

# CAN THE STRONGHOLD WITHSTAND AN ECONOMIC ATTACK?

The Challenges and Prospects of the Belarusian  
Economy in the Near Future

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## INTRODUCTION

Over the years, the Belarusian economy has been displaying decent rates of economic growth, while being labelled by international financial institutions and many commentators as a 'laggard in transition' with an authoritarian polity and a semi-command economy. Some economic successes had initially appeared as puzzling, but were later accepted and understood. But still, with a low share of private sector to GDP and the virtual absence of privatisation along with a slow pace of enterprise restructuring, all imply that Belarus' economy is far from being a 'fully-fledged' market economy.

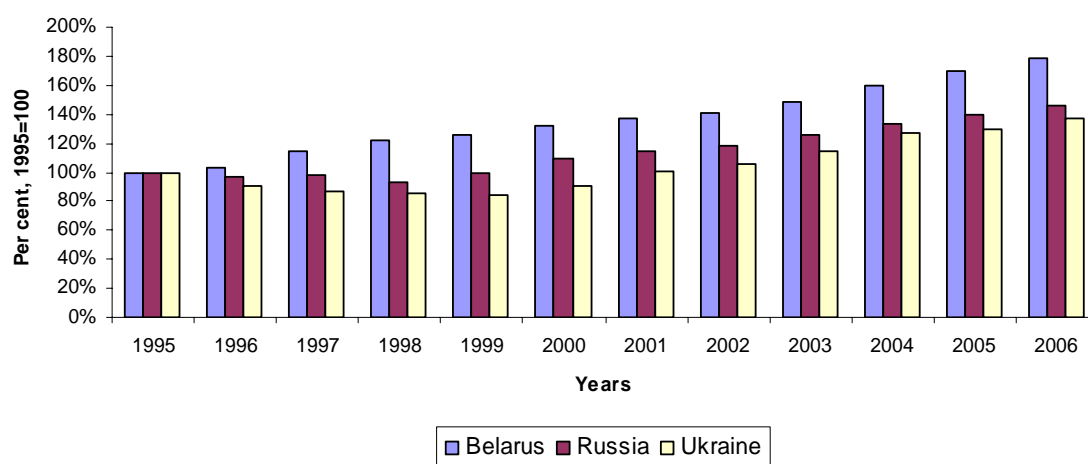
Some commentators explain that economic sustainability is based on the preferential prices for gas and, more importantly, oil that the Belarusian economy consumes and sells abroad (especially refined oil). Also, inefficient enterprises are able to economise on lower energy costs and thus maintain output. The budget has also been capable of collecting revenues to maintain generous social spending, which is presented by the government as a backbone of the 'Belarusian economic model'. To make a long story short, what is puzzling is how the Belarusian economy, contrary to the expectations and predictions based on available interpretations of other countries' experience, has been able to survive? Would its growth capacity be greatly undermined after a gas price hike and imposition of oil duties? What can be expected in the near future? Will there be a major economic crisis? To answer these questions, one has to account for a broader perspective that incorporates not only economic factors, but sheds some light onto the social factors embedded into Belarusian economic decision-making. The structure of the paper is as follows: in the first section, the economic performance of Belarus is analysed. The second section deals with the challenges of gas price hikes and the imposition of oil duties. The third section discusses policy options available for the authorities and also the likelihood of either policy scenario.

### 1. THE ECONOMIC PERFORMANCE OF BELARUS

To begin with, the recession in Belarus was smaller than in Russia and the Ukraine. In particular, the cumulative output decline amounted in Belarus to 36.7%, while in Russia and Ukraine it fell to 44.4%

and 61.5%, respectively (see Chubrik, 2005). Also, the recession had finished by 1995 in Belarus, yet almost 3 years earlier than Russia (1998) and Ukraine (1999) (see EBRD, 2005 for details). This early and relatively rapid recovery of the economy is illustrative. It is during that time that many economic tools had been put into practice and soon become firmly entrenched in Belarusian economic policy-making. Specifically, output has begun to be stimulated by administrative means, including, among other levers, tax exemptions and deferrals, state-induced capital expenditures, and the adoption of production plans to be adhered to. In contrast, in Ukraine and Russia, the state has been much less active, while the scope of privatisation and private sector expansion has been substantial<sup>1</sup>. Also, during that period, in Belarus, the government intervened in the process of credit allocation by using the banking system, and not the state budget, to finance investment in state-owned enterprises. Quasi-budget financing appears to be a long-lasting feature of the Belarusian economy<sup>2</sup>.

**Figure 1: GDP in Belarus, Russia, and Ukraine**



Source: The Ministry of Statistics and Analysis of the Republic of Belarus, Statistical Bulletin, 4<sup>th</sup> quarter of 2006

<sup>1</sup> See various EBRD Transition Reports for more information.

<sup>2</sup> Attempts to estimate the size of quasi-budget deficit have been made by the IMF in a number of its Belarus' country reports.

Table 1: GDP by Demand Factors, 1996–2006

*change against the previous year in per cent*

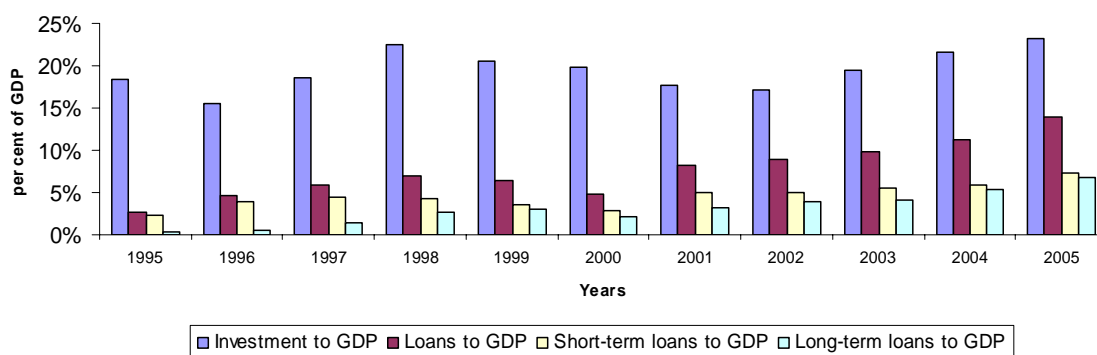
Years	Real GDP growth	Domestic demand	Household consumption	Government consumption	Fixed capital investment
1996	2.8%	4.5%	5.7%	-1.3%	-5%
1997	11.4%	11.2%	11.4%	7.1%	20%
1998	8.4%	14.1%	14.1%	6.0%	25%
1999	3.4%	9.5%	9.5%	5.6%	-8%
2000	5.8%	8.8%	8.0%	5.8%	2%
2001	4.7%	10.8%	17.9%	3.3%	-3%
2002	5.0%	6.9%	11.4%	-1.1%	6%
2003	7.0%	10.4%	7.4%	0.2%	21%
2004	11.4%	12.9%	9.6%	-0.2%	21%
2005	9.4%	12.0%	15.0%	0.4%	20%
2006	9.9%	16.5%	13.2%	-0.3%	31%

Source: IPM Research Centre (<http://research.by>), Ministry of Statistics and Analysis of the Republic of Belarus, various publications

As it can be seen from the Table 1, in 1997 and 1998, investment in fixed capital was increased. This occurred with the strong assistance of the state so money was channelled into state-owned production facilities. As a result, upgrade of machinery and equipment was made possible. However, over a period between 1999 and 2002, investment dynamics slackened, and only since 2003 investment activity seems to have resumed. In any case, this illustrates the importance of investment for economic growth in Belarus. As Figure 2 shows, investment dynamics tend to be positively related to the dynamics of loan expansion. The latter includes credits provided by the National Bank of the Republic of Belarus (NBRB) to the Ministry of Finance within the framework of special government programmes for housing construction, export promotion, and agricultural development. Between 1999 and 2000, there was a squeeze of credit expansion, but since 2001, a revival of investment activity has been observed. Also, it could be noted that there has been a gradual increase of the share of long-term loans in the total

volume of loans. This is also the consequence of a gradual reduction of the dollarisation of the Belarusian economy (see below). Nevertheless, the share of loans in the GDP remains low. According to the World Bank, in the middle-income countries, this figure amounts to 70%, while in the low-income countries, it amounts to 43% (World Bank, 2002, pp. 236ff).

Figure 2. Investment and Loans, 1995-2006



Source: The Ministry of Statistics and Analysis of the Republic of Belarus

Why did the improvement in growth cease to exist in Belarus, but later be revived? One of the major reasons is high inflation in Belarus. It has been widely argued that high inflation is hardly compatible with sustainable economic growth. In particular, a handful of studies cited in *Inflation Targeting* (Bernanke et al., 1999, pp. 18–19) claim that inflation carries with it real economic costs. At the same time, it has been noted that claims of the costs of inflation below 10% are controversial. But above that level, the consequences of inflation could be detrimental for economic growth.

On the other hand, during a period of high inflation in Belarus, rates of economic growth seemed to be overestimated. This is because of miscalculations that distort the real picture (see Chubrik, 2005 details). As it can be seen from the Figure 3, inflation rate (measured by consumer price index dynamics) was ahead of Russia and Ukraine, with a danger of return to the hyperinflation of 1992–1994. The main problem was the nominal devaluation of the Belarusian rouble against the US dollar and the Russian rouble. In turn, nominal devaluation fed a wage-price spiral (see Haiduk et al, 2004,

Chapter 2.3). In 1998, following the crisis in Russia and in the first months of 1999, there was a currency crisis in Belarus that depressed the rates of economic growth. However, in 2004, the economy recorded a high rate again (see Table 2).

Table 2: Inflation and Economic Growth in Belarus, 1995–2006

*change against the previous year in per cent*

Indicator	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Consumer price index, %	244	39.3	63.1	181.7	251.2	107.5	46.1	34.8	25.4	14.4	8.0	6.6
Real GDP growth, %	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	5.0	7.0	11.4	9.4	9.9

Source: Ministry of Statistics and Analysis of the Republic of Belarus

Figure 3a. Consumer prices in Belarus and Russia

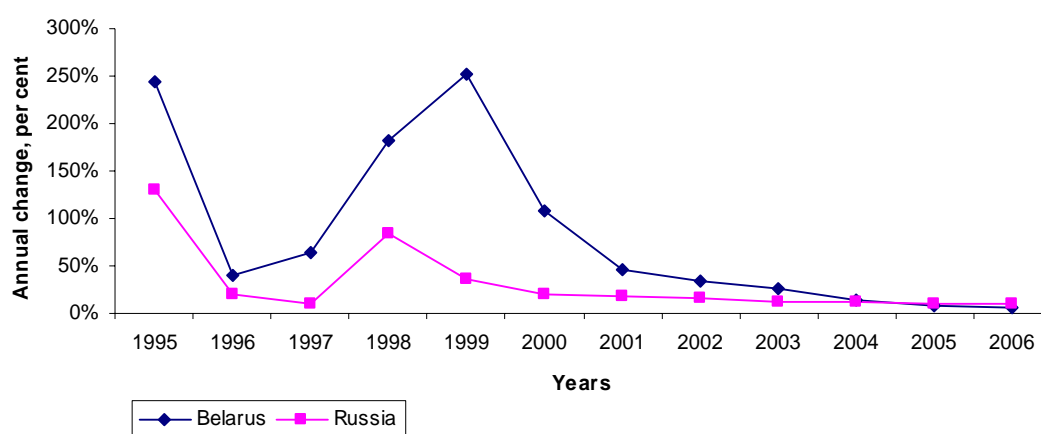
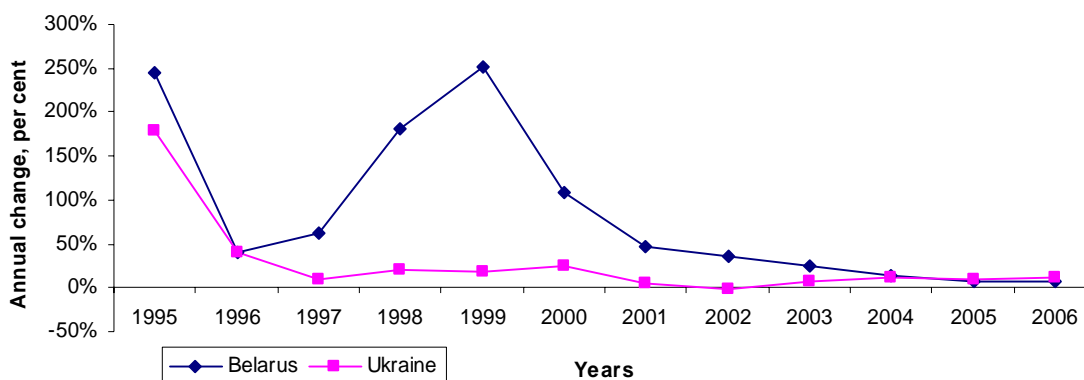


Figure 3b. Consumer prices in Belarus and Ukraine, 1995-2006



Source: The Ministry of Statistics and Analysis of the Republic of Belarus

In general, a problem of inflation in Belarus has two important dimensions. One is the subsidisation of loss-making enterprises. As in other transition economies, Belarus has subsidised certain sectors or even individual enterprises in order to maintain output and employment. Additionally, as in other transition economies, the banking system has often been used instead of the fiscal levers available to the government. As a result, the budget deficit tends to low, and even reaches surplus (as it has been in Belarus, see Table 3). These Figures do not account for the existence of quasi-fiscal deficits in the form of 'policy' loans provided by the commercial banks.

Table 3: Budget deficit, profits and losses, 1995–2006

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Budget deficit, % of GDP	-2.7	-1.9	-2.2	-1.4	-2.9	-0.6	-1.6	-0.2	-1.6	0.0	-0.6	+2.2
Loss-making enterprises, %	17.9	18.4	12.3	16.2	16.9	22.3	33.4	32.0	27.2	20.9	3.5	13.0
Profitability, %	9.9	9.7	10.1	10.9	15.2	13.1	7.8	8.5	9.1	13.4	13.5	13.7
Profits to GDP, per cent	19.0	14.7	18.5	16.5	22.7	20.9	12.1	11.2	11.5	7.6	9.8	9.2



Losses to GDP, per cent	2.1	1.5	0.7	2.5	1.3	1.7	2.6	2.1	1.3	1.4	0.2	0.7
Profits to losses, times	9.20	9.98	27.35	6.50	17.08	12.49	4.60	5.44	8.72	5.36	40.51	13.21

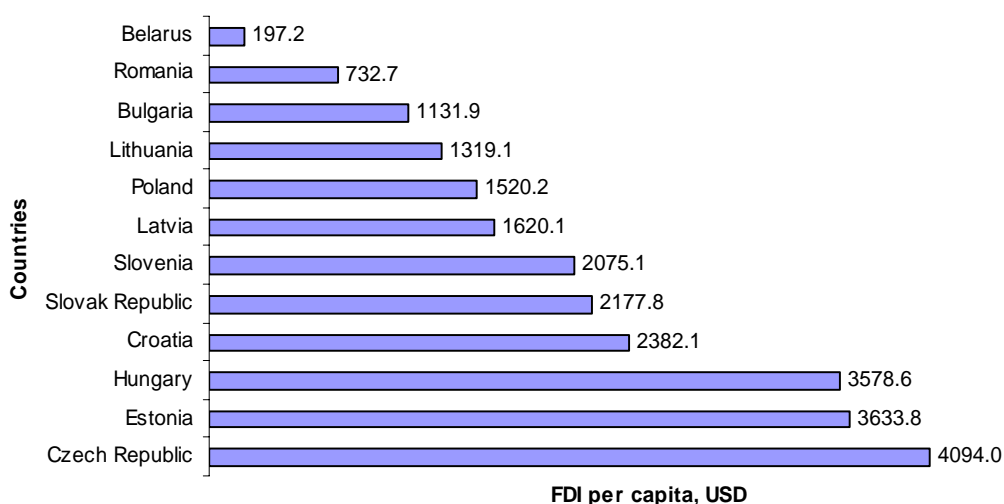
Source: The Ministry of Statistics and Analysis of the Republic of Belarus

The policy of preferential loans could not be *a priori* considered as inefficient. In some East-Asian economies, such a policy had been successful as soon as enterprises were provided a good start to compete with more mature and successful counterparts, especially in technology-sensitive sectors (see a collection of papers edited by Woo-Cumings, 1999 for the empirical evidence). However, there is a problem whether loans provided following the government's instruction are allocated more efficiently, i.e. more growth-enhancing than those provided by loan departments of domestic or foreign-owned financial institutions. The success of either policy choice could partially be judged by considering how the problem of short-termism is addressed.

The problem of short-termism arises when there is a need to embark on an investment-driven economic growth. Since the level of FDI in the Belarusian economy remains at low levels in comparison to other transition economies (see Figure 4), investment has to be financed at home. Faster growth and higher incomes in the future require the sacrifice of consumption in the present. In the post-war Western Europe, this had been achieved by wage moderation within the framework of centralised collective bargaining (Eichengreen and Iversen, 1999). In Belarus, some wage moderation mechanisms have in fact been put in place, but in a very specific and incoherent fashion<sup>3</sup>. More importantly, there is a political business cycle in Belarus, and the labour market is an essential terrain for it to work. Put simply, political business cycle (PBC) attributes the implementation of either economic policy by politicians manipulating with them in order to get elected or re-elected. The existence of the PBC in Belarus means that before the elections, and other important political events like referenda, wages and incomes tend to be increased (see Chapter 3 of Chubrik et al., 2006 and Haiduk, 2005).

<sup>3</sup> For a more detailed analysis of labour market mechanisms see Haiduk et al. (2005).

**Figure 4. Accumulated FDI per capita, 1994-2004**



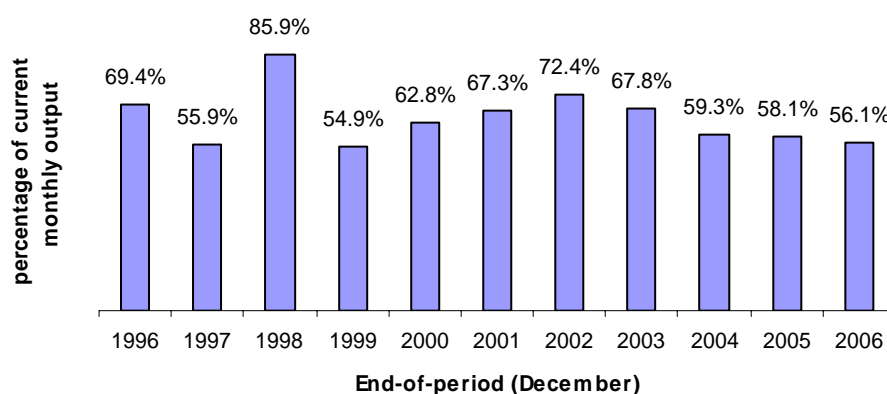
Source: calculated by using the data from the World Development Indicators 2006; UN ECE Economic Survey of Europe, 2005, No.2, p. 85

The problem of short-termism is over as soon as the mechanism is created that encourages investors and wage-earners to trade current gratification for future gains. In Western Europe, this had been achieved through means of corporatism, while in East Asia the state had been playing a more active and sometimes repressive role. For instance, the governments of Taiwan and South Korea supported the development of 'infrastructural sectors' like steel and basic chemicals 'to promote productivity growth in those sectors and to have spill-over benefits on the users of steel and basic chemicals' (Wade, 2005, p. 105). In other words, subsidies, including the provision of low energy prices, had not been 'wasted' as rents, but served to develop competitiveness in certain sectors. The latter are relatively technology-intensive facilities that over time have become internationally competitive<sup>4</sup>.

<sup>4</sup> In 1993, the World Bank study of East Asia claimed that 'sectoral industrial policies were largely ineffective' and warned that 'promotion of specific industries generally did not work and therefore holds little promise for other developing countries' (World Bank, 1993, p. 312, 354). A year after this study was published, the Taiwan semiconductor firm, *United Microelectronics* signed a pact to transfer its 0.8-micron processing technology to German-based *Thesys Microelectronik*. In addition to transferring its processing technology, equipment specification and management expertise, the company offered

The chief problem with subsidisation is not its existence as such. Provisions of subsidies does not automatically ‘crowd markets out’ and undermine competitiveness. Rather, there is a problem despite whether subsidies are spent efficiently or not. In the context of Belarus, this means whether subsidies are both growth and efficiency-enhancing. In contrast to many expectations, active state support has not resolved the problem of the lack of aggregate demand. The latter might be a sign of inefficient economic growth in Belarus. The first indicator is capacity utilisation. Before the beginning of transition it was at the level of 96%, but then dropped to below 30% in 1995. However, since 1999, it increased slightly to reach the figure of above 50% by 2003 (Haiduk et al., 2004, p. 39). However, in some industries, capacity utilisation is even lower. A second indicator for a lack of demand is the continuous existence of high inventories (see Figure 5).

**Figure 5: Inventories of Final Products in Industry, 1996-2006**



Source: The Ministry of Statistics and Analysis of the Republic of Belarus, ‘Social and Economic Situation of the Republic of Belarus’, various years

the German firm manpower training in the area of wafer testing (The Free China Journal, 25 February 1994, p. 8). Today Taiwan has reached the technological level of the middle-ranking OECD countries (Wade, 2005). Although it remains well behind the world technology frontier in most sectors, the achievements made are astonishing.

Although there has been some decrease in the volume of inventories, certain industries like light one and machine-building and metal-working, the percentage by the end of 2006 was 124.1 and 81.5%, respectively. Clearly, in market economies such phenomena as loss-making (see Table 3) and inventories-piling (see Figure 5) are checked by stopping production that cannot be sold. In Belarus, inventories are tolerated due to the existence of the government-defined economic plans for production in the form of indicative guidelines. Finally, losses in the enterprise sector also suggest the existence of a lack of demand. It is only during the last two years profits have been displaying an upward trend (see Table 3 above). It appears that the government stimulation of the economy has helped to maintain decent growth rates, but not created preconditions for sustainable macroeconomic development in the future. As for investment, it has remained well below the level observed in a number of East Asian economies, where figures are often no less than 30% of the GDP registered over a number of years. This level has never been reached in Belarus (see Figure 2 above).

Nevertheless, since recently higher growth rates are observed along with the increasing volume of investment. Also, other important indicators are reduced inflation along with a decreasing share of loss-making enterprises and growing profitability in the Belarusian economy as a whole. Is this evidence sufficient to inform an expectation that the economy of Belarus is ready to repeat its earlier growth experience, but is now without the dangers of inflation and inefficiency? When answering this question, it has to be emphasised that Belarus is a small open economy. Its status implies that there is a constraint on growth in Belarus caused by the balance-of-payment difficulties.

A customary description of the Belarusian economy has been to treat it as 'an assembly shop' of the former USSR, where some relatively advanced industrial facilities used to be located, including those serving the military and industrial complex. This implies Belarus' dependence upon the imports of raw materials and intermediary goods and the crucial importance of exports as an essential outlet for production, given the narrowness of the domestic market. By definition, open economies have to balance their trade in the long run by finding sustainable ways to finance trade deficit. In doing so, many

developing economies revealed their 'original sin' by borrowing abroad (Eichengreen et al., 2002)<sup>5</sup>. For Belarus, this option is limited since it could not raise the funds in the international market - with exception of the Russian market.

Current account adjustment takes place either on the demand or the supply side. In other words, trade adjustment is effectuated either through changes in output quantities, income levels or by changing in relative prices (exchange rates). For Belarus, adjustment through changes in relative prices (i.e. exchange rates) is problematic due to the existence of relatively high dollarisation of the domestic economy.

Dollarisation means that domestic monetary functions are taken up by a foreign currency, usually the US dollar, so that the domestic currency is only partially accepted by the public. Usually, the degree of dollarisation is measured as a percentage of foreign currency deposits to total deposits (see Figure 6). However, it is also very likely that in Belarus cash holding of foreign currency is very high. At least, earlier data collected by 1999 support this claim<sup>6</sup>. In contrast to some highly dollarised economies like Angola, Bolivia, or Cambodia where dollarisation is above 80%<sup>7</sup>, Belarus displays a rather moderate and declining level of dollarisation. However, when compared to East-Central European transition economies, its level appears to be high<sup>8</sup>. Countries like Poland have been able to reverse dollarisation - the proportion of foreign currency deposits to total deposits dropped from 43.2 % in 1994 to 5.3 % in 1999 (Dean et al, 2003). The key to this positive development is the confidence in domestic economic development. In contrast, in many Latin American countries, dollarisation could not be combated while there is a continuous distrust to the domestic economy and its banking system.

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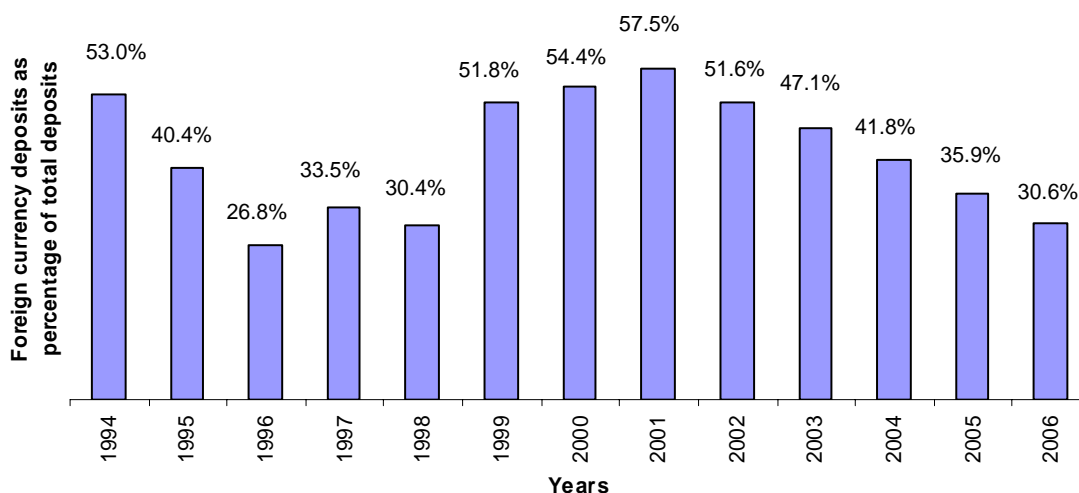
<sup>5</sup> The notion of 'original sin' is used to denote the fact that developing and transition economies could only borrow in foreign currency. Accordingly, they have to earn foreign exchange to pay their debts back.

<sup>6</sup> According to Feige and Dean (2002), there is extra-ordinary high cash relative to bank deposit holdings in Belarus; relative reluctance of the population 'to hold dollars as bank deposits reflects both distrust of banks and a desire to avoid taxes' (Feige and Dean, 2002, p. 22).

<sup>7</sup> Measured as the proportion of foreign currency deposits to total deposits.

<sup>8</sup> For instance, IMF economist Kenneth Rogoff claims that dollarisation level in Russia of 25% is decently high and its reversal is hard to implement in practice, see [www.newsru.com/finance/11jul2003/doll\\_save.html](http://www.newsru.com/finance/11jul2003/doll_save.html). Accessed 2 February 2007.

Figure 6. Dollarisation, 1994-2006



Source

e: The National Bank of the Republic of Belarus

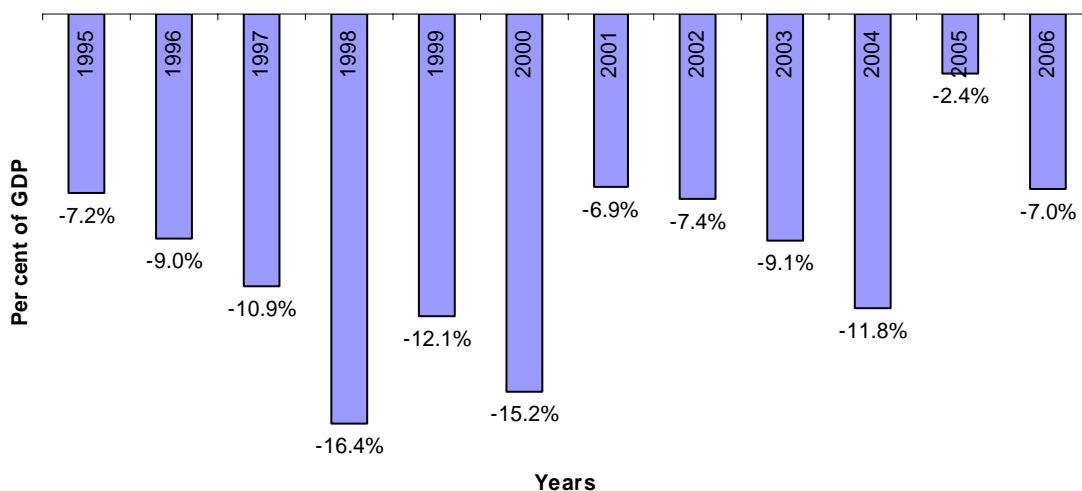
There are a number of disadvantages for the domestic economy caused by dollarisation<sup>9</sup>. Of them, vulnerability in case of a bank run has become more evident in the light of gas and oil price hikes that Belarus has faced early this year. At the very end of 2006, the population began to withdraw their rouble-denominated deposits and to exchange them into foreign currency. This activity had been sparked by uncertainty concerning the negotiations of gas and oil prices between Belarus and Russia. Still, in January 2007, the demand for foreign currency exceeded its supply by USD 177.6 million, thereby forcing the National Bank to sell a small fraction of its reserves to compensate for this gap. Although in the beginning of 2007, deposits have been returned to banks, the potential danger of another bank run is supposed by authorities. Accordingly, it has been claimed several times that the National Bank should strongly adhere to its original exchange rate targets to make sure that no

<sup>9</sup> Such as the loss of seigniorage, the existence of currency mismatch, and the overall fragility of banking system with the problematic execution of the lender of last resort function by the central bank.

devaluation is allowed<sup>10</sup>. Apparently, the monetary authorities are scared of the consequences of even a minor devaluation.

A relatively high degree of dollarisation in Belarus means that the devaluation-inflation spiral is more intensive, and is amplified by a high degree of dependence on energy imports from Russia. How can the challenge of dollarisation be efficiently dealt with? A first-best policy would be to de-dollarise the economy, however this appears to be problematic even over the medium run<sup>11</sup>. What is left as a more realistic, although a second-best, option is to sustain the inflow of foreign currency on the current account. This could be done by two means: by exporting an ever-increasing volume of goods and services (or by decreasing imports by introducing protectionist measures) or by borrowing abroad (in foreign currency).

**Figure 7. Merchandise trade deficit, 1995-2006**



*Source: The Ministry of Statistics and Analysis of the Republic of Belarus*

<sup>10</sup> At least, the Chairman of the National Bank of Belarus has made such claim several times in public.

<sup>11</sup> Feige and Dean (2002) believe that de-dollarisation is hardly possible in countries like Belarus. In contrast, the experience of Poland suggests the reverse: the share of foreign currency deposits to total deposits declined from 43.2 % in 1994 to 5.3 % in 1999 (Dean et al. 2003).

As Figure 7 above shows, Belarus has persistently recorded unbalanced foreign trade. However, the situation has improved substantially over the last couple of years, mainly due to the growing exports. The inflow of foreign currency therefore remains crucial for maintaining the stability of exchange rates and to lower inflation, not to mention its importance for the functioning of export-oriented production facilities. Also, the greater reliance on exports allows the avoidance of foreign indebtedness that, in turn, could only be offset by higher exports in the next period<sup>12</sup>. What are the sources of export-led foreign currency inflow?

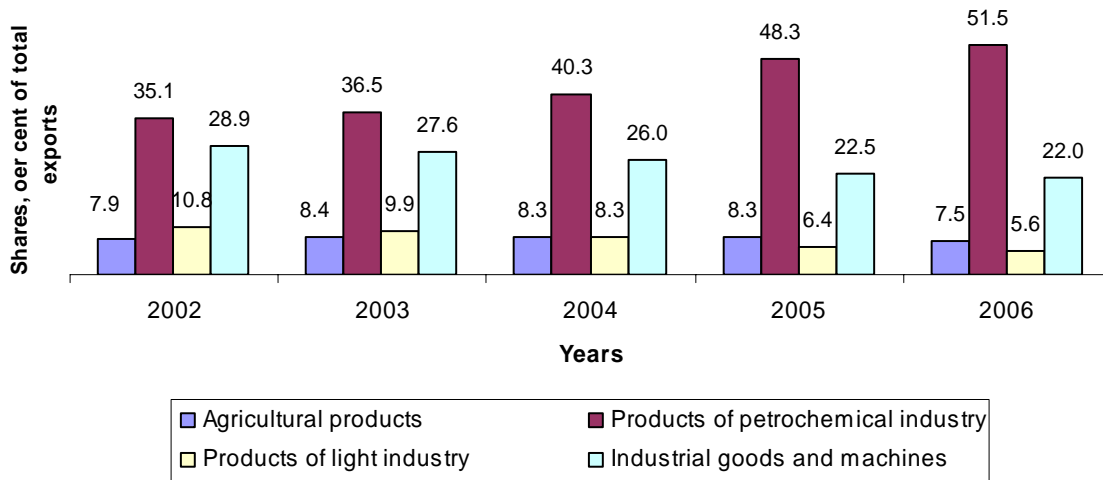
Figure 8 below helps to answer this question. As it can be seen, Belarus used to benefit from growing prices for oil despite being an importer of mineral products. This is because of the domestic processing and exporting of light oil, mainly to EU countries. A related trend is a decline of the share of manufacturing in total exports to the EU economies. The oil export success of Belarus has been related to the ability of the government to set domestic export duties different from the ones adopted in Russia. At first sight, this appears to be in the violation of the 'Union State' agreements on customs unions<sup>13</sup> demanding to equalise the levels of customs duties between the two countries.

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<sup>12</sup> In case there is a failure to pay debts off by exporting more, countries are forced to borrow more. As a result, there is a danger to be trapped into some sort of a 'pyramid', where new funds are borrowed to pay for earlier credits. Such a pyramid is broken as soon as there is a refusal to provide roll-over.

<sup>13</sup> Signed in 1995.



**Figure 8: Some categories of Belarus' exports, 2002-2006**

Source

ce: based on the data of the Ministry of Statistics and Analysis of the Republic of Belarus

The inflow of foreign currency has very likely helped to ease the pressures emanating from the dollarisation of the Belarusian economy. That is why the government of Belarus has been trying to reach the best possible deal in the course of its negotiations with the Russian government on oil prices (see section 2). The poor quality of the Belarusian rouble has forced the government to adopt the USD-denominated targets of real wage increases. The latter are essential part of the PBC (see Table 4).

In order to run the political business cycle, the government employs controls over the labour market, and particularly over the wage setting process. Since wages are a substantial part of the people's incomes, their increases to seek the consent of the voters. Although the most of international observers point to electoral frauds in Belarus, surveys of public opinion reflect the majority support of the current political establishment<sup>14</sup>. Whatever might be the political and social reasons, and the degrees of manipulation with the public attitudes are deeper issue. Nevertheless, from an economic point of view, there are some strategies employed in order to secure content of the population (see Table 4).

<sup>14</sup> See, for instance, recent opinion poll conducted by the Independent Institute of Socio-Economic and Political Studies at <http://www.iiseps.org/opros45.html>. The President is trusted by the 55.4% of the respondents.

The political business cycle is a mechanism that allows compensation for an unbalanced macroeconomic regulation. As it has been mentioned above, investment growth is a crucial component of macroeconomic development, requiring the sacrifice of current consumptions for gains in the future. In Belarus, political controls over the economy, including misguided investment, have created a situation when real wages often exceed productivity (see Figure 9). This implies that fewer funds are allocated to investment. In contrast, in many transition economies real wage growth tend to lag behind productivity dynamics (see, for instance, Galgóczi, 2002). As for Belarus, wages and incomes seemed to be growing in the times of important political events, thereby providing the evidence for the existence of the PBC.

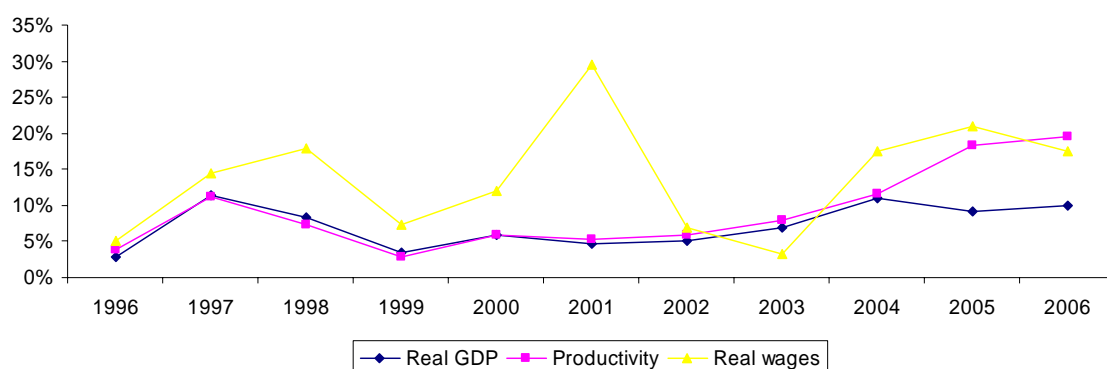
Table 4: The Political Business Cycle in Belarus

Political event	USD-denominated average wage		Wage arrears
	rates of growth	target	
Referendum on May 14, 1995 (change of national symbols, integration with Russia, and land reform)	160% yoy – May 1995, 188% yoy – June 1995	--	--
Referendum on November 24, 1996 (extension of President's authority)	Wage decrease after a month after the referendum	--	September 1996 – 24% of total wage fund (WF), October 1996 – 6.5% of total WF
Presidential elections on September 9, 2001	-36% yoy – 1999, 44% yoy – 2000, 58% yoy – January-August 2001	USD 100 by September 2001	August 2000. – 17% of total WF, September 2000 – August 2001 – 2.4% of total WF (August 2001 – 0.5% of total WF). After the elections were over, increased by 15 times
Referendum on October 17, 2004 (lifting up the limits on the number of President's terms for one person)	28.6, 40.5 and 43.5% yoy – October, November, and December 2004, respectively	USD 200 by the end of 2004, USD 250 by the end of 2005	Since October 2003 there are virtually no wage arrears

Presidential Elections on March 19, 2006	No reduction below 30% yoy over two years	USD 300 by the end of 2006	
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Source: Chapter 3 of Chubrik et al. (2006)

**Figure 9: Real GDP, productivity and real wages**



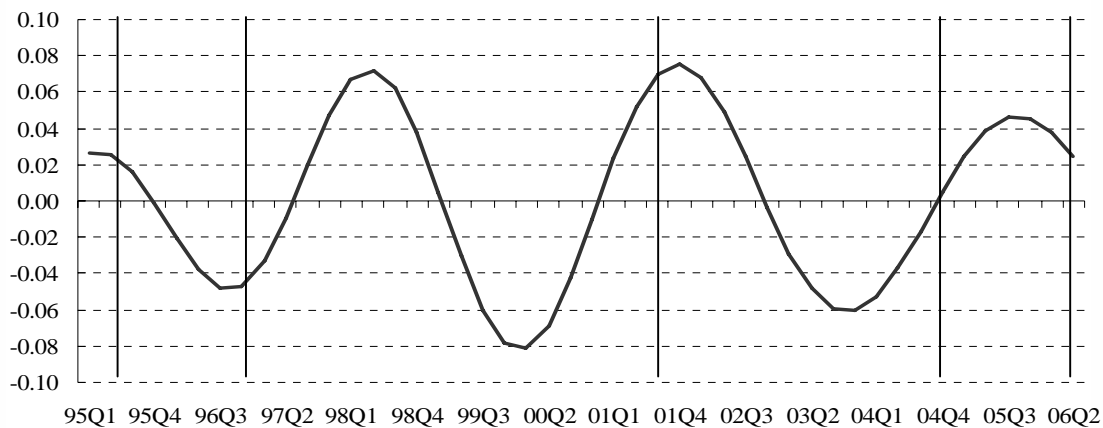
Source: built on the basis of the data taken from the Ministry of Statistics and Analysis of the Republic of Belarus

The indecisiveness of the Belarusian government towards privatisation and the fears of likely closures and bankruptcies as soon as private business would establish controls over enterprises may possibly form the existing wages-productivity gap. In case the latter turns into a continuous feature for the Belarusian economy, there is a danger to slide into a cost inflation again that could only be combated by suffocating economic growth. Growing wages are sometimes a problem since they increase the demand for imports and thus create pressure on the current account. This is because of the preference to buy consumer durables produced abroad, which are often better quality than the domestically produced ones, as soon as income grows. The government is aware of this situation and thus employs a number of regulations to stimulate or hinder wage growth.

Therefore, there are a few contradictions inherited in the Belarusian macroeconomic policies. On the one hand, there is an intention to stimulate wage growth as one of the essential elements of arguably successful 'Belarusian economic model'. On the other hand, wage growth has had some negative consequences, such as the gap between wages and productivity. The latter can be improved over the short term by cutting the excessive labour force, but the government is reluctant to make such steps.

Over the medium to the long term productivity can only be increased via returns to investment, but the latter is often associated with the installation of up-to-date equipment, often requiring lesser employees to work on it. So far, this contradiction has been resolved within the framework of the PBC as wages and incomes have been growing unevenly over the time span (see Figure 10). Periodically, inflationary and balance of payments pressures have been made less acute.

Figure 10: Cyclical Wage Dynamics, 1995–2006 (2nd quarter)



Source: Chubrik et al (2006), p. 31

As for other possible outlets, the existence of a relatively sizeable unofficial labour market needs to be mentioned. In voice-exit terms, this means that people are provided with an 'exit' as soon as they are unhappy with the incomes available within the domestic economy. Accordingly, the stimuli for social discontent are lessened. As the first Labour Survey conducted by the Ministry of Labour and Social Protection revealed, about 117,000 people work abroad (about 2.7% of the economically active population), mainly in Russia (about 98,000 people)<sup>15</sup>. At the same time, the Department for Citizenship and Migration of the Ministry of Interior of Belarus provide figures that show up to 300,000 Belarusian citizens work illegally in Russia (about 7% of the economically active population), while only between

<sup>15</sup> Data are taken from [http://naviny.by/rubrics/economic/2006/11/17/ic\\_articles\\_113\\_148705/print](http://naviny.by/rubrics/economic/2006/11/17/ic_articles_113_148705/print). Accessed March 1, 2007.

3,000 and 4,000 are registered officially. Some of them are formally employed or simply not registered with the government employment service. Accordingly, these people and their families rely on the remittances or earnings from abroad.

Another element helping to resolve the above-mentioned contradiction could be presented as a hypothesis only. It is related to the growing prices for real estate and the expansion of consumer credit in the economy. It might be hypothesised that the growing prices for real estate is used as a way to 'bind' high incomes to prevent inflation and also to stabilise the functioning of the domestic banking system that is used for quasi-fiscal operations. Again, this appears to be a provocative statement, however not well grounded empirically. In essence, the continuously growing real estate prices imply that borrowers, especially those with growing incomes who decided to acquire real estate have sacrifice increasing fraction of their incomes to repay loans. Growing real estate prices informing the need to apply for more sizeable loans appear to be a way to capitalise on those income earners by 'binding' their money resources within the banking system which, in turn, can secure the inflow of funds.

To summarise, the Belarusian economy can be characterised as a 'guided' mechanisms, where the state continues to play a substantial role. Since 2002 onwards, there are signs that its customary ills, including high inflation and loss-making, seem to be cured to some degree. At the same time, the political business cycle remains a continuous feature of the Belarusian economy. Essentially, the preferential prices for gas and the ability to trade with processed oil duty-free have played important role in maintaining domestic production and lessening the balance-of-payments constraint on economic growth. Accordingly, gas price hikes and the imposition of export duties on oil and products thereof have created new challenges for the Belarusian economy.

## 2. THE CHALLENGE OF INCREASED GAS AND OIL PRICES

It has been often claimed that the Belarusian economy is afloat thanks to the generous support from Russia. The 'Kremlin' capitalism is friendly to the authoritarian society on the borders of the Empire. The friendship comes with gifts and benefits to the economy. First, gas has been supplied at a reduced price of USD 46.68 per 1,000 cubic meters. In contrast, in 2006, the Baltic States paid about USD 125, while the average EU price was about USD 250 (Crossland, 2006). If these prices are taken as reference points, then the gain of Belarus in 2006 alone from preferential prices could be estimated as varying between 6 and 11% of the GDP, correspondingly. The gain could be seen as a subsidy to the Belarusian economy and enterprises.

Another important area of support has been even more important than preferential gas prices. It has been shown above (see Figure 8) that trade with oil products refined at the Belarusian refineries (with a joint capacity to refine about 40 million tons of crude oil a year) has allowed to collect substantial foreign exchange revenues and thus lessen the balance of payment pressures described above. Also, the chemical and petrochemical industry displayed a high level of profitability at about 26.5% per annum in contrast to industry-average figure of 15.6 %<sup>16</sup>. Accordingly, oil refineries have been capable to contribute to the state budget quite substantially. In 2006, the government even decided to set up a special National Development Fund, probably copying the idea of the Russia's Stabilisation Fund, to deal with gas price hikes and other challenges. The Fund accumulated 600 million USD exclusively because of the contributions of oil refineries<sup>17</sup>.

However, gas price hikes and the imposition of export duties on crude oil imported by and oil products exported by Belarus appear to be serious challenges for the Belarusian economy. Put simply, growing gas prices could be interpreted as a cut of the subsidy that the Belarusian economy used to capitalise on over the years. The imposition of export duties in the oil sector implies not only a loss of revenues of oil refineries, but also less budget revenues. It could be estimated that taken together, preferential

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<sup>16</sup> Data for 11 months of 2006 only; taken from the Ministry of Statistics and Analysis of the Republic of Belarus.

<sup>17</sup> See <http://research.by>, and specifically 'Belarusian Monthly Economic Review', December 2006.

prices for gas and the absence of export duties on oil products have allowed Belarus to save at least about 6 billion USD, or about 13.5% of the GDP per annum<sup>18</sup>.

Before proceeding with an evaluation of the possible repercussions, new arrangements must be explicated. As for gas imports, Gazprom has managed to increase its exports price to Belarus from USD 46.68 to USD 100 per 1,000 cubic meters<sup>19</sup>. Also, the government of Belarus has agreed to sell to the company a 50%-share in Beltransgaz, the national gas transport network. Some commentators have interpreted this step as a 'cooling down' of the relationships between Belarus and Russia. Whatever the political reasons might be, strong economic motives have also been mentioned, namely Gazprom's intention to increase its capitalisation. The straightforward way to do so is to increase prices and to acquire controls over the gas transport network. As for the oil sector, the new agreements oblige Belarus to pay customs duty for crude oil exported from Russia<sup>20</sup> (at a rate of USD 52.7 per ton of crude oil), and collect customs duty when exporting processed oil to the third countries (at a rate of USD 108)<sup>21</sup>

The most immediate and nature impact of the new arrangements for oil and gas would be a deterioration of the balance of payments. Belarus has been forced to pay more for imported gas and to cover export duties on crude oil imported to Belarus for further processing and exports to the EU. Nevertheless, there is a range of offsetting factors that help to make the pressure less acute and to have some room for a gradual adjustment. As for gas, it is expected that USD 625 million would arrive this year for selling a share of Beltransgaz to Gazprom. As a result, the initial impact estimated to be USD 1.1 billion could be reduced to USD 475 million.

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<sup>18</sup> The figures are for 2006 only.

<sup>19</sup> By 2011, Belarus has to pay an average EU price for gas; the arrangements in fact allow the adjustment to be less acute.

<sup>20</sup> Technically, it is the Russian exporters who are obligated to pay the export duty. It is simply included in the final price at which crude oil sold at the Belarusian market.

<sup>21</sup> See more detailed information at the IPM Research Center's web-site, <http://research.by>. In case Belarus would opt for exporting crude oil, duties would be much higher.

Nevertheless, there would be some necessary adjustments in the domestic economy. Apparently, enterprises would face the increasing costs for gas, heating and electricity (which is also produced by using the imported gas from Russia). The government of Belarus announced in December 2006 that some compensation measures would be deployed to mitigate the gas price hike<sup>22</sup>. Later in February, the government also said that cost-saving arrangements were implemented by gas and energy providers. Also, the government has moderated wages at these enterprises. Accordingly, it is expected that these measures would allow it to contain the cost increase by approximately 23%<sup>23</sup>. Also, other subsidies are likely to be granted to a range of manufacturing enterprises.

At the same time, expenditure cuts are planned. In January, the Ministry of Finance has announced its plans to cut budgetary expenditures by about 2–2.5% of the GDP to maintain the budget deficit at a level of 1.5% of GDP, in contrast to the surplus in 2006 (3.4 % of GDP). Apparently, the problem is that additional revenues are unlikely to be capable to offset the expenditure increase so the cost-cutting seems to be unavoidable. This is the most profound implication, together a deterioration of the balance of payments, for the Belarusian economy. Reduction of expenditure could imply a slower rate of economy growth and, also informed by the likely reduction of investment expenditures.

As for the oil sector, a preliminary estimate shows that the imposition of the customs duties could deprive Belarus of 1.1 billion USD. However, there are some offsetting factors. First, lower world market prices for oil have helped to reduce price of imports from USD 240 (in 2006) to USD 187 (in 2007) per ton of crude oil. Together with an import duty of 52.7 USD, this implies that in fact price of imports has not been changed. However, lower world market prices for processed oil would depress the revenues of oil refineries. In turn, the need to collect export duty also leads to a reduction in the volume of revenues, although the Belarusian budget is expected to gain about USD 1.07 billion<sup>24</sup> (if the 2006 volume of exported oil is considered). Aware of the decline in revenues, the government has cut excise taxes to

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<sup>22</sup> See information at [http://www.government.by/ru/rus\\_news30122006.html](http://www.government.by/ru/rus_news30122006.html).

<sup>23</sup> [http://naviny.by/rubrics/economic/2007/02/06/ic\\_news\\_113\\_266441/](http://naviny.by/rubrics/economic/2007/02/06/ic_news_113_266441/).

<sup>24</sup> Initially the budget acquires about USD 1.5 billion, but there is a VAT refund to exports of oil products, so the net gain appears to be about USD 1.07 billion, see <http://research.by>.



increase the profitability of oil processing (especially at home). Accordingly, enterprises would be able to finish investment programmes they have embarked on. Nevertheless, according to the estimate by the Research Centre of the Institute for Privatisation and Management<sup>25</sup>, there might be a substantial reduction of profitability in the oil sector down to 5% per annum, thus dampening income tax revenues by about 300 million USD. As a result, revenues of the state budget are expected to suffer by losing 560 million USD as a result of lower excise taxes.

The overall impact of the new arrangements for the oil sector is expected to be a deterioration of the balance of payments. An initial estimate of USD 1.1 billion has to be corrected for about USD 300 million, thus providing a figure of USD 800 million. Taken together, new agreements could likely deteriorate the balance of payments by approximately 1.2 billion USD in 2006 alone.

To summarise, the major repercussions of new arrangements on gas and oil supply are related to the deterioration of the balance of payments. This is the most important and immediate consequence that in the short term, could be cured by devaluation, import restrictions, or foreign borrowing, or a combination of all three measures. In principle, there is a range of options available to governments that strive to obtain foreign exchange - growth of exports, including by such means as competitive devaluation and/or cost cutting, foreign borrowing, or restrictions on imports. Of these, devaluation is the most problematic, if not dangerous, step to make due to a relatively high degree of dollarisation of the Belarusian economy. Devaluation might unchain the wages-prices spiral that could only be stopped by politically unacceptable real wage cuts and slower rates of economic growth. Cost-cutting is hard to implement. As it is shown above, the Belarusian budget is deprived of a fraction of revenues it has used to rely upon, and there are no immediate funds to compensate for the losses. It appears that enterprises would be forced to deal with increasing costs, while there are no guarantees for a full-scale compensation. It appears that the government has a number of issues to deal with so there is the question of how different parameters could be realistically combined to reach a certain outcome. This is the subject of the final section's discussion.

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<sup>25</sup> <http://www.ipm.by>; <http://research.by>.

### 3. SCENARIOS AND POLICY OPTIONS: WHAT ARE THE LIKELY CHOICES?

How could the challenges of increased costs be met? In principle, the crucial task is to increase efficiency of the Belarusian economy as a natural reaction to the hardening of budget constraints. For this purpose, costs have to be cut. Over the short run, this could be done by reducing wages. Over the medium to the long run, returns to efficiency-enhancing investment could be expected. The question is therefore whether the government is ready to tolerate reduction of revenues and to embark on moderation of wages and incomes for the sake of increasing macroeconomic efficiency in the future. It has to be stressed that in the next couple of years, the devaluation option is very unlikely. It could be very realistically expected that the government would attempt to avoid devaluation by any means. This is due to the devaluation-price spiral. Therefore, the underlying assumption is that the Belarusian government is strongly motivated to ensure the supply of foreign exchange in order to avoid painful devaluation. This assumption is rather feasible because of the very high economic and political costs of devaluation.

In essence, there is a choice between sacrificing incomes and consumption today in order to increase efficiency in the future. For this purpose, foreign borrowing could be used. Also, the Ministry of Economy has announced its readiness to approve privatisation of a number of large Belarusian enterprises in chemical, petrochemical and manufacturing industries. Although this intention might act as a first step towards liberalisation, many essential issues are still not addressed. In particular, what is much more important is the market-friendly environment and secure property rights. These two features are hardly available in Belarus. For instance, there is still a 'golden share' rule by using which the government could claim the privatised property back. Also, it has been stressed several times before that majority holding should be kept by the government during the early stages of privatisation<sup>26</sup>. In addition, it has not to be forgotten that a list of enterprises available for privatisation is published every year, and so far investors were not particularly enthusiastic about privatisation opportunities in Belarus.

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<sup>26</sup> See the discussion on this issue at: <http://www.svaboda.org/articlesprograms/libertyexpertise/2007/3/9F892997-D613-4D61-9E8D-68F88C095B54.html>.

Even very recently, it has been reminded that 'privatisation in Belarus will not be dirt cheap'<sup>27</sup>. In any case, the privatisation process is not an easy deal, and requires some time. In the current situation, the government of Belarus needs money rather urgently in order to 'patch' the budget up. Accordingly, the borrowing option looks more realistic since money could be provided within a first half of 2007<sup>28</sup>.

Indeed, at the end of February, the government of Belarus announced its plans to borrow money from the Russian Federation. Initially, there were plans to attract as much as USD 3 billion, including the issuing of Eurobonds to the amount of 600 million USD. Later, the amount was reduced to 1.5 billion USD. Whatever the volume of foreign borrowing, a more important issue is how these funds will be spent. In case the borrowed money would be used for maintaining existing production facilities, including energy-intensive ones, then some troubles can be expected in the future. In this case, the government would need more and more money to cover the increased costs and to pay the loan back. Accordingly, it would be forced either to borrow more or to maintain trade surplus. In other words, a slow pace of modernisation, especially in terms of energy consumption and increase of energy efficiency, imply that in the future more borrowing would be required or a painful cost-cutting, including reduction of wages and incomes. Alternatively, given that Russia is the major creditor for Belarus, some property could be demanded by the Russian government in exchange for new loans.

It appears that policy scenarios could be informed by an uneasy choice the government has to make between the need to secure budget expenditures and incomes and increasing energy costs that create balance of payments pressures. Accordingly, a choice of a particular mode of adjustment forms depends on a policy scenario opted for.

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<sup>27</sup> More detailed information is available at: <http://www.svaboda.org/articlesfeatures/economics/2007/2/FFB86CB7-BDDF-4455-BAB3-1D3194E002E7.html>.

<sup>28</sup> See information available at: <http://www.svaboda.org/articlesfeatures/economics/2007/3/756EF6DE-53BE-4117-B0B5-C088EE765741.html>.

### SCENARIO 1: MORE LIKELY, BUT LESS ADVANTAGEOUS

The first scenario suggests that the government would attempt to preserve the *status quo* as much as it is possible. Since the decision to borrow is almost a final one, then the task for the government is to maintain supply of foreign exchange in order to avoid devaluation and also to collect some additional revenues for the purpose of paying off debts. This scenario suggests that the bulk of investment would unlikely be channelled into technologically 'advanced' projects. Rather, the government would attempt to stimulate production and even increase protectionism in order to force consumers to buy domestically-produced durables. Indeed, the government has already announced plans to support such enterprises as 'Atlant' (refrigerator producer) and 'Horizont' (TV producer) with a hope that these companies would gain competitiveness in the future. In particular, there are plans to expand a range of consumer durables produced at home. In order to expand domestic sales, these companies are likely to be supported with higher import tariffs imposed on substitutes produced abroad. Another essential feature of this scenario is that the government would not allow real wages to decrease, but maintain their slow growth. This might reduce, but not eliminate, the wages-productivity gap. All this implies that the government is ready to accept sagging GDP growth over 2007 and, perhaps, 2008. However, it is very likely that in 2008 wages would continue to grow slowly. Most likely, the political business cycle would be employed again, this time before the parliamentary elections.

In short, the first scenario suggests a protracted and not really painful adjustment of the Belarusian economy, although reduction of income seems to be unavoidable. This reduction could be manifested in slower rate of growth of real wages than before. Specifically, real wages could be squeezed by high rate of inflation and or slower rate of nominal wage growth. This would adversely impact Belarusian households (i.e. their consumption, opportunities for buying real estate, etc.).

## SCENARIO 2: LESS LIKELY, BUT MORE ADVANTAGEOUS

The second scenario is less likely but still possible. The funds borrowed abroad could be allocated more efficiently in the sense of investing into energy-saving technologies. The latter would require a more decisive modernisation of domestic enterprises. As a result, the dependence of the Belarusian economy on imported energy could be reduced. However, this scenario requires a greater degree of wage moderation since less money would be allocated for this purpose in order to secure increase in investment. At the same time, liberalisation measures would be required. These measures should definitely include a greater respect for property right and the reduction of government intervention into the economic decision-making process, particularly at the microeconomic level. At the same time, macroeconomic regulation should be preserved to ensure exchange rate and price stability.

These measures are necessary to have higher returns on investment made at home. Still, there is a reliance on domestic investors since foreign ones are unlikely to pour substantial resources into the Belarusian economy given its political climate. In fact, there are proper socio-political conditions to embark on some sort of reformist policy. Suffering from lower real wages and incomes could be explained by some unfriendly policies emanating from the Russian Federation and also the EU who is ready to withdraw Belarus from its Generalised System of Preferences. Also, in 2007, the PBC was at the bottom, so there is an opportunity to sacrifice some consumption relatively unproblematically. Fundamentally, the government could legitimise these adverse effects as the products of external environment - like the unfriendly policies of the Russian Federation.

This scenario does not suggest substantial political changes, but the scenario is still likely because the first one contains a danger that the slow pace of restructuring would not provide adequate returns on investment. Also, the first scenario could bring a dangerous dependence on foreign borrowing. This is because money borrowed abroad would likely be spent not very efficiently so either new borrowing or export enhancement would be required - the latter could not be achieved in the short-run. The inability to pay loans back is a bad scenario for Belarus. In this case, the Russian government could force its Belarusian counterpart to offer some industrial capacities for privatisation to set the debts off. With

these considerations in mind, the government might opt for more radical changes as projected in the second scenario.

To summarise, the first scenario appears to be less painful, but its gains are not clear-cut. Its implementation means that the structural features of the Belarusian economy remain intact. However, some sacrifice of consumption is inevitable, and that emanates from the increased costs. The second scenario is more promising in terms of its macroeconomic and microeconomic efficiency. However, its content depends on the exact shape of its liberalisation policies. Which of these scenarios would materialise is hard to predict right now. The choice of either path would become more visible as soon as more steps are implemented by the government. Currently there are strong reasons to believe that authorities tend to follow the first scenario, but it is very likely that the second one or a combination may be observed in the future.

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