOEs, curbing new inflows of directed lending²²², price liberalisation, implementing new procedures in the forex deal-making process, etc. The majority of these steps are treated as structural changes.²²³ Furthermore, the programme envisages a number of indicative parameters – such as fiscal balance for the general government, restrictions on wage increases in the budget sector, ceilings on broad money growth – which again mainly repeat those already adopted by the Belarusian authorities.

Given this 'light' design of the programme and the high degree of its political determination, the programme has not become a strong pillar for the economic environment. The authorities consider it mainly as a 'money-pumping' source: it allows being more flexible and to hurry not too much when dealing with the bulk of challenges.

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²²² The adopted parameters are identical to those adopted by the government before.

²²³ Also the programme envisages as structural measures: developing a new strategy for management of state property, establishment of a new antitrust body (this was realised by renaming the Ministry of Trade into Ministry of Antitrust Regulation and Trade), less role of the government in the economy. But these measures either do not envisage concrete commitments, or can hardly be measured.

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Annex Table 1 / Belarus: Selected economic indicators, 2000-2015

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Population, th pers., average	9'980	9'929	9'866	9'797	9'730	9'664	9'605	9'561	9'528	9'507	9'491	9'473	9'465	9'466	9'475	9'493
Gross domestic product, BYR bn, nom. ¹⁾	9'134	17'173	26'138	36'565	49'992	65'067	79'267	97'165	129'791	137'442	164'476	297'158	530'356	649'111	778'095	869'702
annual change in % (real) ¹⁾	5.8	4.7	5.0	7.0	11.4	9.4	10.0	8.6	10.2	0.2	7.7	5.5	1.7	1.0	1.7	-3.9
GDP/capita (EUR at exchange rate)	1'200	1'400	1'600	1'600	1'900	2'500	3'000	3'400	4'500	3'600	4'300	3'900	5'200	5'800	6'200	5'100
GDP/capita (EUR at PPP)	5'000	5'400	5'700	6'200	7'200	8'100	9'000	10'000	10'900	10'600	11'700	12'500	13'100	13'300	13'700	13'500
Consumption of households, BYR bn, nom. ¹⁾	5'012	9'531	15'114	20'332	26'130	32'955	39'792	49'175	66'244	74'997	88'470	139'955	244'863	318'332	392'116	437'136
annual change in % (real) ¹⁾	8.0	17.9	11.4	7.4	9.6	15.0	13.0	13.7	17.2	0.1	9.5	2.3	10.8	10.9	4.3	-2.4
Gross fixed capital form., BYR bn, nom. ¹⁾	2'302	3'893	5'747	8'683	12'656	17'254	23'511	30'487	43'225	49'346	64'698	113'230	178'455	244'296	263'693	248'350
annual change in % (real) ¹⁾	2.3	-2.3	6.6	20.6	19.9	19.5	31.6	16.4	23.8	5.0	17.5	13.9	-11.3	9.6	-5.3	-15.9
Gross industrial production																
annual change in % (real)	7.5	5.9	4.0	6.7	15.3	10.0	11.2	8.6	11.3	-3.1	11.7	9.1	5.8	-4.9	2.0	-6.6
Gross agricultural production																
annual change in % (real)	9.5	1.7	0.4	6.8	12.6	1.7	5.9	4.1	8.9	1.0	2.5	6.6	6.6	-4.2	2.9	-2.8
Construction industry																
annual change in % (real)	-11.8	1.2	6.8	16.0	14.6	12.1	20.1	15.9	21.1	4.6	12.9	6.7	-8.6	4.6	-5.7	-10.0
Reg. employment, th, average	4'444	4'422	4'387	4'347	4'326	4'414	4'470	4'518	4'611	4'644	4'703	4'691	4'612	4'578	4'551	4'470
annual change in %	0.0	-0.5	-0.8	-0.9	-0.5	2.0	1.3	1.1	2.0	0.7	1.3	-0.3	-1.7	-0.7	-0.6	-1.8
Reg. unemployed persons, th, end of period	95.8	102.9	130.5	136.1	83.0	67.9	52.0	44.1	37.3	40.3	33.1	28.2	24.9	21.0	24.2	43.3
Reg. unemployment rate, in %, end of period	2.1	2.3	2.9	3.1	1.9	1.5	1.1	1.0	0.8	0.9	0.7	0.6	0.5	0.5	0.5	1.0
Average monthly gross wages, ths BYR	59	123	189	251	348	464	582	694	868	982	1'217	1'900	3'676	5'061	6'052	6'700
annual change in % (real, gross)	12.0	29.6	7.9	3.2	17.4	20.9	17.3	10.0	9.0	0.1	15.0	1.9	21.5	16.4	1.3	-2.5
Consumer prices, % p.a.	168.6	61.1	42.6	28.4	18.1	10.3	7.0	8.4	14.8	13.0	7.8	53.2	59.2	18.3	18.1	13.5
Producer prices in industry, % p.a. ²⁾	186.8	70.6	38.8	35.0	23.7	12.1	8.6	21.2	15.2	13.6	13.6	71.4	76.0	13.6	12.8	16.8
General governm.budget, nat. def., % of GDP																
Revenues	34.8	33.5	33.0	33.4	44.2	47.4	48.4	49.5	50.6	45.7	41.5	38.7	38.5	40.3	38.7	41.0
Expenditures	35.4	35.1	33.2	35.0	44.1	48.0	47.0	49.0	49.2	46.4	43.3	35.9	37.7	40.1	37.3	39.0
Net lending (+) / net borrowing (-)	-0.6	-1.6	-0.2	-1.6	0.0	-0.7	1.4	0.4	1.4	-0.7	-1.8	2.8	0.8	0.2	1.3	2.0
Public debt, EU-def., % of GDP										34.7	39.5	45.9	38.5	37.6	39.8	40.0
Central bank policy rate, % p.a., end of period ⁴⁾	80.0	48.0	38.0	28.0	17.0	11.0	10.0	10.0	12.0	13.5	10.5	45.0	30.0	23.5	20.0	25.0
Current account, EUR mn ⁴⁾	-497	-590	-345	-402	-956	368	-1'097	-2'188	-3'499	-4'316	-6'187	-3'518	-1'446	-5'737	-4'034	-1'582
Current account, % of GDP ⁴⁾	-4.0	-4.4	-2.2	-2.6	-5.2	1.5	-3.8	-6.7	-8.2	-12.5	-15.1	-9.5	-2.9	-10.5	-6.9	-2.0
Exports of goods, BOP, EUR mn ⁴⁾	6'535	7'461	7'674	8'094	10'436	12'199	14'938	16'928	22'319	14'494	18'311	28'499	35'391	27'701	27'492	23'396
annual change in %		14.2	2.9	5.5	28.9	16.9	22.5	13.3	31.8	-35.1	26.3	55.6	24.2	-21.7	-0.8	-12.7
Imports of goods, BOP, EUR mn ⁴⁾	7'647	8'558	8'705	9'439	12'406	12'889	16'879	20'033	26'902	19'494	25'251	30'913	34'952	31'183	29'537	25'305
annual change in %		11.9	1.7	8.4	31.4	3.9	31.0	18.7	34.3	-27.5	29.5	22.4	13.1	-10.8	-5.3	-10.3
Exports of services, BOP, EUR mn ⁴⁾	1'096	1'285	1'433	1'503	1'574	1'880	2'114	2'572	3'239	2'614	3'583	3'906	4'901	5'690	6'113	5'939
annual change in %		17.2	11.5	4.9	4.7	19.5	12.4	21.7	25.9	-19.3	37.1	9.0	25.5	16.1	7.4	-1.8
Imports of services, BOP, EUR mn ⁴⁾	598	895	903	769	802	916	1'353	1'514	1'939	1'561	2'247	2'334	3'140	3'983	4'424	3'873
annual change in %		49.8	0.9	-14.9	4.3	14.2	47.7	11.9	28.1	-19.5	43.9	3.9	34.5	26.8	11.1	-9.6
FDI liabilities (inflow), EUR mn ⁴⁾	129	107	262	152	131	246	282	1'313	1'544	1'321	1'041	2'787	1'137	1'703	1'445	1'309
FDI assets (outflow), EUR mn ⁴⁾	0	0	-218	1	1	2	2	11	22	72	38	87	121	199	57	100
Gross reserves of NB, excl. gold, EUR mn ⁴⁾			402	369	507	935	812	2'683	1'921	3'369	2'591	4'648	4'390	3'589	2'820	2'510
Gross external debt, EUR mn ⁴⁾	2'251	3'382	3'751	3'340	3'624	4'334	5'199	8'484	10'834	15'382	21'449	26'305	25'518	28'807	32'982	34'175
Gross external debt, % of GDP	18.2	25.0	24.5	21.5	19.6	17.9	17.8	25.8	25.4	44.6	52.2	71.3	51.9	52.5	56.0	70.1
Average exchange rate BYR/EUR	739	1'272	1'704	2'353	2'698	2'684	2'715	2'959	3'046	3'983	4'007	8'051	10'778	11'834	13'220	17'828
Purchasing power parity BYR/EUR	182	323	463	601	719	833	921	1'015	1'253	1'365	1'476	2'504	4'283	5'145	5'985	6'771

1) According to SNA 1993. - 2) Domestic output prices. - 3) Refinancing rate of NB. - 4) Converted from USD.

Source: wiiw databases incorporating Eurostat and national statistics. Forecasts by wiiw.

Annex Table 2 / The largest companies in Belarus, 2014

Classification criterion	Company name	Ownership
The largest producers by the value of sales at producer prices	Belaruskalii (potassium fertilisers)	State-owned
	Belarussian Metallurgical Plant	State-owned
	Minsk Automotive Plant	State-owned
	Minsk Tractor Plant	State-owned
	Minskenergo	State-owned
The largest tax payers (share of contribution to budget revenue, %)	Gazprom Transgaz Belarus (4.9%)	Foreign owned
	Belaruskalii (potassium fertilisers)(3.8%)	State-owned
	Naftan (oil refinery) (3.5%)	State-owned
	Mozyr oil refinery (3.5%)	Joint venture (Belarus state and foreign)
	Lukoil Belarus (2.5%)	Foreign owned
	Grodno Tobacco Factory "Neman" (2.3%)	State-owned
	Tabac-invest (1%)	Private
The largest exporters	Minsk Plant of Grape Wines (1%)	State-owned
	Belarus Oil Company (trade in oil products)	State-owned
	RN Zapad (Rosneft West) (foreign trade and local distribution of fuels)	Private
	Belarusneft (oil and gas extraction and processing)	State-owned
	Belarussian Metallurgical Plant	State-owned
The largest employers (number of employees)	Interservice Belarus (trade in oil and oil products)	Private
	Evrotorg (retail trade) (22.6 ths)	Private
	Belpochta (Belarus Post) (20.5 ths)	State-owned
	Belarus Bank (19.5 ths)	State-owned
	Minsk Automotive Plant (18.8 ths)	State-owned
	Minsk Tractor Plant (18.8 ths)	State-owned
	BelTeleCom (17.8 ths)	State-owned
Belaruskalii (potassium fertilisers) (17.6 ths)	State-owned	

Source: Rudyi (2016).

Annex Table 3 / Composition of Belarusian exports and imports: top 20 export and import commodity groups (HS-2 digit level), 2014

Exports

HS 2-digit code	Commodity group	Share in total exports, %
27	MINERAL FUELS, MINERAL OILS AND PRODUCTS OF THEIR DISTILLATION ...	33.5
31	FERTILISERS	8.5
87	VEHICLES OTHER THAN RAILWAY OR TRAMWAY ROLLING-STOCK, AND PARTS AND ACCESSORIES THEREOF	6.9
4	DAIRY PRODUCE; BIRDS' EGGS; NATURAL HONEY; EDIBLE PRODUCTS OF ANIMAL ORIGIN, NES	6.6
84	NUCLEAR REACTORS, BOILERS, MACHINERY AND MECHANICAL APPLIANCES; PARTS THEREOF	4.6
39	PLASTICS AND ARTICLES THEREOF	3.1
72	IRON AND STEEL	2.9
73	ARTICLES OF IRON OR STEEL	2.5
85	ELECTRICAL MACHINERY AND EQUIPMENT AND PARTS THEREOF; SOUND RECORDERS ...	2.5
2	MEAT AND EDIBLE MEAT OFFAL	2.4
44	WOOD AND ARTICLES OF WOOD; WOOD CHARCOAL	2.2
99	OTHER	1.7
94	FURNITURE; BEDDING, MATTRESSES, MATTRESS SUPPORTS, CUSHIONS ...	1.6
38	MISCELLANEOUS CHEMICAL PRODUCTS	1.4
40	RUBBER AND ARTICLES THEREOF	1.2
16	PREPARATIONS OF MEAT, OF FISH OR OF CRUSTACEANS, MOLLUSCS OR OTHER AQUATIC INVERTEBRATES	1.2
90	OPTICAL, PHOTOGRAPHIC, CINEMATOGRAPHIC, MEASURING, CHECKING, PRECISION, ...	1.0
62	ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, NOT KNITTED OR CROCHETED	0.9
7	EDIBLE VEGETABLES AND CERTAIN ROOTS AND TUBERS	0.8
17	SUGARS AND SUGAR CONFECTIONERY	0.8
	OTHER	13.9

Imports

HS 2-digit code	Commodity group	Share in total imports, %
27	MINERAL FUELS, MINERAL OILS AND PRODUCTS OF THEIR DISTILLATION; ...	33.5
84	NUCLEAR REACTORS, BOILERS, MACHINERY AND MECHANICAL APPLIANCES; PARTS THEREOF	4.6
87	VEHICLES OTHER THAN RAILWAY OR TRAMWAY ROLLING-STOCK, AND PARTS AND ACCESSORIES THEREOF	6.9
85	ELECTRICAL MACHINERY AND EQUIPMENT AND PARTS THEREOF; SOUND RECORDERS ...	2.5
39	PLASTICS AND ARTICLES THEREOF	3.1
72	IRON AND STEEL	2.9
73	ARTICLES OF IRON OR STEEL	2.5
8	EDIBLE FRUIT AND NUTS; PEEL OF CITRUS FRUITS OR MELONS	0.6
30	PHARMACEUTICAL PRODUCTS	0.4
90	OPTICAL, PHOTOGRAPHIC, CINEMATOGRAPHIC, MEASURING, CHECKING, PRECISION, ...	1.0
29	ORGANIC CHEMICALS	0.7
23	RESIDUES AND WASTE FROM THE FOOD INDUSTRIES; PREPARED ANIMAL FODDER	0.3
48	PAPER AND PAPERBOARD; ARTICLES OF PAPER PULP, OF PAPER OR OF PAPERBOARD	0.5
40	RUBBER AND ARTICLES THEREOF	1.2
3	FISH AND CRUSTACEANS, MOLLUSCS AND OTHER AQUATIC INVERTEBRATES	0.4
38	MISCELLANEOUS CHEMICAL PRODUCTS	1.4
64	FOOTWEAR, GAITERS AND THE LIKE; PARTS OF SUCH ARTICLES	0.6
7	EDIBLE VEGETABLES AND CERTAIN ROOTS AND TUBERS	0.8
76	ALUMINIUM AND ARTICLES THEREOF	0.6
21	MISCELLANEOUS EDIBLE PREPARATIONS	0.1
	OTHER	35.5

Source: wiiw calculations based on the UN Comtrade data

Annex Table 4 / Inward and outward FDI indicators for Belarus, 2005-2015

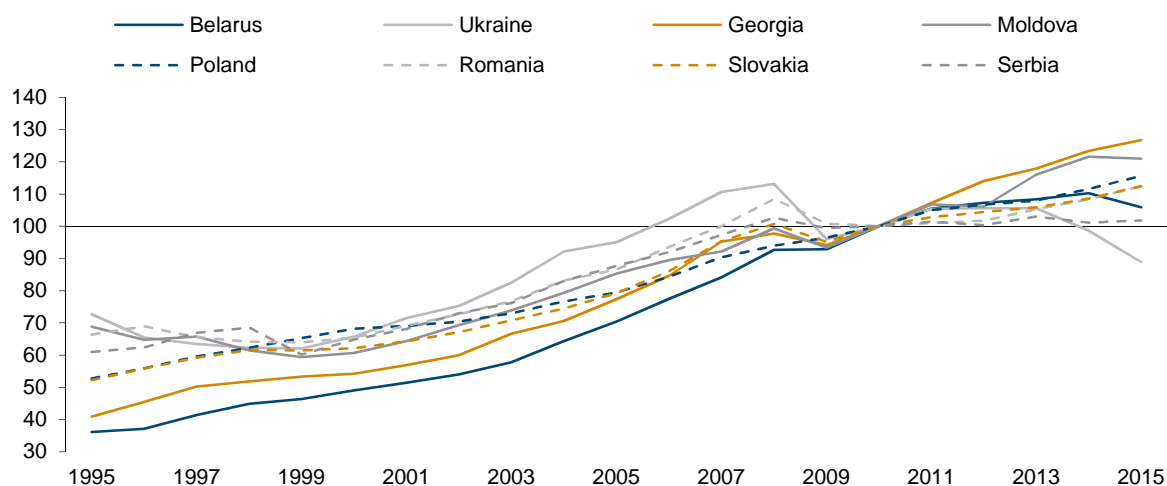
Direction	Unit	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
FDI inflow	EUR mn	245	280	1311	1544	1321	1041	2787	1110	1690	1418	1444
FDI inflow	EUR per capita	25	29	137	162	139	110	294	117	179	150	152
FDI inflow	in % of GDP	1	1	4	4	4	3	8	2	3	2	3
FDI inflow	in % of GFCF	4	3	13	11	11	6	20	7	8	7	10
FDI outflow	EUR mn	2	2	11	22	72	38	87	94	186	30	108
FDI outflow	EUR per capita	0	0	1	2	8	4	9	10	20	3	11
FDI outflow	in % of GDP	0	0	0	0	0	0	0	0	0	0	0
FDI outflow	in % of GFCF	0	0	0	0	1	0	1	1	1	0	1
FDI inward stock	EUR mn	2014	2077	3044	4778	5952	7479	10048	11011	12120	14617	16440
FDI inward stock	EUR per capita	209	217	319	502	627	789	1062	1164	1280	1542	1731
FDI inward stock	in % of GDP	8	7	9	11	17	18	27	22	22	25	34
FDI outward stock	EUR mn	12	14	31	52	101	155	227	344	527	522	628
FDI outward stock	EUR per capita	1	1	3	5	11	16	24	36	56	55	66
FDI outward stock	in % of GDP	0	0	0	0	0	0	1	1	1	1	1

Source: wiiw FDI database relying on national sources.

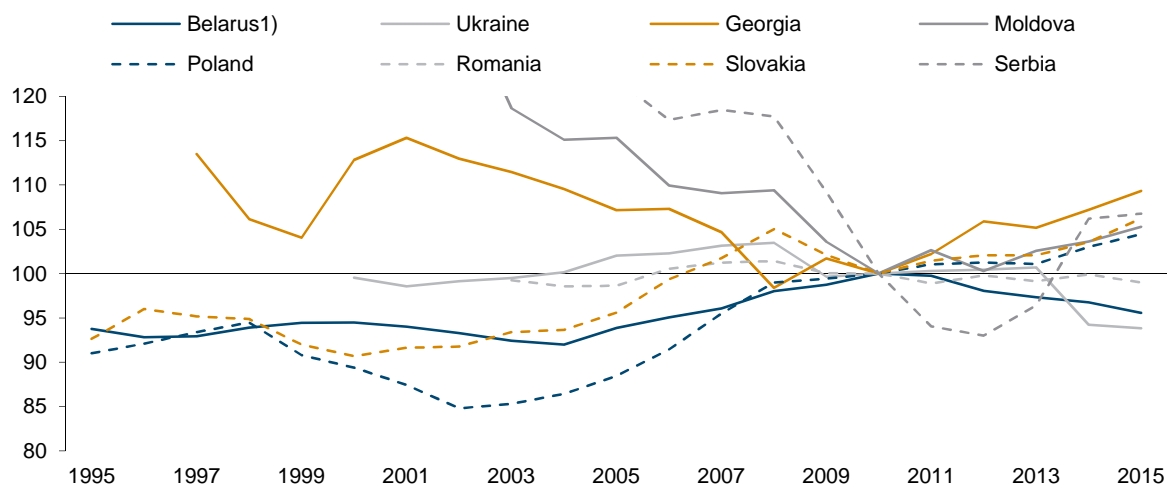
Annex Table 5 / Recent larger greenfield FDI projects in Belarus

Launch date	FDI project
January 2016	Denmark-based digital advertising company Adform is to expand operations at its office in Minsk. The firm plans to create between 30 and 60 new jobs in software development in 2016 following a USD 21.25 million investment from the Scandinavian pension fund Danica.
November 2015	Wood processor and furniture manufacturer Vakaru Medienos Grupe (VMG), a subsidiary of Lithuania-based SBA Group, plans to expand its manufacturing plant in the Mogilev Free Economic Zone. The company plans to double its current 60,000 sq m facility to 120,000 sq m.
September 2015	Taifun, a manufacturer of construction chemicals and subsidiary of Poland-based Grupa Atlas, has established a new production plant in Grodno. The 4000 sq m asphalt felt paper production facility is the company's third plant in the country.
August 2015	Telecommunications company Velcom, a subsidiary of Austria-based Telekom Austria, plans to open a new data centre in the Minsk oblast in October 2016. The USD 30 million centre will provide cloud services to Belarusian clients as well as clients abroad. It will comprise four machine halls with 200 server cabinets in each.
May 2015	Penetron Belarus, a subsidiary of US-based ICS Penetron International, plans to open a new production facility in Homiel. Expected to be operational by summer 2015, the plant will manufacture the full range of the company's capillary waterproofing products. Output will be used initially to meet domestic needs in Belarus before the next phase expands exports to Ukraine and the nearby Baltics.
May 2015	Caparol, a subsidiary of Germany-based Deutsche Amphibolin-Werke von Robert Murjahn, has opened a manufacturing plant in the Free Economic Zone Brest. It will produce water-dispersion paints, plaster, filling and presizing. The products will be sold to customers in neighbouring countries.
May 2015	China-based ZTE, a provider of telecommunications equipment and network solutions, plans to establish a new factory in the China-Belarus Industrial Park. The company will partner with Germany-based VASL Speditions- und Handelsgesellschaft in the project. Construction of the facility is expected to be launched in June 2015.
May 2015	Hong Kong-based China Merchants Group plans to invest USD 500 million to develop a logistics hub in the China-Belarus Industrial Park. The facility could encompass 1 million sq m with plans for around 50,000 sq m to be developed during 2015.
September 2014	US-based General Motors, an automobile company, plans to establish an assembly plant in Minsk. The facility is expected to produce between 20,000 and 25,000 cars per annum which will be new models to the region.
October 2013	Poland-based Grupa Atlas, a manufacturer of construction chemicals, has established a subsidiary, Typhoon Isolation, in Minsk in order to open a production plant. The facility is located in the Free Economic Zone Minsk and is the company's second plant in the country.
July 2013	Wood processor and furniture manufacturer Vakaru Medienos Grupe (VMG), a subsidiary of Lithuania-based SBA Group, has invested USD 102.29 million to construct an industrial complex in the Mogilev Free Economic. The complex will initially create 700 new jobs with plans to increase the workforce to 1000 people by the end of 2013. It will produce furniture for IKEA, which will be exported to Russia.
June 2013	France-based PSA Peugeot-Citroën has opened a new manufacturing facility in Abchak near Minsk. Located on the premises of the joint venture Unison, it will initially manufacture 2000 to 2500 cars for the local market.
June 2013	Culligan-Bel, a division of US-based water filtration specialist Culligan, will launch an assembly facility in Zaslavl by the end of 2013. The company hopes that Belarus will become its base in Europe for water treatment equipment. It will create 50 jobs initially and more than 150 jobs may be created in the future.
February 2013	Russia-based Omsk Carbon Group, a leading producer of carbon black, will set up a production plant in an economic zone in Mogilev in 2015. Omsk Carbon Mogilev will manufacture carbon black for automobile tyres, initially producing up to 80,000 tonnes. The cost of the project is USD 130 million and 450 jobs will be created. The products will be for both domestic and international markets.
January 2003	Arvi, Lithuania, which engages in fertilisers and sugar production, plans to construct a production and processing complex. The company plans to invest EUR 23.5 million and is to begin manufacturing in 2015.

Source: fDi Intelligence, from the Financial Times Ltd 2016.

Annex Figure 1 / Real GDP in selected countries, index 2010 = 100

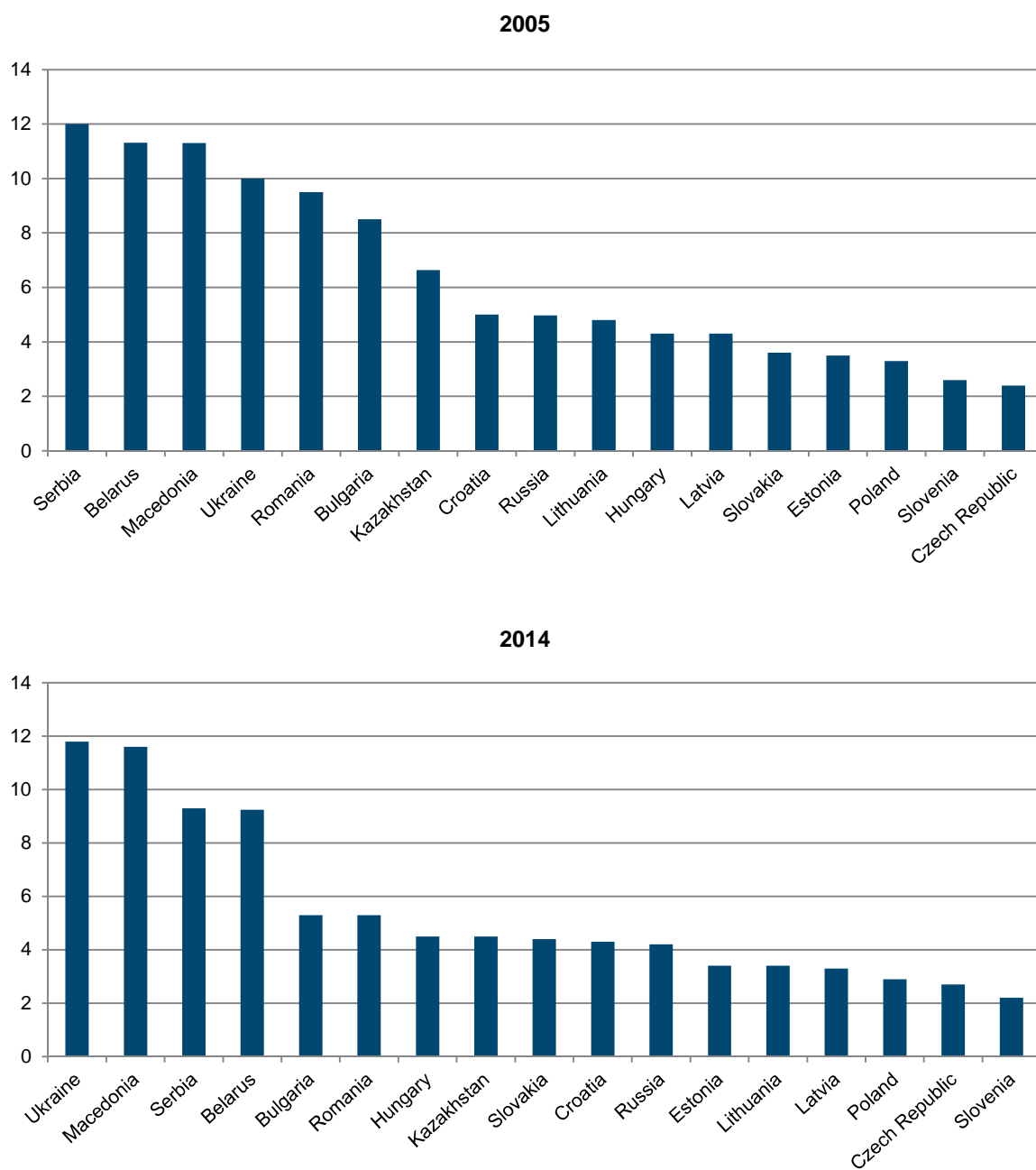
Source: wiiw Annual Database incorporating national and Eurostat statistics. CIS Statcommittee Database, National Statistics Office of Georgia, National Bureau of Statistics of Moldova.

Annex Figure 2 / Employment in selected countries, LFS definition, index 2010 = 100, corrected for breaks

1) Registration statistics.

Source: wiiw Annual Database incorporating national and Eurostat statistics. CIS Statcommittee Database, National Statistics Office of Georgia, National Bureau of Statistics of Moldova.

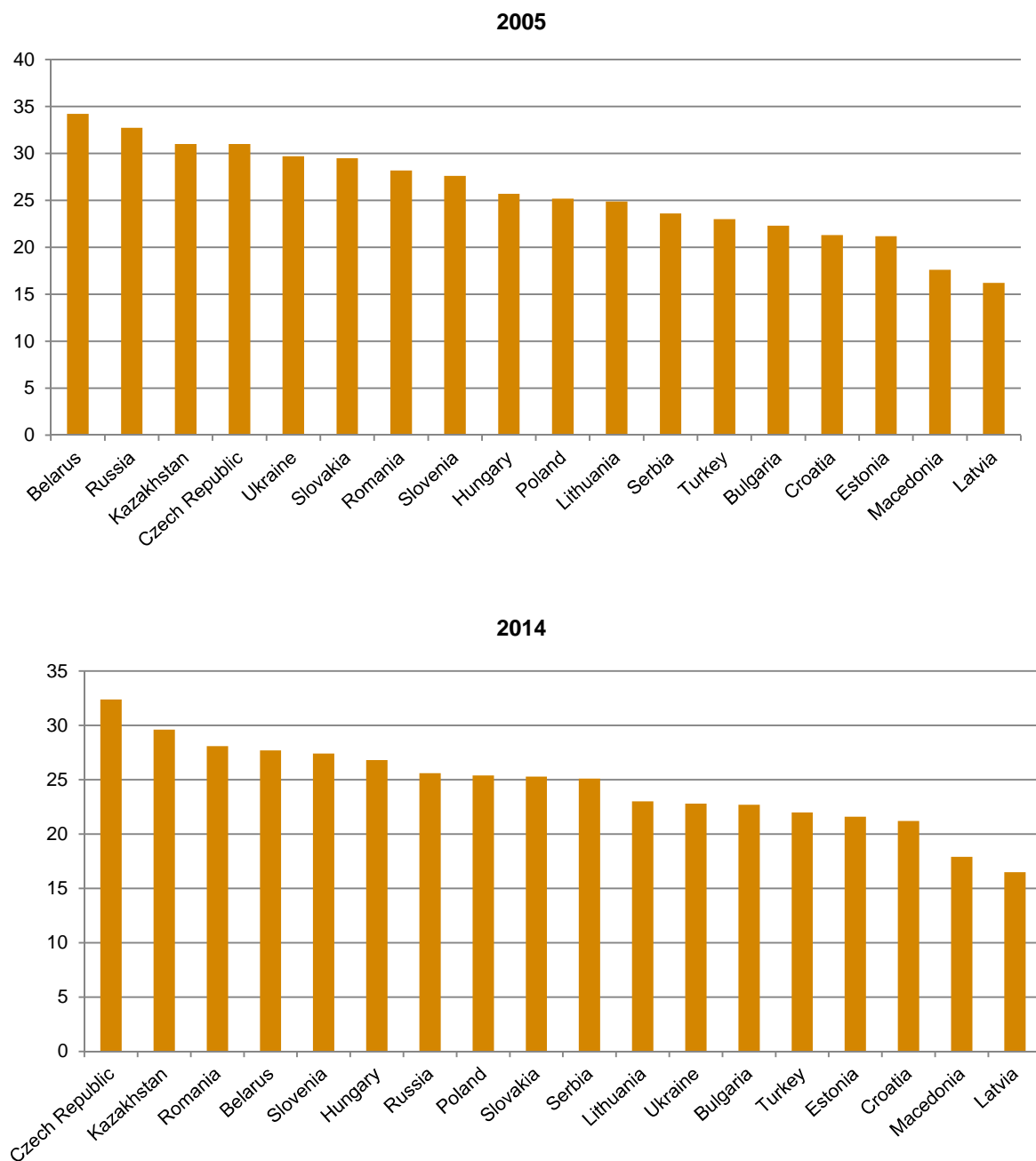
Annex Figure 3 / Share of agriculture¹⁾ in gross value added, %, in selected countries, 2005 and 2014



1) Includes fishery.

Source: UNECE; National Statistical Committee of Belarus.

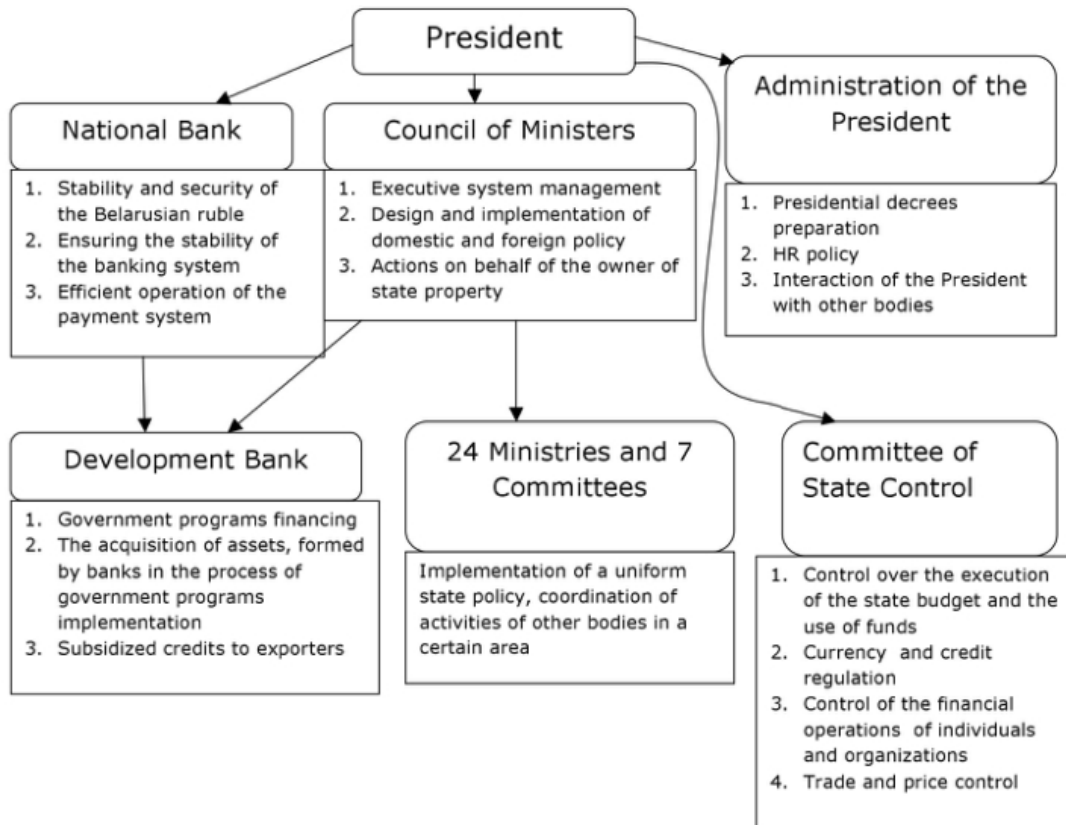
Annex Figure 4 / Share of industry¹⁾ in gross value added, %, in selected countries, 2005 and 2014



1) Mining, manufacturing and utilities.

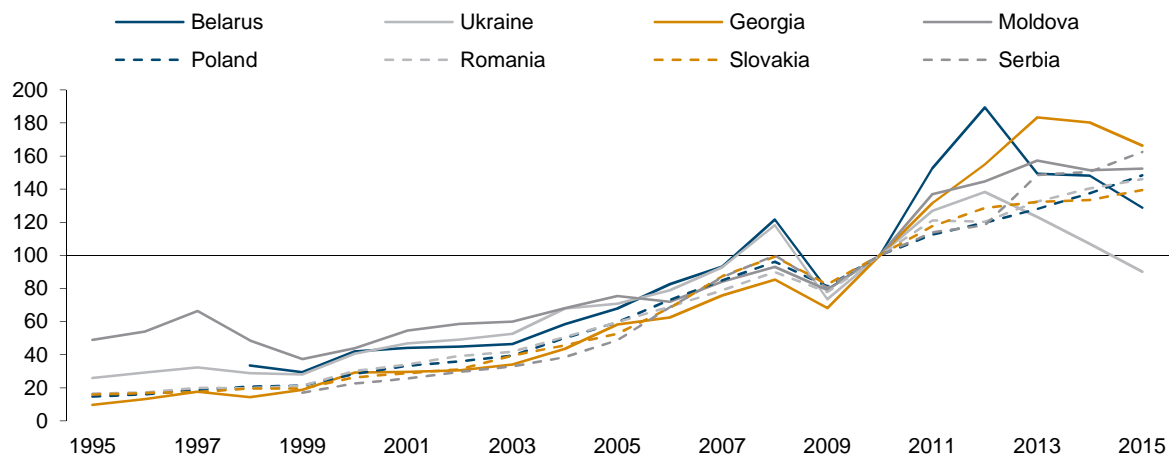
Source: UNECE; National Statistical Committee of Belarus.

Annex Figure 5 / Economic administration in Belarus



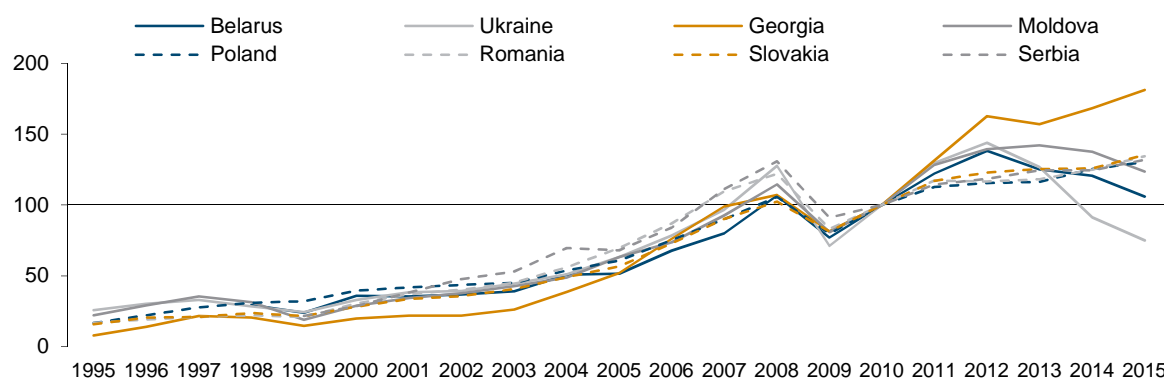
Source: Grushevaya and Shappo (2015).

Annex Figure 6 / Export dynamics in selected countries, nominal index 2010 = 100



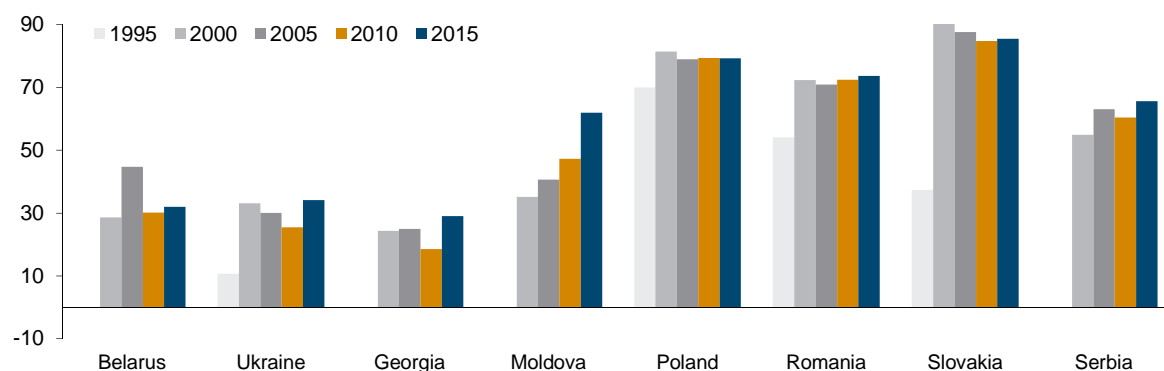
Remark: Serbia, break – from 2010 general trade, special trade before.

Source: wiiw Annual Database incorporating national and Eurostat statistics, CIS Statcommittee Database, UN COMTRADE.

Annex Figure 7 / Import dynamics in selected countries, nominal index 2010 = 100

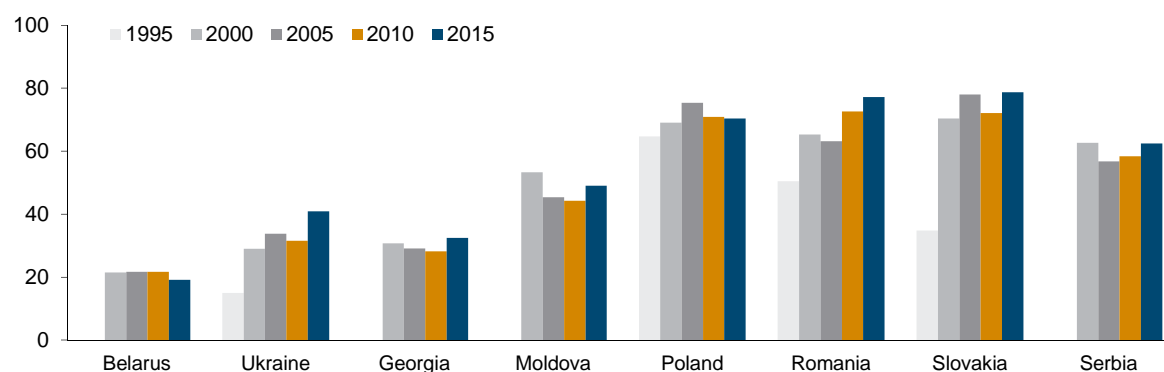
Remark: Serbia, break – from 2010 general trade, special trade before.

Source: wiiw Annual Database incorporating national and Eurostat statistics, CIS Statcommittee Database, UN COMTRADE.

Annex Figure 8 / Share of exports to the EU in total exports, %, 1995 to 2015

Remark: 1995 exports to EU-15, from 2000 exports to EU-28.

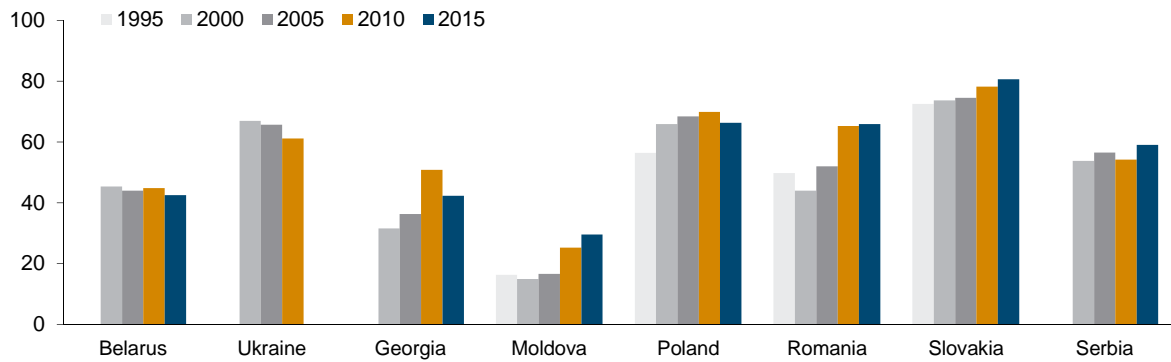
Source: wiiw Annual Database incorporating national and Eurostat statistics, CIS Statcommittee Database, UN COMTRADE.

Annex Figure 9 / Share of imports from the EU in total imports, %, 1995 to 2015

Remark: 1995 imports to EU-15, from 2000 imports to EU-28.

Source: wiiw Annual Database incorporating national and Eurostat statistics, CIS Statcommittee Database, UN COMTRADE.

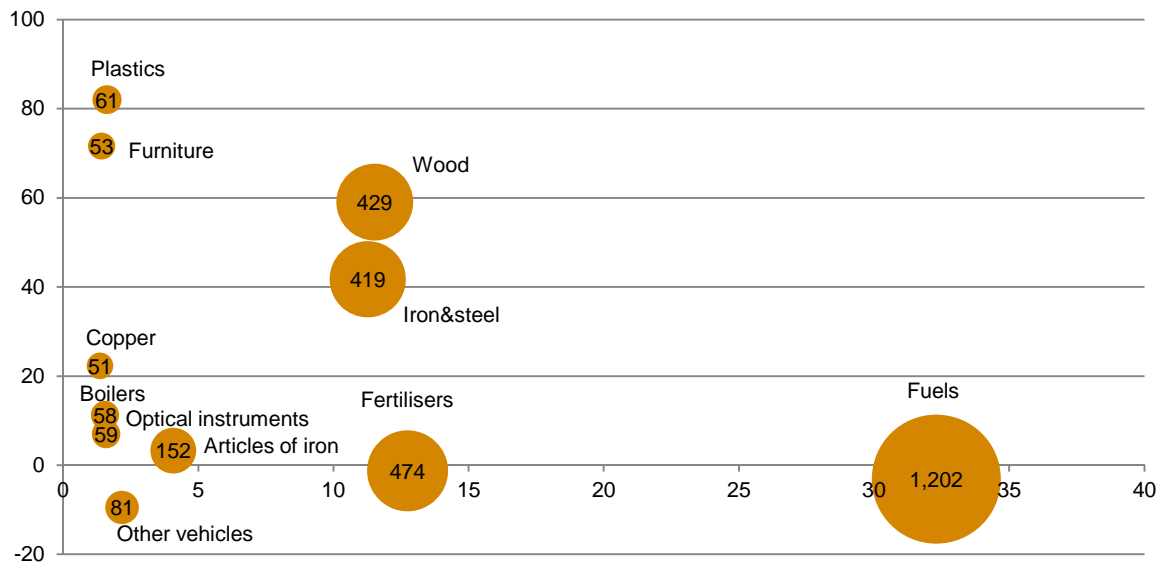
Annex Figure 10 / Share of manufacturing (SITC 5,6,7) in total exports in selected countries, %, 1995 to 2015



Remark: 1995 exports to EU-15, from 2000 exports to EU-28.

Source: wiiw Annual Database incorporating national and Eurostat statistics. UN COMTRADE.

Annex Figure 11 / Top 10 EU import commodities from Belarus, 2015 (million EUR, in the bubbles), rate of change in 2013-2015, % (Y-axis) and share in total, % (X-axis)



Source: Eurostat Comext, wiiw calculations.

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