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P r o h l á š e n í

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Acronyms and Abbreviations

BDR	Belarusian Democratic Republic
BPF	Belarusian Popular Front
CASE	Center for Social and Economic Research
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CMEA	Council of Mutual Economic Assistance
CPI	Consumer Price Index
EBRD	European Bank of Reconstruction and Development
FSU	Former Soviet Union (states)
IMF	International Monetary Fund
IPM	Institute of Privatization and Management
MSA	Ministry of statistics and analysis of Belarus
NBB	National Bank of Belarus
PPI	Producers Price Index
USSR	Union of Soviet Socialistic Republics
WB	World Bank

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1. Introduction

Almost 20 years has passed from the collapse of the Soviet Union and socialism in Europe. This event has raised the question – how to transform a command planned economy to the self-regulated market? Although, international financial institutions (WB, EBRD, IMF) suggested the package of standard market reforms (called Washington Consensus), all post-soviet countries had to pass through their own way of market transformation.

The success of post-soviet transformation differs across the region. Countries of Central and Eastern Europe and Baltic states had managed to create fully-fledged market economies relatively quickly. However, former Soviet Union states (or countries of CIS) had implemented only partial transition reforms, and to this day suffer from economic distortions and lack of democracy. Thus, the socio-economic transformation in CIS countries is far from being complete.

The first part of the study describes the main negative characteristics of a centrally planned economy and the challenges which post-soviet countries have met during the process of transition. The main transformation reforms and the factors which stipulated the success in transition across the region are also discussed in the study. Through the analysis of the experience of transformation in post-soviet countries, conclusions were made as to the main reasons which stipulated a slower transformation path in the CIS region in comparison to the CEE countries.

In the second part of the study the economic transformation in Belarus is analyzed. The country is rated among the least transformed countries in the post-soviet region, despite its high initial potential for successful transition to the market economy. After a few years of implementation of market reforms, the economic policy was reversed and transformation was almost suspended in Belarus. The semi-authoritarian system of governance, with its high administrative control over the economy and the shallow private sector, had been established. Nevertheless, the sustainability of the established economic and political systems is undermined with time. Therefore, the market transformation is an inevitable process, which is bound to happen in Belarus sooner or later.

The aim of this study is to investigate the process of economic transformation in Belarus. In particular, the study analyzes the initial conditions of Belarus after the Soviet Union collapse. The first years of economic transformation and the economic identity of Belarusian economy are described. The study also includes analysis of economic growth, description of the Belarusian state macroeconomic policy and analysis of factors which influence the continuation of economic transformation in Belarus. In order to summarize the above-mentioned analyses, the SWOT analysis of the Belarusian economy is introduced. This analysis helps to draw the complex picture of Belarus in the world economy.

PART I

The Phenomenon of the Transition Economy

2. Model of Soviet Socialism

Theoretical forms of capitalism and socialism have never found its pure implementation yet. But its theoretical models differ in a certain range of features, which could be found in the real world. For almost the whole of the 20th century the world was divided into two competitive parts, characterized by different systems of governance and economical arrangements. The USA and Western European countries were characterized by capitalistic market economies and democratic systems of government. On the other hand, there was The Soviet Union and East European socialist countries, which were governed by communist parties and were characterized by totalitarian government. Countries from the Soviet Union block were “building communism” with diligence and fighting with inside and outside enemies, as there was always somebody (or something) that was interfering their way towards a “bright future.” Such fears became prerequisites for the economic and foreign policies of the Soviet Union. Enemy images were used throughout the entire existence of the Soviet Union to mobilize society and create a command planned economy.

Karl Marx and other socialist economists tried to develop theoretical models of a fair state, where the wealth would be divided equally among people, thereby eradicating exploitation and poverty. The Soviet Union was the first country which tried to implement this socialist theory into practice and which proclaimed itself a socialist state. Communist ideology quickly became the leading ideology in the state. Communism was seen as the end point of social and economic development, as the Promised Land in the Bible myth. Like the classic proverb says – the road to hell is paved with good intentions. The communism experiment of building a “bright future” had resulted in deep poverty of millions of people, devastation of the environment and damage of the whole economy in the union republics. Such a historical experiment had proved that society couldn’t exist within an artificial model, where natural human behavior was repressed. Natural human being qualities such as individualism, personal interest and private property were changed for collectivism, common interest and common property in the Soviet Union. The dissolution of such economic and social arrangements was unavoidable¹, and not only because socialism leads to inefficiency and generate only extensive growth², but also because the state itself was founded on fear and fraud.

For the whole history of the Soviet Union’s existence it was continually preparing for war. To a large extent the condition of alertness caused the policy of mass industrialization, which was initiated by Stalin a long time before WWII began. The military sector remained a prerogative

¹ The new world order, which emerged after the dissolution of Soviet Union describes Samuel P. Huntington in his famous book [“The Clash of Civilizations”](#)

² The characteristics of the socialist economy and impossibility to reforms it is disclosed in J. Kornai’s work “The Socialist System, The Political Economy of Communism.”, 1998

throughout the whole existence of the Soviet Union. It was a sector which perpetuated high mobilization of human and capital resources.

The economic policy installed by Soviet Union hardly took into account the local conditions, indigene culture and traditions of satellite states. That led to a situation where most of the traditional sectors in the union republics were neglected in favor of huge industrial plants. The national identities were also continuously replaced by the Soviet one.

All of the above mentioned factors would later determine the process of market transformation within the Former Soviet Union states. In contrast to Central and Eastern Europe countries, which remained independent during the whole period of socialism, FSU states faced the challenge of national state creation. The government in newly independent states very often suffered from poor governance and low national consciousness, together with lack of unity among people which subsequently created the emergence of ad hoc political leaders who took power thank to populism rhetoric. In the case of Belarus, poor national consciousness and lack of any prior independence caused a lagged transition and later suspension of market reforms. Its post-soviet development is characterized by “socially-oriented market economy” and authoritarian presidential power.

The renovation (or creation) of democratic order became the requirement for the perfect market transformation. But important elements of democratic societies like the rule of law and system of trust among people were neglected during socialism. Thus transitional economies had also met with the problem of creating civic society and the renovation of trust among people³. These previously lacking elements became an important precondition for creating a properly functioning market mechanism in transitional economies.

The following section describes the main features of the centrally planned economic order in the Soviet Union and its repetition in the other countries of the soviet bloc. The main points of why the system collapsed are also mentioned, together with a description of the further economic transformations to the market economy in the Soviet Union states and CEE countries.

2.1 Framework

The differences between capitalist and socialist economies can be placed into four main categories: **decision-making** level, the way of information allocation- **market** or **plan**, the task of **property rights** (public versus private), and incentives of economic players (**material** versus **moral**) (Gregory/ Stuart, 2003).

Decision-Making Level

The Soviet Centrally planned economy was vertically arranged in its system of decision-making levels. The government was organized into two cabinets: The Council of Ministers and

³ There can be found more about level of trust and civic society development in Czech republic in “Česká občanská společnost: po patnácti letech rozvoje“ by Tereza Vajdova and el., 2004

The role of trust for proper market functioning in transitional economies can be found in T.Sedlaček diploma work “On the Morals of an Economic Man”,2001

The Central Committee of the Communist Party (CPSU), ruled through a Politburo body. Communistic party represented the principal organ of decision making. It also filled the functions of control and supervision. The party operated through a Centralized structure, beginning at the national level and terminating with individual party cells in each industrial enterprise, farm, and organization (Gregory/Stuart,1999). The main government institutions were Gosplan - State planning commission, Gosbank - the State bank and the Gossnab -State Commission for Material and Equipment supply.

The Central Committee of the CPSU, or more specifically its Politburo, was setting up plan targets which corresponded to party goals. Every five years (the term of a plan), the All-Union Congress of the CPSU was in session, during which goals and plans were discussed and approved. After the approval of a five-year plan, it was processed by the Council of Ministers and composed with other industrial ministers, chairmen of various state committees and agencies in ministerial status. The Council of Ministers elaborated on the plan targets and sent them to Gosplan, the state planning agency. Plan targets were converted by Gosplan into operative plans and then sent to enterprises through ministries of particular branches. Because it was too difficult to learn about the real needs of consumers and industries, Gosplan worked through a trial and error method. Likewise, because the planning was provided for sectors rather than regions, plan targets very often were “discussed” and “corrected” after consultancy with ministers of particular industrial department.

- **Information and Resource Allocation**

The system of central planning was arranged so that the flow of information was possible only vertically from top down, on the lower levels. Economic plans were the main sources of information for enterprise managers⁴. Comparable with market economies where the prices and quantity of produced goods are set up by demand and supply, in centrally planned market economies, information was replaced by directive plan. Although formally it was allowed to provide feedback from producers and consumers in order to prove the progress of the existent plans, it was never done in reality. The existent political climate wasn't very favorable for any critics of government directives and decisions. Thus plans were based mostly on faulty and outdated information. As a result, the directive setting of prices didn't reflect the real value of things. Consumer goods were overvalued while at the same time, industrial input (gas and oil) were set on a miserable price.

The lack of proper information and resource allocation caused the development of a huge second economy in the Soviet Union. It smoothed the gaps created by the centrally planned economy, but in the long run its existence deteriorated the concept of trust and rule of law which is so necessary for the functioning of a market economy.

⁴ “The plan is a comprehensive document covering many facets of the firms operations, and it has the force of law. The plan specifies both inputs and outputs in physical and financial terms; it specifies the sources and the distribution of funds for the firm”. Gregory/Stuart: “Comparative Economic Systems”, 1999. p.197

- **Property Rights**

A property right is one of the most significant areas where the difference between socialism and capitalism lies. Karl Marx asserted that private property is immoral and leads to the exploitation of the working class. That is why collective and state ownership of all means of production was a foundation of the soviet economy. In rural areas, where all land was organized into collective or state farms⁵, small land-holding was permitted for sustenance farming. In some countries of the CEE (Poland and Hungary), even under the socialist government, there existed limited private property rights. Owning a shop was permitted, but so long as there weren't employees. Besides some exemptions in rural areas, all economic activity was governed by a collective state enterprise. Reduction of private ownership hadn't created an equal and fair society as it was supposed, but rather gave a rise to the class of state officials who were responsible for collective assets. It gave them power but at the same time reduced responsibility, as their responsibility was geared more to the head political members rather than to ordinary people.

- **Incentives**

The reduction of private property had also reduced the role of material incentives for workers. The communist ideology and state propaganda strongly emphasized moral incentives to stimulate workers. Nevertheless, history had proved that the absence of material incentives in the economy leads to more immoral economic behavior in the society.

- **Foreign Trade**

Foreign trade within the Soviet block was organized through the Council of Mutual Economic Assistance (CMEA or COMECON). It was founded in 1949 in Moscow by the Soviet Union, Bulgaria, Czechoslovakia, Hungary, Poland and Romania in response to the Marshal Plan assistance program provided at that time in Western European countries.

The main purpose of the Council was to organize bilateral trade and investments between the Soviet bloc countries and isolate their trade contacts from capitalist countries. But the organization of bilateral trade within CMEA appeared to be a more difficult issue. Due to the fact that prices on trade commodities were set up by individual governments and didn't reflect the real market value of goods, it was difficult to conduct trade on the basis of relative prices. That is why trade was conducted mainly on a barter basis through bilateral agreements between governments. The usual scheme was when consumer goods from Central and Eastern Europe were changed for energy resources from Moscow. After the collapse of socialism the CMEA ceased to exist.

⁵ "The agriculture was provided through collective farms (Kolchoz) or on state farms (Sovchoz) in the Soviet Union. The main difference was that collective farms formally were entities owned by worker-farmers, with elected the chairman as a head of the collective farm. State farms (Sovchoz) had a similar structure as enterprise and the high management was set up from above as on enterprise (private enterprise)". Gregory/Stuart: "Comparative Economic Systems", 1999. p.211

2.2 The Fundamental Problems of a Socialist Economy

Over-Industrialization Reached by Extensive Growth

Development of heavy industry and military sectors was the main priority for all soviet leaders. From the very beginning of its existence, The Soviet Union was military oriented state and large amount of resources flowed into military sector and heavy industry. At the same time production of consumer goods and services was underdeveloped. Mass industrialization programs were installed in all countries within the Soviet Union without taking into account the local economic peculiarities and traditions. That caused the neglecting of traditional production in some regions. On the other hand, it was much easier to rule the country through imposition control on a number of big industrial enterprises. In the Soviet Union the existence of industrial towns situated around a plant was not uncommon. But time had proved that such economical arrangement were not only inefficient but even devastating for the economy and local environment.

All efforts of Soviet leaders to accelerate production power and outperform capitalist economies were useless. Those economies' indicators of well-being and even military sector development were much better than in the Soviet Union, even though it was the richest country in natural resources at that time. The extensive character of industrial and economic growth of The Soviet Union caused an overall low efficiency of production. The economic results were reached through high mobilization of available inputs, labor and capital, but the level of innovation and technology remained low. At the same time, development of capitalist economies is characterized by intensive growth strategies, where growth is derived by increasing output per unit of factor input, or in other words, growth is reached by the better usage of available inputs.

Low Morale of Managers to Follow the Plan

The principal-agent problem was as relevant for a socialist economy as for a capitalist one. While capitalist managers were motivated by enhancing enterprise performance and profitability, soviet managers were interested only in the fulfillment of a plan. Stuart and Gregory (1999) describe such a situation as **the managerial success indicator problem**. Soviet managers were offered substantial rewards for achieving planned objectives, but amount of input resources and quality of reached output was not taken into account. Such an atmosphere of blurry objectives encouraged dysfunctional managerial behavior rather than plan achievement⁶. In order to fulfill the plan, enterprise managers very often ignored goods assortment, as it was much easier to produce such types of goods, which helped to meet gross output targets. While creating their models of socialist economies, socialist theorists didn't take into account the existence of dysfunctional management behavior. It was supposed that the economy would function well if managers would strictly follow the planned objectives and orders of superior authorities. But in practice the reality was totally different. The informal relations between enterprise managers and government officials played a significant role in centrally planned economies. The plan preparation was always accompanied by discussions of plan targets among enterprise managers

⁶ More in Gregory/Stuart: "Comparative economic systems", 1999. Chapter 9: The soviet command economy, p.200

and ministers of the corresponding industries. Negotiations and the following corrections of planned objectives caused discrepancies between final the original plan and its execution.

The Second Economy and the Unobserved Market

The imperfectness of legal institutions caused by a centrally planned economy led to the emergence of the unobserved market. Shortly after the composition of the imposed command planned economy, it became obvious that at least some market mechanisms are indispensable. This “second (or market) economy” existed in two forms- the legal one and the illegal counterpart “unobserved economy”. Private commercial activities, which were allowed by authorities, existed mainly in rural areas (people could work on their private plots and then sell their products on the market) and in small-scale construction services. The government also used market forces to regulate labor distribution by region, by season or by profession (Gregory/Stuart,1999, p.208). The policy of full employment and an absence of a labor market made such regulation indispensable.

But the number of legal market activities was incomparably less than the black market types. The existence of the unobserved market helped the official economy to last and function for a longer time. Like a valve which lets the hot air out, so did unobserved markets by allocating unreasonably high incomes of households to the service sector. The most common illegal activity was the theft of state property or goods for private needs or for future sales. Illegal activities were so widespread that it was even hard to measure its extent. The majority of the population was involved in the existent second shadow economy; from ordinary workers to the representatives of high echelons of government⁷. The unobserved market played a very controversial role within the economy. From one hand, workers had additional material incentives, as higher wages and other payments could be spent in the second economy, but from the other - it affected the fulfillment of a plan. As a result, unethical behavior became a norm. In market economies, unethical behavior of economic players is disastrous for the whole system. Vice versa, in communist regimes, it helped to keep the system alive.

The illegal second economy was tolerated by the soviet government for the majority of its years. But further detriments of the economic situation aroused thorny debates concerning a total reformation of command economy. It was necessary to legalize most market activities. Eventually reforms had started in late 1980 with initiative by M.Gorbachov. These reforms resulted in the collapse of the whole system down. The market activities began to expand, but the emergence of market institutions was lagging.

The inglorious end of the socialist experiment had proved the assertion of the Hungarian economist, Janos Kornai, that a command socialist economy couldn't be reformed, but only demolished.

⁷ More information about unobserved market and shadow economy can be obtained from the writings of Michael Alexeev (<http://mypage.iu.edu/~malexeev/>), and from the research project of Feige, Edgar L. and Urban, Ivica “Measuring Underground (Unobserved,Non-Observed, Unrecorded) Economies in Transition Countries: Can We Trust GDP?”;2007

2.3 The Legacy of Central Planning

The inefficiency of a Centrally-planned economy became evident immediately after the end of WWII. There were several attempts to reform the soviet economy, but none of those reforms were carried out. The system remained almost unchanged until Perestroika began.

In the beginning of the 1950s, some steps were made to weaken the command administrative foundation of the economy. “Market socialism” was seen as an ideal system and had already existed in Yugoslavian countries at that time. The concept of “market socialism” was studied and described by polish economist Oskar Lang. The idea of market socialism consisted in keeping social ownership of capital, while resources would be allocated by the market. It allowed a more efficient decentralization of the decision making process. In market socialism, prices are still planned, in comparison to the amount and assortment of goods which are controlled by the respective enterprise managers. Both material and moral incentives are used to motivate participants.

In the Soviet Union during 1965 there were prepared the so-called “Kosygin reforms”, which were however never carried out. At the end of the 1960s, after “Prague Spring,” the soviet government had been afraid that liberal reforms would have undermined the whole system of socialism. Reforms were consequently stopped and replaced by the policy of “turning screws”.

1970-1980 was the period of the L.Brezhnev government which was strongly associated with further economic stagnation. The Soviet Union had lagged behind capitalist countries in all spheres. The military sector – a sector of enormous importance for soviet leaders at that time became fully uncompetitive comparing to Western military production. As a result, the issue of economic reformation became more urgent. The realization of the much discussed reformation finally began soon after M. Gorbachev took office⁸.

The planning of the reformation needed a deep analysis of the whole soviet economy to find out the roots of the problem. The debates which followed on how to optimize the economy raised two topics which had been virtually closed since the 1930s: the actual (as opposed to the officially publicized) performance of the Soviet economy and the efficiency of the vast bureaucracy (Savchenko A., 2000, p. 49). The complete analysis of the economy confirmed the suspicion of many soviet economists that growth achievements were at a great extent exaggerated by party-controlled statistics⁹. After the results of research were received, it became

⁸ “Rather, it was dissatisfaction with diminishing inputs into the development of the military system provided by the ailing economy. Laszlo Csaba notes that the first policy statements made by Gorbachev after he came to power indicated his anxiety over the possible loss of military superiority (Csaba, 1995, p.39)”, Savchenko A. : “Rationality, Nationalism and post-Communist market transformations. A comparative analysis of Belarus, Poland and the Baltic States”; 2000.

⁹ “Among attempts to come up with an adequate evaluation of Soviet economic performance the most compelling and comprehensive was research by Grigory Khanin. In 1988 he published an article in which he argued that official statistical data on the economic growth in the Soviet Union since the 1930s had been grossly inflated and that the actual rate of growth was more modest. According to calculations, the volume of added value in the Soviet economy in the period of 1929-87 increased 6.9 times as opposed to 89.5 times according to official statistics. These figures were especially disturbing because they indicated that not only had the limit of expansion based on new resources been reached, but the system did not possess an ability to provide economic growth based

obvious that the economy producing only extensive growth had no resources for further growth acceleration. In the late 80s, the Soviet Union had already reached its limits for further economic expansion.

The oversized soviet bureaucratic apparatus was the other factor discussed as a reason for economic stagnation. It was pointed out that a planned economy could only function effectively if the bureaucrats would not bar the plan fulfillment. While discussing reformation to the economy, soviet economists were continuously referring to the Marxist-Leninist theory. Henceforth, only in 1990, mainstream discussions about the economy started to turn from how to reform socialism to a realization that it cannot be reformed (Savchenko A., 2000).

Further deepening of the economic recession and attempts to provide market reforms within the lacking market institutions caused the disintegration of the Soviet Union and the emergence of 15 new independent states. There were a large number of factors which caused the start of transformation in the former Soviet countries. First of all there was a lack of economists who knew about the functioning of market capitalism. Information about how to transform the previous economy to a capitalist one was lacking. All reformation schemas and policies were suggested by international financial institutions¹⁰. Most of those schemas were implemented without appropriate analysis as to their consequences.

At the moment when new independent states were just entering into transition, countries from the former soviet bloc (CEE) had already been in the process of transition. In many of those countries, market relations had already existed even under socialism. Their attempts to reform the economy were more beneficial than the previous ones during the soviet times.

3. The Patterns of Transition in CEE and CIS (FSU) Countries

The breakdown of socialism in Europe and disintegration of the Soviet Union provoked a lot of discussion about better ways of transforming a centrally planned economy to a market one. The economists who worked during the transition hadn't had appropriate knowledge to suggest concrete schema of reforms, nor could they have relied on Western specialists who lacked experience in the realization of market transformation reforms.

A package of necessary reforms to provide rapid transition to the market was developed by various International financial organizations such as: IMF, World Bank, and EBRD. That package was also called the 'Big Band' reforms or 'Washington Consensus'. But the extent of implementation of those reforms differed across the countries in transition. It was difficult to follow the strict scheme of reforms and transition was provided by a trial and error method.

on increased productivity". Savchenko A.: "Rationality, Nationalism and Post-Communist Market Transformation"; 2000, p.50

¹⁰ World Bank, International Monetary Fund and European Bank for Reconstruction and Development were the main advisors. Their program of rapid transformation to market economy, called Washington Consensus or Strategy of 'Big Band' was highly criticized by economists and journalists for its poor considering of indigenous conditions of transition countries and lack of time for new institutions to emergence.

Almost twenty years passed from the time when the first steps towards a market economy were undertaken in countries of Central and Eastern Europe, including the Former Soviet Union states. It is enough time to have a look on the transformation process from a distant present and make some conclusions about reached success and failures, and analyze what caused both results.

In the following section, an attempt to answer the following questions will be made: What reasons led to the delay of market reformation in some countries, more often in FSU states? What patterns of reforms can be observed in transition countries? What were the main factors which predetermined further post-transition development?

3.1 The Role of Initial Conditions

The path and pattern of transition depended a lot on the countries' initial conditions which it faced before transformation began. The researches provided EBRD and the World Bank proof that initial conditions secured a significant role in the transformation process, but only during the early stages. The continuous implementation of market reforms, after liberalization and stabilization are reached, diminish the negative impact of initial conditions¹¹. Further success in transition were affected by other factors, such as - the method of privatization, emergence of financial and market institutions, quality of governance.

Factors which predominated the start of transition in CEE and CIS countries:

- **The time when transition began**

Even in times of socialism, the CEE countries had performed much better than The Soviet Union Republics. In addition to having a better starting position, the CEE countries began economic transformation a few years earlier than the former Soviet Union states, which only started their transformation after the dissolution of the former government. It is worth mentioning that Baltic States reached much better success in the initial transformation stage than other FSU countries. It was caused by strong willingness of its citizens and elites to renovate state independence and reduce political and economic dependency from Moscow.

- **Geographical location**

CEE countries were highly influenced during the transitional phase by their close geographical position to the European Union. Immediately after the collapse of socialist regimes, they headed for renovating political and cultural ties with the European Union.

After the CMEA ceased to exist, there arose a question as to how to organize inter-republican trade, which had been on the barter basis before. Due to their close geographical location to Western European countries, the CEE countries were able to quickly reorient their trade towards

¹¹ "A strong role of initial conditions is found by De Melo et al. (1997). However, Havrylyshyn et al. (1999), using the same measures with additional years of data, point out that even if this was true in early years, the statistical significance of the initial conditions declines over time (Bakanova et al. (2004), find the same results)". Havrylyshyn, Oleh; "Growth Recovery in CIS Countries: The Sufficient Minimum Threshold of Reforms", Comparative Economic Studies; 2008

the EU region. Their further process of accession to EU helped to attract foreign investments, which is vital to the economic restructuring and market development. Transitional countries as a whole were considered a risky region, so the process of EU accession gave more confidence to investors about the stability of the region. Foreign investments were crucial not only from the sense of additional capital, but they also brought know-how, new managerial techniques and created demand for market institution.

CIS countries, especially those located in the Caucasus and Asia, were distanced from Western market democracies, which in turn lowered the political and economic influence on their countries and limited access to foreign investment. Their unstable political and economic situation didn't give them credibility to potential investors. Only countries with abundant natural resources, such as gas and oil, were able to attract investment in those sectors. CIS countries were dependent on CMEA in a greater extent, and it caused their post-soviet trade orientation, which remained almost unchangeable from the times of the Soviet Union disintegration. Most of the countries in the former Soviet Union region still remain, to this day under Russian economic and political influence. The financial crisis that had happened in Russia in 1998, had negatively affected most of the CIS economies, while slowing down their further transitional progress.

- **The existence of institutional traditions and the history of independence**

The number of years under central planning and the existence of independence before socialism was established played an important role during the process of transition. The significance of those factors rose especially in the second stage of transition, when there was a strong need for market and democratic institutions to continue in the transition process.

Comparing CIS with CEE countries and Baltic states, the latter experienced less time under central planning, had history of independent institutional building and, what also important, had strong national consciousness¹² to consolidate the nation in times of inevitable transition recession. In addition to economic distortions, Former union states had to deal with complexity of independent state building.

In the EBRD Transition report (1999) there are mentioned other factors which conditioned the start of transition in post-socialistic countries. They are – the level of urbanization, the importance of agriculture in national economy¹³, the degree of industrialization, the extent of initial macroeconomic imbalances, the geographical orientation of trade and legacy of state institution. In its research, following the path of transition in post-socialist countries, the EBRD measured the correlations of the initial condition factors to learn which had the most effective result. The results showed the following sequence of factors: *initial level of GDP, the distance to the EU, distortions in the allocation of employment, the period country spend under central planning and macroeconomic imbalances*. It was therefore a combination of historical legacies

¹² More about capitalism and importance of national consciousness can be found in article “Capitalism, ethics of work and Belarusian national consciousness/Капитализм, этика труда и белорусское национальное сознание”; Belkevich Dmitry; <http://liberty-belarus.info/content/view/1802/36/>

¹³ “Hungary, countries of former Yugoslavia and Poland were characterized by a larger initial private sector; and Poland and Romania were distinguished by the importance of agriculture in the economy”. EBRD, Transition Report; 1999, p. 28

dating back to the pre-socialist period and the nature of distortions that emerged under central planning (EBRD, Transition Report; 1999).

3.2 Patterns of Transition

The process of transition was uneven across the region. Countries had showed different paths of transition reforms. Now CEE states can already be considered market economies. Presently, the process of transition is complete and most of those countries are already rightful members of the European Union. Their industries have already reached the benchmark level of developed countries, and the economies are characterized by sustainable growth.

In contrast, most CIS countries are still preserved in a state of transition. Their economic performance is lower than the performance of already transformed CEE countries, and they can hardly be considered fully fledged market economies. Most of the CIS countries had implemented transformation reforms only after they got independence, but their further development in transition showed very diverse results. The transition reforms were soon suspended in many CIS countries, after only a few years of its realization. It was caused by different factors where initial conditions were also significant. The transformation process depended on the government's willingness to implement reforms and on the specific chosen approach (the rapid reforms -shock therapy or more gradual approach). Liberalization and stabilization reforms helped the emergence of the market initiative. But at the same time they created winners and losers of reforms¹⁴. The winners of reforms often blocked the actual realization of further transformation reforms to stay in the reached privileged position.

The Financial crisis in Russia in 1998, had also negatively affected neighborhood countries. After that, a lot of CIS transition countries suspended price and trade liberalization and the banking reforms. Lack of necessary institutions made the process of privatization and the creation of financial markets too problematic.

After 1997, the process of market transformation had slowed down in most transitional countries¹⁵. The liberalization and stabilization reforms represent the first phase of transition reforms and are relatively quick to realize. The second phase of transition is represented by privatization and institutional reform, which require more time to realize. The success of the second phase of reforms affected the overall success of market transformation.

There were many discussions about the best approach for market transformation. What was better: to provide gradual reformation or apply rapid reforms? Most countries in transition used the "shock therapy" approach, which did not always lead to desirable results. The main argument for the "shock therapy" approach was that it would quickly establish functioning markets, force enterprise to restructure and create conditions for new business to emergence. The business sector, in turn, would create a strong demand for supporting institutions (EBRD, Transition Report, 1999, p. 34). The main risk was that downsizing of unprofitable enterprises would take place more quickly than an increase in employment for new business.

¹⁴ More about Winners and Losers of Transition reforms is in "The First Ten Years: Analysis and Lessons for Eastern Europe and the Former Soviet Union", World Bank, 2002; p. 91

¹⁵ More is in EBRD, Transition Report, 1999

The gradualist approach was believed to have allowed non-viable enterprises to cut back their operations and employment more slowly and therefore enable the new private sector companies to expand at the same rate as the decline of the state sector (EBRD, Transition Report, 1999, p. 37). Gradual transformation would have also allowed for necessary market institutions to develop in the same line with growth of markets and private enterprises. This approach was not considered desirable due to the argument that a partially reformed economy would preserve rents and create powerfully vested interests that would block further reforms.

Two approaches differ mainly in the time needed to prepare these new market institutions. CEE countries, which had much better initial conditions, were able to rapidly transform and develop necessary institutions. Nevertheless, that approach was still highly criticized by international and local economists¹⁶. In CIS countries the “shock therapy” reforms led to more drastic results. The economy was not able to adapt quickly to those changes and create necessary law and enforcement mechanisms. CIS countries lacked a tradition of independent institutional building. The democratically elected governments were inclined to make populist decisions rather than provide necessary market reforms. As a result, in most of the CIS countries, economic transformation hasn’t been finished yet and countries are suffering from government corruption and growing budget deficit.

John Marangos ‘(2005)¹⁷, in his criticism of the Big Band reforms points out that instead of creating industrial capitalism similar to that in Western countries, rapid market reforms created in-transition merchant capitalism economies. Private business was emerging not in production, which required good protection of property rights and high investments, but rather in trade. Shock therapy in CIS countries turned former officials and enterprise managers into new capitalist owners, as they had better access to information and were physically closer to state property than ordinary people. Consequently, ordinary people gained little from the redistribution of property. The unfortunate experience of the former Soviet Union countries prove the argument that for new independent states the issue of institutional building was much more important than for CEE countries. Impossibility to set up the necessary institutional basis for proper functioning of the market caused the suspension of market transformation in former soviet countries.

It is hard not to agree with John Marango’s arguments, but unfortunately, at the same time we have no evidence of successful gradual market transformation amongst transition countries. The transformation process in post-socialist countries as a whole was realized through ad-hoc methods; through trial and error rather than based on a strict scheme.

3.2.1 Pre-Transition Situation

Transition countries faced very similar range of problems during the first stage of transition. The main challenge was to overcome output decline, inflation increase, redistribution of the workforce and unemployment, low productivity rate, fiscal deficit and quasi-deficit and external imbalances which arose with the need of reorientation of trade.

¹⁶ The critics of rapid reforms approach in Czech Republic can be found in Mlčoch, L.: *Uvahy o české ekonomické transformaci*, Vyšehrad, Praha 2000

¹⁷ “Shock Therapy and Consequences in Transition Economies”, Marangos John, *Development*, 2005, 48(2),

Output Decline

The output decline was observed almost in all transition countries. It became a result of price deregulation and change in relative price ratios. There was a need to reallocate resources in order to change industrial structure inherited from centrally planned economy. The economical distortions were caused by over-militarization and over-industrialization (resulting in the underdevelopment of the service sector), perverted trade flows among former Soviet republics and CMEA countries, excessively large and poor specialization of industrial enterprises and agricultural farms (lack of small enterprises and farms)¹⁸.

In CIS countries, output decline was much deeper due to their stronger ties with Moscow¹⁹. In the former Soviet Union, enterprises were linked between themselves through inter-sector links. At first, trade was opened up between enterprises and only then among union republics. Breaking of union ties made enterprises seek other partners. This situation also complicated bankruptcy and liquidation processes, as liquidation of one enterprise could lead to a “chain effect” in the economy – to financial difficulties in the other enterprises.

The CMEA dissolution also had a more negative impact on the former Soviet Union states rather than on CEE countries. The CIS countries couldn't easily reorient their trade in the direction of the European Union and so trade remained reserved for traditional partners from the CIS region.

The World Bank (2002) characterizes transition recession as the number of years of output decline. The CIS transition recession was much deeper than in CEE due to the Russian fiscal-financial crises in 1998. CIS had an average of 6.5 years of declining output (CEE only 3.8 years), resulting in the loss of half the initial level of measured output. Even at the end of the decade, CIS had recovered only 63 % of its starting GDP values (World Bank (2002)).

¹⁸ “Shock Therapy versus Gradualism Reconsidered: Lessons from Transition Economies after 15 years of reforms”, Popov, V; Comparative Economic Studies, 2007, 49(1-31)

¹⁹ “Within the Soviet Union, the division of labor between the consistent republics was imposed from the center and controlled by the Central authorities. The main task of coordination was assigned to the All-Union industrial ministries. They directed exchange between enterprises. The regional aspect of coordination of exchange was carried out by the State Planning Committee of the USSR that controlled balances of trade between the republics. Exchange between enterprises were of primary importance and subject to control and coordination, while inter-republican trade was mostly reflected in ex post facto statistical analyses”. Savchenko, A., 2000

Table 1.1: The Transition Recession in CEE and CIS Countries

<i>Countries</i>	<i>Consecutive years of output decline</i>	<i>Cumulative output decline (percent)</i>	<i>Real GDP, 2000 (1990 = 100)</i>
CSB^a	3.8	22.6	106.5
Albania	3	33	110
Bulgaria	4	16	81
Croatia	4	36	87
Czech Republic	3	12	99
Estonia	5	35	85
Hungary	4	15	109
Latvia	6	51	61
Lithuania	5	44	67
Poland	2	6	112
Romania	3	21	144
Slovak Republic	4	23	82
Slovenia	3	14	105
CIS^a	6.5	50.5	62.7
Armenia	4	63	67
Azerbaijan	6	60	55
Belarus	6	35	88
Georgia	5	78	29
Kazakhstan	6	41	90
Kyrgyz Republic	6	50	66
Moldova	7	63	35
Russian Federation	7	40	64
Tajikistan	7	50	48
Turkmenistan	8	48	76
Ukraine	10	59	43
Uzbekistan	6	18	95

Notes: CBS- Central and South- Eastern Europe and the Baltics, CIS- Commonwealth of independent states

Source: World Bank country data; Maddison (1982)

Table 1.1 shows output decline in two groups of countries. Among CBS (or CEE) Poland had the shortest and the mildest recession – a 6 % drop in production over two years.

The three Baltic countries had the longest (5–6 years) and the deepest (35–51 %) recessions among the CSB. In the CIS Armenia, Georgia, and Moldova saw the steepest declines—Georgia, an astonishing 80 % fall in output, largely a result of the long internal turmoil—while Belarus (-35 %) and Uzbekistan (-18 %) had mild declines. Three CSB countries (Bulgaria, the Czech Republic, and Romania) had at least two years of output declined after their initial recovery (WB (2002), p. 3).

Employment and Productivity

The output decline and pressure for restructuring increased costs on enterprises. Labor costs became too high, particularly due to over-employment and low productivity in the majority of enterprises. The government was challenged with a sharp increase of unemployment rates. There were different patterns of labor market adjustments used among transition countries.

One, used mostly in CIS and countries of South-Eastern Europe, was characterized by significantly smaller decline in employment compared to the drastic decline in output and labor

demand. To eliminate mass layoffs and social extensions, enterprises lowered real wages, used arrears and non-payment of wages to cut labor costs.

The highly prolonged transition recession and slow process of emergence of market enforcement mechanisms hampered the development of new viable business sectors, which could have absorbed an abundant labor force. The reduced labor force moved to low-productivity services and subsistence agriculture - sectors which served as “shock absorbers” during the absence of a functioning social policy.

The other approach towards labor market adjustment was observed in the CEE countries and Baltic States. There, employment declined at the same rate as output. While job was reduced in old, existing enterprises, the new employment was to be found in new created enterprises. In CEE countries, generous social safety nets were introduced at the start of reforms to smooth the impact of the transition recession on the society. In particular, the pension system was widely used as a way of cushioning the social impact of large-scale redundancies. As a result, the social security systems had recorded increasing deficits, which had been a burden to the fiscal position. Expenditures in CEE had remained above the level in typical middle-income countries, with associated high tax burdens and disincentives for private investments (EBRD, Transition report, 1999, p. 58).

The CEE countries were able to restructure their markets quite fast thanks to attracting foreign investment and emergence of new firms, which absorbed free work force. Productivity experienced a fast increase thanks to investments in innovation, technological improvement and the introduction of new management practices²⁰.

In CIS countries, the situation in the labor market worsened due to the continuing existence of city-companies in military and heavy industry sectors which were difficult to restructure. During the transition that cities were characterized by high unemployment rate, increased criminality and social destruction as a whole.

Inflation, Fiscal and External Imbalances

During the first years after the collapse of centrally planned economies sharp increases in inflation was characteristic for the whole post-soviet region. It was caused by a combination of factors - price deregulations and large fiscal and quasi-fiscal deficits due to the collapse of the tax base. Lack of sources of revenue and the need to provide financing of social restructuring programs led to the monetary financing of budget deficits, and hence rapid increase in inflation. CEE countries were able in quite a short time to restore their production and repress inflation. In CIS countries high inflation rates were observed for quite a long time due to a more complicated macroeconomic situation which occurred after the disintegration of the Soviet centrally administrated monetary system.

The new independent states were very sensitive to high inflation pressure as met the necessity to take responsibility for their budgets, credit and monetary policies. Earlier the economic policy was provided exclusively by the central authority in Moscow. After the disintegration of the

²⁰ “Some of the advanced countries have entered the phase of rapid productivity growth, driven by product innovation, fresh investment, improved technologies, and modern management methods (by deep restructuring)”. EBRD, Transition report, 1999

Soviet Union, small independent countries, such as Belarus and the Baltic States, inherited a large industrial base, specializing on the end-production. The disintegration of production channels of the former distribution system caused great losses for enterprises. Production costs increased immediately²¹. A lot of enterprises were insolvent. However, because a bankruptcy institution hadn't been set up in independent countries yet, the enterprise debt continued to accumulate. This situation led to the **crisis of arrears**. Enterprises simply felt lack of money to pay on inter-enterprise channels (Savchenko A., 2000).

In the past, the Soviet Union financial system was fully centralized and administrated through a Central bank and its territorial branches. After disintegration, newly emergent commercial banks could also participate in credit trading amongst enterprises. It created additional inflationary pressure, because money supply remained centralized. Only the Russian National bank could conduct money emission on ruble zone, while non-cash money emission was controlled by each independent national bank in each country (Savchenko A., 2000).

Fiscal deficit in transition countries had increased not only due to output collapse but also because of the continuous state support of insolvent enterprises. Soft budget constraints in the form of implicit subsidies (tax arrears) created additional pressure on the budget deficit. Imposition by the tax system was challenging in all transition countries, as there was a lack of tax payment discipline among enterprises.

The current account deficit rose immediately after the disintegration of CMEA, when exports to former trading partners dropped, imports became more widely available to people in transition economies. According to the EBRD report (1999), current account deficits decreased in 1993-94, as stabilization took hold, output started to recover and exports began to be reoriented towards Western markets. The deficit increased again during 1995-1998, reflecting the surge in imports and increased capital flows into the region. Increase of innovative and technological investments for enterprise re-equipment can also be explained by the account deficit in the second part of 1990s.

3.2.2 Liberalization

The first step towards market transformation was associated with the reduction of government control over the economy, thus creating a self-regulating market structure. The path of liberalization was different across the region and greatly depended on initial conditions and political development in a country. Liberalization signifies the abolishment of state orders and procurement, state production and trading monopolies and Centralized allocation of foreign exchange (From plan to market, WB (1996)). The first step of liberalization is deregulation of domestic prices, trade and production. Most CEE countries provided fast liberalization of prices and trade, in contrast to the gradual approach in Bulgaria, Romania and most of the CIS (EBRD, Transition report (1999)). Additionally, prices on energy and household essentials were a case of

²¹ Enterprises specializing in production of primary goods gained from the liberalization of prices, i.e. Russian oil and gas production.

phased liberalization²². In many CIS countries, prices on energy and household essentials still remain underestimated.

For measuring achievement in market liberalization and in transition reforms as a whole, *the scale of 4 points* developed by EBRD is most commonly used. In the EBRD Transition report (1999) liberal markets are defined as those having an EBRD transition indicator score of 3 on price liberalization (most prices are deregulated except for housing rents and infrastructure tariffs) and 4 on trade liberalization (full current account convertibility) (EBRD, Transition report (1999)).

Table 1.2: Process in Transition in Selected Countries

Countries	Private sector share of GDP in% (EBRD estimates)	Governance & enterprise restructuring	Price liberalization	Trade& foreign exchange system	Competition policy	Banking reform& Interest rate liberalization
Czech Republic	80	3	3	4+	3	3+
Hungary	80	3+	3+	4+	3	4
Poland	65	3	3+	4+	3	3+
Russian Federation	70	2-	3-	2+	3+	2-
Ukraine	55	2	3	3	2	2
Belarus	20	1	2-	1	2	1
Lithuania	70	3-	3	4	2+	3
Latvia	65	3-	3	4+	3-	3
Estonia	75	3	3	4	3-	4-

Source: EBRD, Transition report (1999), selected countries

Deregulation resulted in a sharp increase in prices and further inflation acceleration, decline in output and drop in trade, due to disintegration of CMEA²³. Rapid liberalization in most transition countries had led to the crushing of planning institutions before new market institutions could develop. It led to unregulated and uncontrolled deals between market participants and a

²² For more about phased liberalization of energy and housing prices see Box 2.1 in “From plan to market”, WB (1996)

²³ ”According to one rough estimate, Russia’s price subsidies to other countries were worth \$58 billion in 1990, of which \$40 billion went to the rest of the Soviet Union and \$18 billion to other CMEA countries. Ending these subsidies raised the cost of imported production inputs, reducing aggregate supply and output. Many non-NIS countries suffered overall terms-of-trade losses of more than 10 % of GDP, and even as high as 15 to 20 % in the case of some highly import-dependent countries.” From plan to market, WB (1996)

prolonged existence of the unobserved market. However, at the same time it created competition pressure for enterprises and forced them to financial discipline and further restructuring.

3.2.3 Stabilization and Fiscal Policy

Liberalization led to the release of market forces which were restrained under central planning. Before repressed, hidden inflation (existed in form of shortages and long queues) was revealed as soon as prices were freed. There was a need to organize market processes and reduce negative outcomes, induced by the liberalization process. Patterns of macroeconomic stabilization varied across countries to the degree of imposed financial discipline. EBRD measures the strength of a country's macroeconomic stabilization efforts as the number of years since the start of transition with both a moderate rate of inflation (less than 30 %) and sustainable fiscal deficit (less than 5 % of GDP). Countries in Central Europe and the Baltic region have achieved this level of macroeconomic stability in almost half of the period since the start of transition, and those in CIS have largely failed to cross this threshold (EBRD, Transition report 1999, p. 30).

It is crucial for a transition economy to get inflation under control and reduce excess money supply. The first necessary measure was the imposition of hard budget constraints on enterprises and reduction of subsidizing through state budget and the state or commercial banks. The crediting of insolvent enterprises by banks negatively contributed to the acceleration of inflation. The set up of tax discipline was crucial for countries in transition, which suffered huge budget deficits as tax collection was supposed to be the main source of revenue. The acceptance of tax non-payments, as a form of implicit government support on unprofitable enterprises discouraged more profitable businesses to pay taxes.

Price liberalization and burst of inflation was also associated with depreciation of domestic currency. Increased demand for import and capital flight put continued pressure on the exchange rate and it in turn accelerated inflation through rising import prices (From plan to market, WB (1996), p. 38).

One of the most effective stabilization tools was the establishment of a fixed exchange rate. As WB (1996) mentions in its report: the fixed exchange rate helped to bring high inflation down more rapidly and at lower cost to growth. The automatic exchange of foreign for local currency by Central banks at a fixed rate allowed enterprises and households to rebuild their real money balances more easily²⁴. WB experts argue that instituting a fixed exchange rate can be efficient in the short term to get inflation under control; in the long run however, it is not so evident. Practice showed that in stabilized economies, it is preferable to use flexible exchange rates. It reduces pressure on the state monetary system during an active period of fluctuations in the exchange rate²⁵. Some transition countries also utilize exchange rates fixed to the basket of foreign currencies.

²⁴ "...with flexible rather than fixed exchange rates, domestic authorities have complete discretion over monetary policy, so they have to tighten credit further to make their commitment to stabilization credible." From plan to market, WB(1996), p. 39

²⁵ More in "Peněžní ekonomie a bankovníctví" by Z.Revenda, M.Mandel, p.. 554- 575

Dollarization

High rates of inflation and low confidence in national currency caused the dollarization in transition economies. It was more typical for the former Soviet Union states than for CEE countries. The latter were able to quickly introduce their currency's convertibility and to stabilize the macroeconomic environment as a whole. In CIS countries, where the inflation was kept very high for quite a long time, people tried to avoid large devaluations of their savings and thus turned their holdings into foreign (hard) currency, most frequently into US dollars. Usually, the degree of dollarization is measured as a percentage of foreign currency deposits to total deposits. But the cash holding were also very high in the CIS region²⁶. The high rate of dollarization undermined the transition from realized macroeconomic policy to stabilized economy.

3.2.4 Privatization and Enterprise Restructuring

Privatization was the next very important phase of the transformation process. It was predicted that privatization would not only help to restructure enterprises but also to "depoliticize" them and reduce the state interference into the economy. Expectations were made about the effect of privatization on creating a group of private owners, which would put additional pressure on governments to continue in the reform realization. The existence of private owners in the economy positively influenced the business environment which was crucial for market development.

Privatization was a process aimed to create new capitalist owners in transition countries and change management incentives from plan targets to profitability goals. The prediction was that owners would be interested in enterprise performance and would initiate their restructuring faster than the state.

Despite the acknowledgement of the crucial changes necessary to sustain the economy, it was not clear how to create new efficient ownership structure in post-socialist economies in a short period of time surrounded with the viable capitalist economies which have been in existence for centuries. Countries which had experienced less time under socialist governments used the procedure of restitution (The Czech Republic or Lithuania, for example) to return property, which was nationalized under Communists. Nevertheless, there was also need to restructure and privatize big enterprises, farm land, small firms and housing. For this purpose different methods of privatization were used to transfer property to private hands

The need for enterprise restructuring arose discussions about whether it is better to impose financial discipline and restructure enterprise first and only then to privatize, or to privatize and leave further restructuring on new owners.²⁷

²⁶ More about Dollarization can be found in "Dollarization and Euroization in Transition Countries: Currency Substitution, Asset Substitution, Network Externalities and Irreversibility article" by Edgar L. Feige and James W. Dean, 2002

²⁷ EBRD and WB have different opinion about order of providing restructuring and privatization. EBRD points out that it is better to leave restructuring on new owner (Transition report, 1999). At the same time WB writes in its report that in absence of a well functioning market, enterprise privatization can lead to unpleasant results and it is

Large amount of surveys studied the factors which were influencing the enterprise performance most? Research, provided by EBRD and WB, prove that market competition and financial discipline are more important for enterprise restructuring than privatization. The performance of privatized enterprises also depends a lot on ownership structure, existence of outside owners, and extent of state capture.

It was expected that privatization would bring a lot of gains to the economy, but in the case of undeveloped market institutions, it led rather to unfair redistribution of property rights. The restoration of the rule of law in the society and creation of well functioning institutional bases was as crucial for transition economies as other market reforms.

Large-Scale Privatization

How to restructure the large industrial plants was the main concern for all governments in transition. Rather to become source of revenues large enterprises became insolvent, because were not able to bear competition in new conditions. As a result, enterprises became a subject of different government support - direct subsidies, toleration of tax arrears and non-payment of utility bills. It was supposed that privatization would change the situation in enterprises and force managers towards restructuring. There were a range of objectives which were expected to be reach by the privatization process. Because there was no ideal solution to the problem, every method of privatization represents a tradeoff between desirable objectives. The Table 1.3 below illustrates dependence of methods of privatization on accomplishment of objectives.

Table 1.3: Tradeoffs among Privatization Routes for Large Firms

Method	Objective				
	Better corporate governance	Speed and feasibility	Better access to capital and skills	More government revenue	Greater fairness
Sale to outside owners	+	—	+	+	—
Management-employee buyout	—	+	—	—	—
Equal-access voucher privatization	?	+	?	—	+
Spontaneous privatization	?	?	—	—	—

Source: WB, From plan to market, 1996

better first to provide restructuring of state-owned enterprises and then to privatize them. But both institutions agree that privatization is necessary in any case as it rises efficiency of the whole economy.

- **Methods: Sale to Outside Owners**

Direct selling to outside owners or strategic investors is considered to be the most effective method of privatization. In contrast to mass-privatization methods, it creates concentrated ownership which has a positive impact on corporate governance. Strategic investors are usually associated with deep enterprise restructuring²⁸. They bring know-how, new management techniques and investments in technology and innovation which is crucial for enterprise competitiveness. Direct selling also becomes a source of financial resources for state budgets, which suffers from deficit.

In addition, there are a number of negative aspects associated with direct selling. It is not so easy to provide them to transitional countries, which lack transparency and sufficient property rights protection. The real enterprise value is difficult to establish in a situation where the financial market is not yet and there is no transparent audit scheme. The government is usually inclined to overestimate the price of the state enterprise. From the point of view of ordinary citizens, who were not participating in this process, such privatization was considered to be unfair and very often was associated with corruption. For foreign investors, the decision to buy an enterprise from a transition country can be quite risky business. Besides dealing with an uneven political situation, poor law of property rights protection and corruption, there can also be strong resistance of enterprise managers and employees to foreign investor. Foreign investors were more eager to invest in countries with supposed access to EU rather than to new independent states (CIS countries). That explains the large uneven distribution of investment resources across the region. CIS countries were associated with much higher investment risks. Only those countries²⁹ with abundant natural resources were able to attract large investments in oil and gas sectors.

The direct selling of enterprises was widely used in Hungary, Slovakia, Poland, Bulgaria, Estonia and Latvia.

- **Methods: Management-Employee Buyout**

Management-employee buyout is a method of mass privatization, which was used in transition countries as an alternative to direct selling. This method is considered to be more politically feasible and fair than direct selling, but the economical effects are rather ambiguous. The positive repercussion of such a method is that insiders (managers and employees) can have a positive effect on enterprise performance, as they are usually disposed with more information about firm functioning and its internal structure. It is also worth mentioning that insiders have better opportunities to monitor managers and influence their decisions. While at the same time,

²⁸ "At the enterprise level, a basic distinction can be drawn between "reactive" and "deep" restructuring. Reactive restructuring refers to the downsizing of production, workforce and capacity associated with the loss of old markets. Deep restructuring involves the development of new product lines, the identification of new markets and the implementation of new management techniques and business strategies. This type of restructuring ultimately leads to an expansion in output and the creation of new jobs." EBRD, Transition report (1999),p.165

²⁹ For example Russia and Kazakhstan could successfully attract FDI in the oil sector. More information about the FDI inflow into resources rich countries can be found in the research "Nature's blessing or nature's curse: the political economy of transition in resource-based economies " by of Akram Esanov, Martin Raiser and Willem Buiter

dispersed ownership can weaken corporate governance, as for transitional economies it is more difficult to impose control over management. Institutions for management monitoring are poorly developed or don't exist in transition countries in contrast to fully fledged market economies.

Management-employees buyouts are easier to provide for profitable and successful enterprises in contrast to those with difficulties. Governments, which sold enterprise shares to insiders for a lower price, got little revenues from such operations. Outsiders were also discouraged to participate in such privatization, as they could find it difficult to influence enterprise management. In turn, the insiders lack of new skills, know-how and management methods to provide effective enterprise restructuring.

Experience of transformative countries shows that lack of market knowledge and strong competition leads managers to seek outside investors. Management-employee buyout methods of privatization illustrated a serious tension between political feasibility and economic desirability. Serious preferences were given to management and employees in order to gain their support, but procedures to protect minority shareholder's rights were not installed and neither were the promotion of secondary trading (From market to plan, WB (1996), p. 55).

This method of privatization was primary implemented in Albania, Croatia, Romania and Belarus. In Lithuania, voucher program of privatization had features of management-employee buyouts. Several voucher-based programs in Georgia and Russia gave large preferences to insiders so that most privatized firms were initially owned primarily by managers and employees. Employees and their families used vouchers and cash to buy stakes in their firms (From market to plan, WB (1996), p. 54).

- **Methods: Equal Access Voucher-Privatization**

Voucher privatization was considered to be the most politically feasible and fair method of privatization but with little economic effect. Ownership rights were distributed amongst citizens through vouchers, which served as a form of security. The voucher gave a right to purchase shares of privatized enterprises. People got an opportunity to own some share of common property and participate in enterprise governing. In order to raise efficiency of such a method of privatization in many countries National Investment Funds were created which allocated vouchers, and then invested them into enterprises. Investments by means of Investment funds gave opportunities to create more concentrated ownership of enterprise and encouraged the creation of a financial market.

However, voucher privatization was widely criticized for its small economic effect. First of all, free distribution of vouchers undermined its value and there wasn't a clear idea of its real worth. It was expected that the National Investments Funds³⁰ would quicken the restructuring of enterprises privatized through the voucher method, but the reality appeared to be different. More often investment funds were not interested in restructuring enterprises. For example, the Czech Investment Funds were founded by state-owned banks. The last tolerated enterprise insolvency

³⁰ "Corporate Governance and Ownership Structure in the Transition: The Current State of Knowledge and Where to Go from Here", CASE; p. 27

and low payments of credits slowed the whole restructuring process³¹. Low transparency and lack of ethical behavior of Investment Funds in the Czech Republic led to grey schemas and “tunneling³²”. As a result, investment funds didn’t become the proper institution to provide enterprise restructuring. The main advantage of voucher privatization was its speed and visible fairness, but it didn’t raise revenues for government. Corporate governance was not well defined as there was no concrete owner of an enterprise.

Voucher privatization was first implemented in Lithuania and Czechoslovakia. Later Albania, Armenia, Kazakstan, Moldova, Poland, Romania and Ukraine also used it as one of the realized methods of privatization. Georgia and Russia used their voucher programs to pass ownership rights to insiders. In some countries, voucher privatization was not used as the major method but rather to transfer only minority stakes of certain firms.

The other kind of privatization, which occurs quite often in transition economies, is **spontaneous privatization**. Simply said, it is theft of state property by managers of state enterprises or government officials. It was well observed in many of CIS countries, where citizens’ control over privatization was not so strong as in CEE (where such examples were also met).

³¹ More about low path of restructuring of Czech enterprises can be found in Marta Nečadova „Příčiny nízkého tempa restrukturalizace podnikové sféry v ČR“, 2005, Vysoká škola ekonomická.

³² “Tunneling means the possibility to legally strip assets from a privatized company or from an Investment Fund through numerous legal methods, including self-dealing and misuse of insider information.”: Sedláček T. “On the morals of economic man”, 2001

Table 1.4: Progress and Methods of Privatization of Medium-Sized and Large Enterprises

EBRD large-scale privatization transition indicator score		Direct sales	Voucher	Management-employee buyouts
Central and Eastern Europe And the Baltic states				
Albania	2	–	Secondary	Primary
Bosnia and Herzegovina	2	Secondary	Primary	–
Bulgaria	3	Primary	Secondary	–
Croatia	3	–	Secondary	Primary
Czech Republic	4	Secondary	Primary	–
Estonia	4	Primary	Secondary	–
FYR Macedonia	3	Secondary	–	Primary
Hungary	4	Primary	–	Secondary
Latvia	3	Primary	Secondary	–
Lithuania	3	Secondary	Primary	–
Poland	3+	Primary	–	Secondary
Romania	3-	Secondary	–	Primary
Slovak Republic	4	Primary	Secondary	–
Slovenia	3+	–	Secondary	Primary
Commonwealth of Independent States				
Armenia	3	–	Primary	Secondary
Azerbaijan	2-	Secondary	Primary	–
<i>Belarus</i>	1	–	Secondary	Primary
Georgia	3+	Secondary	Primary	–
Kazakhstan	3	Primary	Secondary	–
Kyrgyzstan	3	–	Primary	Secondary
Moldova	3	Secondary	Primary	–
Russia	3+	Secondary	Primary	–
Tajikistan	2+	Primary	Secondary	–
Turkmenistan	2-	Secondary	–	Primary
Ukraine	2+	Secondary	–	Primary
Uzbekistan	3-	Secondary	–	Primary

Source: EBRD data (1999)

Small-Scale Privatization

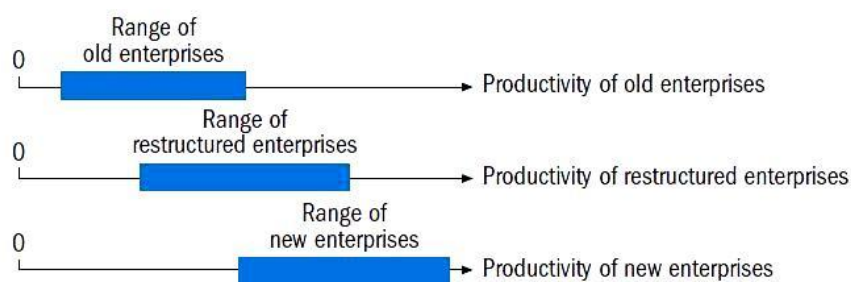
Small-scale privatization was much easier to realize than large scale privatization, which helps explain why it was much more successful in all transition countries. Small firms were mainly concentrated in trade and services with little requirement of technology and special knowledge. Entry into small businesses was easy. Small enterprises were usually privatized through auction selling (for example in the Czech Republic) or ranged in voucher programs. In Hungary, there was a developed private trade and service sector before the transformation started. In Russia, small scale privatization preferences were provided to insiders, the same as with large scale privatization. Studies of small scale privatization in Central Europe, Russia, and Ukraine show the need to bring in outsiders, who tend to invest more and supply services better (From market to plan, WB (1996)).

More complicated was the process of farm land privatization. In CEE countries and Baltic States, where memory and documentation of prior farm land ownership was preserved, the method of restitution prevailed. In the former Soviet Union states, the prevailing of state owned enterprises made people unable to perceive land as an asset, which can be freely tradable. CIS countries had to use other schemes of privatization as compared with those used by the CEE. Land rights were distributed to employees of state farms and other rural residents through in-kind transfers, as in Albania and Armenia, or through paper entitlements (legal recognition that the holder owns a part of a cooperatively farmed unit), as in Belarus, Moldova, Russia, and Ukraine (From market to plan, WB (1996)).

New Firms and Foreign Investment

Transition results from different countries proved that the emergence of new private sectors is more crucial for market transformation than privatization of state-owned firms. There were a lot of barriers in transition economies for new businesses to emergence in the form of strict market regulations and underdevelopment of market institutions. Countries with large budget deficits had difficulties to avoid the confiscatory taxation that tended to quash an emerging private sector, and firms found it hard to set prices, negotiate contracts, and estimate investment in an environment of high inflation (From market to plan, WB (1996)). Creation of new private firms was often based on assets or labor released from downsizing state enterprises. Additionally, asset privatization was much easier in realization than privatization of the whole enterprise.

Productivity Distribution of Old, Restructured, and New Enterprises



Note: The figure allows for outliers in both directions, as there is no reason why single old enterprises, everything else being equal, might not occasionally produce higher value added per employee than new enterprises, or why new enterprises might not occasionally have disappointing results.

Source: World Bank data.

3.2.5 Institutional Changes

Liberalization, stabilization and privatization were the indispensable reforms needed to establish a frame of market transformation. The successful realization of those reforms depended a lot on the countries initial conditions. But with time, when output and growth were restored the influence of initial conditions declined. The sustainability of post-recession economic growth depended on the maturity of institutional frameworks in the country. Financial institutions (e.g. WB, IMF) which were supervising market transformation in post-socialist countries, were often criticized for paying little attention to the emergence of necessary market institutions³³ when they suggested the “shock therapy” approach. Henceforth, the importance of institutional bases would be widely discussed as further market transformations would face the lack of proper market regulations and enforcement mechanisms. The lack of political will to provide institutional changes, led to the slow-down or even reversal of transitional reforms³⁴.

Once the basic reforms of liberalization and privatization were implemented and the state had consolidated its new role, the focus of institutional reforms shifted towards the strengthening of the supporting institutions, such as **competition policy, bankruptcy, corporate governance and regulation of infrastructure and finance** (EBRD, Transition report, (1999)).

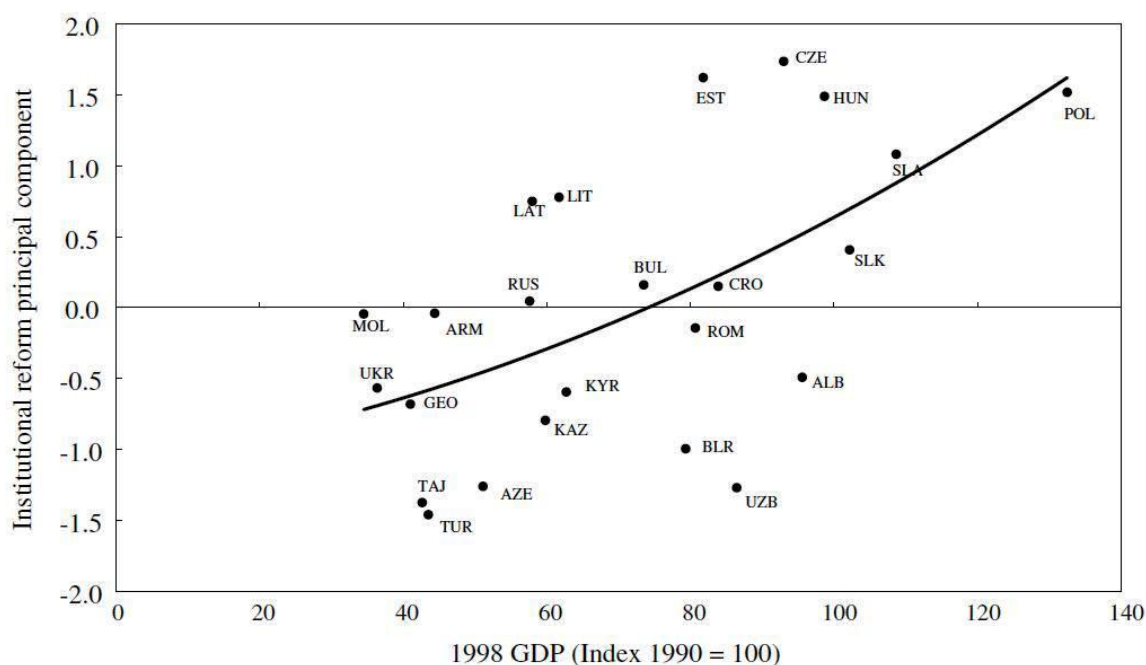
First of all, it was important to set up private ownership in the economy and thus, to move economical incentives from government towards private sector. Over-industrialization in new economic conditions became a burden for the economies rather than a source of high revenues. The issue of redistribution of the labor force and recourses toward more productive, profitable

³³ More is in “Shock Therapy and its Consequences in Transition Economies”, Marangos John, Development (2005)

³⁴ EBRD(1999), Transition report “It is important to recognize that the capacity of the state to provide good economic governance has differed widely across the region. Some governments inherited relatively well-established national bureaucracies, consolidated national states a popular eager to rejoin the market economies of western Europe and with some prior exposure to market reforms. Other, particularly among the states in the CIS periphery and in south-Eastern Europe, had to grapple with the challengers of nation-building and independence at the very time that they had to achieve a major transformation of the state’s role in the economy.”

and effective industries was a major concern. Due to the fact that for a long time the service sector was neglected during the first years of transition, its shares rose significantly. The other issue was reorientation of trade after disintegration of CMEA. CEE countries, due to their close geographical position to the EU, reoriented their trade towards Western European countries; CIS remained tied to each other and Russia.

Figure 1.1: Growth and Institutional Reforms



Source: "Institutions matter in transition. So do policies." Havrylyshyn O., 2002

Which institutional changes matter for successful transformation? Among the most important are the **rule of law, governance (corporate governance), competition policy and business environment, banking and a financial system.**

The Rule of Law

The institution of the **rule of law** was ruined in transition countries after they had been under socialism for many decades. However, it is an inevitable element for the proper functioning of society and economy itself. The rule of law represents informal laws accepted by everyone in the society. It creates the basis for official law and its enforcement mechanisms. The first stage of transition then should be: the "return of law" to the countries, to replace arbitrary rule by powerful individuals or institutions with a rule of law that inspires the public trust and respect that will enable it to endure (From plan to market, WB (1994)).

The building of post- socialist legislative system depended a lot on how able was the country to restore its pre-socialistic law. Compared to CEE countries, CIS had not had any memory of a pre-soviet legislative system at all³⁵. The following approaches of legislative system building can be defined as follows (From Market to Plan, WB (1996), p. 87):

³⁵ "Some transition economies were able to draw on relatively developed legal traditions, formed before the establishment of central planning. In these countries, mainly in CEE, in the initial steps, institutional reform often

- “Home-grown law”- drawn up either from scratch or from legislation enacted before Central planning.

- Law transplanted from established market economies.

- An intermediate approach - borrowing ideas from the best practice models abroad and then adapting them through original legal drafting and political debate. It usually works better than previous approach (transplantation of law)

The law can be also introduced in transition economies through tier contacts with developed countries. Countries which were in the process of joining the EU were motivated to make their law consistent with EU and international law.

There are several main functions of economic law in market economies. The definition and protection of property rights; setting rules for exchanging those rights; establishing rules for entry into and exit out of productive activities; and promoting competition by overseeing market structure and behavior, as well as correcting market failures (From market to plan, WB (1996), p. 88).

One of the main problems for newly established market economies was the lack of formal enforcement mechanism. It had the effect of reducing firm confidence and other market players in courts and legal enforcement mechanism. Property rights issue was the next area which required immediate regulation. The privatization process created different groups of owners which required protection of their property rights.

Corporate Law and Corporate Governance

Privatization created new ownership on enterprises structure which was supposed to improve corporate governance and foster enterprise restructuring and performance. Privatization as a whole proved to bring less positive impact on enterprise performance than was expected. Such additional factors as, financial discipline (hard budget constraints), market competition, corporate governance and ownership structure³⁶ were more important for restructuring than privatization itself. The extent of improvement of corporate governance in privatized firms depended on the possibility of the state to intervene into firms’ governance. The institutional environment (bribes, laws, financial market) in individual countries also influenced the performance of newly created or privatized enterprises. Factors such as, the share of foreign stake in a company (share of outsider), management turnover and flexibility of ownership rights (possibility to change the owner) also had a significant impact. Research³⁷ by the CASE Institute on transition economies, concluded that the type of corporate governance (concentrated or dispersed) is not crucial for enterprise performance but rather, alienability or flexibility of ownership structure is the key to successful restructuring. The possibility to change ownership is

consisted simply of resurrection laws that had never been repealed and had not been implemented during socialism.” EBRD, Transition Report (1999)

³⁶ “...the competitive and regulatory environment is more important than the question of ownership per se. In competitive markets there is a presumption in favor of private ownership. Where there is a natural monopoly, vigorous regulatory action is required (Yarrow, 1986)”, - Corporate governance and ownership structure”, CASE, 2003

³⁷“Corporate governance and ownership structure”, CASE, Warsaw 2003

an important feature for recently privatized companies as it represents the level of application of ownership rights.

In transition countries, there used to be different schemes of privatization, more or less similar in their approach and results. Because privatization was usually provided “from above”, the enterprise ownership structure was determined by the chosen method of privatization, regardless to its size, the markets in which it operated in, or other specific characteristics. Further success and development of privatized enterprises depended on the possibility to change ownership structure and create its **own identity** (CASE, 2003). In the early phase of transition, privatization had little impact on restructuring enterprises and its performance. But its significance rose later with further market development, when change and improvement of the institutional environment began to influence enterprise functioning.

The most common methods of privatization were direct selling to strategic investor, management-employee buyout or equal-access voucher privatization³⁸. Each method led to a certain ownership structure inside a firm and as a result it influenced the market structure of the economy as a whole. The method of mass privatization was implemented almost in all transition economies. Mass privatization was widely criticized for its diffused ownership structure, which resulted in the lack of deep enterprise restructuring and poor corporate governance. The experience of many transition economies had showed that privatized enterprises tended to become more concentrated on ownership³⁹. WB and EBRD in their studies showed that concentrated ownership and faster enterprise restructuring created a positive impact on a company's performance. But deeper analysis of enterprises in transition also showed that better enterprise performance and deep restructuring is provided only when major ownership stake belongs to outsiders (foreign or local). Insiders (managers and employees) more often are interested in their continued employment in the firm than in the rise of enterprise efficiency.

Corporate governance in privatized enterprises had always been similar to models of governance already existing in well developed market economies. To understand the peculiarities of corporate governance in transition economies, there is a need to look at the conditions in which different models of governance and types of ownership existed in developed market economies.

Mass privatization is compromised of equal division of ownership rights among participators, which leads to dispersed ownership- the main feature of the **Anglo-Saxon model**. The main complication in this model arises between managers and shareholders – how do shareholders impose control over management and participate in enterprise governance. This brings up the principal-agent problem, a typical issue for Anglo-Saxon capitalist economies. The existence of well developed financial markets and financial institutions is a precondition for efficient enterprise governance. Control is exercised through financial institutions such as investment banks and stock markets. There, shareholders can ‘vote’ on selling their shares on

³⁸ ”Different types of owners- managers and workers, the state, outside strategic investors and portfolio investors- can have different objectives for a firm and different means of effecting change within the company.” EBRD, Transition report (1999)

³⁹ ”A recent survey found that 65 % in 1993 to 56 % in 1995- a modest move in the right direction.” From plan to market, WB (1996), p. 55

the stock-market if they don't like work of the management. Dispersed ownership conditions are also a requirement for the transparency of financial operations and a firm's documentations⁴⁰.

The direct selling of enterprise to strategic investors implicates concentrated ownership⁴¹ in the hand of major shareholders. Such ownership structure is usual for **Continental model** of governance and can be found in continental Europe (also in Japan). A conflict of interest rises here between the owners of major stakes and minority shareholders. Banks play the important role in these models which oversee a firm's financial health. Banks represent the main source of investments for the firm, and in case of a firm's insolvency they can participate in its corporate governance.

There were debates about whether the ownership and corporate control structures emerging in post-Communist countries of Central and Eastern Europe would bear a greater resemblance to those in Anglo-Saxon countries (where capital markets dominate) or to those of continental Europe and Japan (characterized by concentrated ownership and a stronger role of banks in corporate governance and control)(CASE,2003). In transition economies, the privatization process often led to combination of various components of all traditional models. But none of those models met adequate and efficient institutional bases for its full-fledged existence. In many transition countries, enterprises have quite dispersed ownership, but with very illiquid markets and weak institutional investors (in contrast to the Anglo-Saxon countries). At the same time sustained trends towards ownership concentration can be observed, but there is a lack of adequate external financing and efficient monitoring mechanisms, characteristic of the continental European model. Unlike either the Anglo-Saxon or the German-Japanese system, the institutional environment created in Central European wholesale privatization and its aftermath, has brought neither the informational transparency necessary for efficient markets nor the additional capital necessary for restructuring (CASE, 2003).

One of the most important issues in enterprise restructuring was the replacement of old management, which had little experience of enterprise functioning in a market economy, or very often was fully corrupted. The **management turnout**⁴² had very positive impact on corporate governance of enterprise in transition country. New managers are usually more interested in enterprise performance than their predecessors. They frequently bring new management practice and knowledge. But it is not so easy to find good managers in transition economies. Enterprises privatized by strategic investor faced management turnout more often than state-owned enterprise or privatized by insiders.

⁴⁰ "It is generally believed that a high need for company transparency (information disclosure) is reached if a shareholder base is broad (i.e., concentration is low)."- "Corporate governance and ownership structure", CASE, 2003

⁴¹ CASE institute mentioned that the main negative aspect of concentrated ownership is that concentrated ownership may negatively affect firm performance through its impact on managerial initiative. If concentrated ownership provides incentives to control the management, it may also reduce the managers' initiative or incentive to acquire information (Aghion, Tirole, 1997). Also, concentrated ownership implies lower levels of stock liquidity which, in turn, weakens the informational role of the stock market (Holmström, Tirole, 1993).

⁴² "In addition to the type and concentration of ownership, the replacement of old management by new may be of crucial significance for the improvement of corporate governance and enterprise performance. The main conclusion is that enterprise restructuring in transition countries requires new human capital, which can best occur through management changes."- "Corporate governance and ownership structure", CASE, 2003

The EBRD (1999) described different possibilities of how to bring new management practices to provide restructuring of state-owned enterprises before privatization. The state can hire an international management company to take over certain management functions. Such so called **management contracts** would typically be based on a fee that partly reflects the performance of the enterprise and may also contain a buy-in option as an additional incentive (Transition report, 1999, Chapter 9. Restructuring large industrial enterprises, p. 175). The other possibility is the **twinning contracts and management consultancy**, which has a much bigger effect in smaller enterprises, where local managers are more long-term profit oriented. As a whole, competitive environment, financial discipline and ownership type are among the most significant factors which stimulate management turnover.

Competition and State Intervention

The competitive environment and hard budget constraints are very important factors of enterprise restructuring. Strong competitive pressure motivates enterprise management for better resource allocation and use in production. In the EBRD Transition Report (1999), research analyzing business environment and enterprise performance in different countries was undertaken in collaboration with the World Bank. The research concluded that competition had a positive impact on enterprise restructuring, but only in situations when the number of competitors did not prevail three. Only in such an environment could enterprise get some market power by innovation to perform well⁴³. Those enterprises which were monopolized or faced strong competition showed smaller sales and felt certain difficulties on the market.

Government intervention into corporate governance can significantly influence enterprise competitiveness on the market. The government usually is inclined to support state monopoly companies to set them at a more preferable position on the market. But such a policy is distortive for the business environment as a whole. In CIS, regulation of business was stricter than in CEE states, which can be explained by the existence of deeper budget deficits in these countries. There are different forms of states intervention. In advanced economies, the state appears to intervene to support the work-force; the less advanced countries are more likely to intervene in enterprises decisions as a tool for macroeconomic management, as they did under central planning. One such important macroeconomic tool was setting prices as a measure to restrain inflation. State intervention and control over economy differ across the region. The highest level of state intervention was reported in such advanced transition countries as Hungary, the Slovak Republic and Slovenia, and the least advanced countries, such as Belarus, Ukraine and Uzbekistan⁴⁴. Noteworthy is that even advanced countries in transition are characterized by a high level of government control, what can lead to conclusion that not exactly the quantity of state intervention shapes enterprise perception about government but rather its type (EBRD, Transition report 1999).

⁴³ "These finds support the 'Schumpeterian' view that strong economic performance is associated with some market power gained through innovation. For a comprehensive analysis of competition and innovation and their contribution to growth and development, see Aghlon and Howitt (1998)", EBRD, Transition report (1999), p.132

⁴⁴ "The level of reported price intervention is extremely high: Belarus (88 %), the Slovak Republic (64 %), Moldova (54 %) and Ukraine (44 %)". EBRD, Transition report (1999)

Corruption

Corruption damages legal arrangement of society and negatively influences the business environment. It was widely present in transition economies especially in CIS countries (Russia, Ukraine, Kazakhstan and Belarus) during the first years of transition and its effects are still present today. Corruption can be displayed in different forms. Usually, it exists in the form of bribes given to government officials to get preferences in business or to get access to limited resources. Bribes represent an additional “tax” for businesses. Countries with tighter business regulations usually have a higher level of corruption. The average bribe tax in the CIS countries is 5.7 % of revenues and it is almost twice the level reported in Central and Eastern Europe (3.3 % of revenues) (EBRD, Transition report (1999)). Slow development of market institutions, lack of transparency and efficient regulation contribute to the high corruption level in CIS.

As a whole, corruption and state intervention are more typical for high capture states, where government still plays a paternalistic role in the economy. Governments in such States are usually influenced by some vested interests, which can influence the economic policy in their gain. Corruption damages trust of economic actors in market institutions and damages enforcement mechanism. The existence of corruption undermines all market reforms and negatively influences further economic development.

Underground or Shadow Economy

During the time of Perestroika, liberalization was started which aimed to legalize market activities, already in existence under the plan but had been considered illegal. The liberalization of market forces without well developed market institutions led to even greater spread shadow activities than what had already been present under the plan. Mass lay-offs which were observed during the first years of transition shifted significant parts of the labor force into unobserved markets. High shares of unobserved market activities made official numbers of GDP growth unreliable. There were several attempts made to describe and measure underground economies in transition countries. Kaufmann and Kaliberda (1996) were the first to apply a consistent methodology to measuring the unofficial economies in post- socialist countries⁴⁵. In their study they started from the observation that in the short run electricity consumption and total economic activity move in more or less parallel fashion, with near unit elasticity. Thus the difference between the growth rates of measured GDP and electricity consumption can yield an estimate of the change in the size of the unofficial economy, which Kaufmann and Kaliberda define as “the unrecorded value added by any deliberate misreporting or evasion by a firm or individual”⁴⁶. More information about measuring shadow economies can be found in the works of Edgar L. Feige and Ivica Urban⁴⁷.

⁴⁵ “Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies: A Framework for Analysis and Evidence” by Kaminski, Kaufmann, D. and A. Kaliberda. (1996), B. *Economic Transition in Russia and the New States of Eurasia*, London: M.E. Sharpe

⁴⁶ “A Note on Measuring the Unofficial Economy in the Former Soviet Republics”, Michael Alexeev and William Pyle

⁴⁷ “Measuring Underground (Unobserved, Non-Observed, Unrecorded) Economies in Transition Countries: Can We Trust GDP?” Feige, Edgar L. and Urban, Ivica

Table 1.5: Estimates of Unofficial Economies in 1995 in FSU states

	Unofficial economy share, 1989 (%)	Index of official GDP, 1995 (1989=100)	Index of electricity output, 1995 (1989=100)	Unofficial economy share, 1995 (%)	Unofficial economy share, 1995 Johnson <i>et al.</i> (1997) (%)
Azerbaijan	32.8	31.4	70.1	69.9	60.6
Belarus	28.6	56.1	61.2	34.5	19.3
Estonia	22.1	69.1	68.9	21.9	11.8
Georgia	32.8	16.0	37.6	71.4	62.6
Kazakhstan	32.8	46.5	62.3	49.8	34.3
Latvia	22.1	47.3	62.3	40.9	35.3
Lithuania	22.1	45.1	50.6	30.6	21.6
Moldova	28.6	43.0	58.8	47.8	35.7
Russia	18.0	49.1	74.0	45.6	41.6
Ukraine	25.3	39.0	67.0	56.5	48.9
Uzbekistan	32.8	84.0	79.0	28.5	6.5

Source: Michael Alexeev and William Pyle

Financial Institutions and Capital Market

A full-fledged market economy is impossible without a well defined financial sector⁴⁸. The emergence of a financial system and its' institutions can't be separate from other transition reforms. The first institution which was inevitable to set up during the first phase of transition reforms was a Central Bank, independent from government. Only an independent central bank can provide an efficient macroeconomic stabilizing policy in an atmosphere of hyperinflation and other economic imbalances. But the practice of transition economies showed that the presence of a central bank was not always independent in its decisions as government still tried to intervene in the control monetary policy.

The first liberalization policies gave an opportunity for non-government banking systems to emergence. It was provided through privatization of state-owned banks or the creation of new one. The existence of intermediate financial institutions is important for any market economy. They represent additional sources of capital for new firms and monitor their financial health.

The dissolution of the Soviet Union and further liberalization created a favorable environment for the emergence of new banks. The absence of proper market rules and government regulations led to acceleration of bad loans in many banks and their further liquidation. State enterprises, which faced strong market competition, were the main source of bad loan portfolios in banks. But such financial flows from banks to enterprises dried up, as stabilization took hold in almost all CEE countries and many new independent states (From Plan to Market, WB (1996)). The continuous access of state enterprises to cheap bank credits remained a barrier for new private firms to emerge for a long time. The problem of bad loans existed through the whole process of market transformation. The credit policies provided in many countries were supposed to help

⁴⁸ "Developing of financial sector takes time. Reform must seek ways to nurture a system of banks, nonbanks intermediaries, and capital markets that will evolve not in response to government dictate but to the changing needs of the market." From plan to market, WB (1996)

enterprises with financial resources, but rather kept unprofitable state companies afloat. The largest credit insolvency was in the agriculture sector and most of the banks aimed to finance that sector were often illiquid and bankrupted.

The emergence of the capital market was very important during mass privatization where reallocation of property rights was provided. The absence of capital market institutions led to an exchange of vouchers and shares on the informal market, resulting in difficulties for enterprises to indentify the ownership rights among shareholders. The capital and financial markets create a necessary institutional environment for the proper functioning of new, privatized and state-owned firms. But the tight government regulations of those markets imposed barriers for its development. Most transition countries had already reduced state regulations of financial institutions. It remained only in higher captured states with slow market transformation.

4. Conclusions

The socialist system which existed in the Soviet Union and in the countries of the soviet bloc was a great experiment of social and economic building with deplorable results. The centrally planned economy had proved to be inefficient and impossible to reform. The existence of market forces proved to be indispensable for proper resources and information reallocation.

After the collapse of socialism and the dissolution of the Soviet Union, CEE and new independent states started the process of transformation of their economies from plan to market. But the transformation was not easily accomplished in practice. At the start of transition, post-socialist countries faced a similar range of problems: output decline, high inflation or even hyperinflation, fiscal and current account deficits, mass layoffs and corruption. But the extent of recovery from the original transition-recession differed across the region. It depended on initial conditions of countries and the policies taken by governments. CEE countries had better internal and external conditions for reformation and were much more successful in the transformation process than most CIS countries. The last had met not only with the problems of transition recession, but were challenging the building of statehoods. Most CIS countries lacked institutional traditions and a historical memory for the fruitful creation of a democratic state and market economy. That is why today most CIS countries suffer from political disorder or experience once again authoritarian power. Even after the implementation of a number of market reforms, their economies still can't be considered fully-fledged market economies. At the same time, countries from the CEE and Baltic states have been already accepted to the European Union and can be considered transformed market economies.

PART II

Economic Transformation in Belarus

5. Initial Conditions

5.1 The Socio-Political Pre-Conditions

In Belarus, the response towards the disintegration of the Soviet Union was different than in other Soviet republics. In the early 90ies almost on the whole post-socialist territory an expansion of nationalist mass movements could be observed which demanded a return to pre-communist origins – to the nation-state, democracy, and a capitalist market economy. Belarus also experienced an albeit weak revival of national culture, language and identity, despite the fact that the Soviet and pro-Russian nomenclature managed to preserve their key positions in power. But even though mass protests and demonstrations occurred in Minsk just as in other union republics, ideals and intentions of independence had little support if compared to e.g. the neighboring Baltic States.

Thus, the first free parliamentary elections in spring 1990 already indicated a weakness of the national forces. The nationally oriented opposition, represented by the Belarusian Popular Front party, won only 26 seats out of 345 possible. The BPF was founded on similar principles as the popular front parties in the Baltic States, but compared to the latter it had to deal with a much more complicated and hostile environment. The Belarusian economy was strongly incorporated into the Soviet Union's economy. Hence, an aimed for state independence would also entail the challenge of a total rebuilding of the former economic system in order to make it less dependent on the center (Russia). But ideas of political and economic independence had little value for the majority of the Belarusian population. Thus, until today Belarus preserved its former economic structure, which stipulates tight economic relations with Russia.

Historic Overview

Belarusians began to debate their right for an independent state not until the beginning of the 20th century. Before, they were incorporated into the Polish state (the Rzeczpospolita) and then into the Russian Empire. A first attempt at creating Belarusian statehood was made with the founding of the Belarusian Democratic Republic. It was proclaimed under German occupation during the First World War, on the 25th of March 1918. Yet the new state was recognized only by few states and lasted only for six months. Even though the Belarusian Democratic Republic couldn't be considered a fully sovereign state, its proclamation was of great importance for the acknowledgment of Belarusians as a separate nation and their right to live in an independent state. After Minsk was occupied by the Red Army in December of 1918, the Belarusian Democratic Republic ceased to exist and was soon replaced by a soviet regional entity – the Belarusian Soviet Socialistic Republic (BSSR) (created on January 1, 1919)⁴⁹.

⁴⁹ Later members of BDR parliament were forced to immigrate to Western countries.

In the 1920ies the Communistic party widely supported the development of a Belarusian culture and provided a consistent policy of Belarusization, which helped to create a nationally oriented intelligentsia and favored the rising of Belarusian national consciousness⁵⁰. Nevertheless, in the 1930ies this policy was replaced by drastic repressions of national culture and national oriented intellectuals. Newspapers and books that were considered as being “too nationalist” were banned, and the newly emerged national intelligentsia was suffering from brutal reprisals by the Communist government⁵¹. Nevertheless, national consciousness among parts of the Belarusian population was already awakened, and the participation of Belarusians in the administrative and cultural life of the BSSR continued. After World War II, however, the situation in Belarus began to change gradually. The republic’s leaders paid more attention to the renewal of the post-war economy than to the development of national culture. Hence Belarusian leaders placed emphasis on what they considered to be of primary importance. They didn’t mind that they sacrificed things they hardly considered important at all, namely, Belarusian language, Belarusian culture, and Belarusian national identity⁵².

Large-scale industrialization became a high priority for post-war Belarus, regardless of all social and environmental consequences. In a short period of time a number of manufacturing, chemical and oil processing plants were established, which were dependent on resource supply from other regions of the Soviet Union (mainly Russia). Most of the production created in that sector was oriented on export to CMEA members. Because of its economical structure, which was oriented on the production of the final products, Belarus was called the “assembly shop” of the Soviet Union.

The new ruling elite that emerged within the large industrial base didn’t have any national sentiments. It was a group of people, which can be considered as typical Soviet elite, lacking a well-defined and articulated sense of national identity⁵³. Tight economic relations with Russia made the industrial leaders more interested in obtaining benefits from the union center (for themselves or for the enterprises they were responsible for) than in the general prosperity of the country. The directors of enterprises and heads of collective farms were routinely elected to

⁵⁰ Belarusization was initiated by Belarusian Communists to gain support among the Belarusian speaking population (Jadish, Polish and Russian were also widely spoken in Belarus). The period of Belarusization started during the times of NEP (New Economic Policy)- a time of relative liberalization, and lasted only from 1924 to 1929. The toleration of the expansion of nationalism can be explained by the competition for power between Trockij and Stalin. Two days after Trockij emigrated, Stalin immediately began his attempts to wipe out nationalism in the Soviet Union republics.

⁵¹ There were widely known incidences of mass executions of members of the Belarusian intelligentsia near Minsk during the 1939 and 1941 years. Responsible for these executions was the NKVD. The burial place was discovered by archeologist Zianon Pazniak in 1988. The publication of the results of his investigation ‘Kurapaty- the road of death’ became an impulse for a pro-democracy and pro-independent national movement. Later Zianon Pazniak became one of the founders and head of the Belarusian Popular Front party. About Kurapaty also wrote David R. Marples in his book “*Kurapaty: The Investigation of a Stalinist Historical Controversy*”, 1994

⁵² “Rationality, Nationalism and post-Communist market transformation.” The author also writes: “Belarus became the testing ground for Russification under the guise of “internationalization”. By the early 1970s, in Minsk, the capital of Belarus and a city with a population of about one million people, no school used Belarusian as the language of instruction (Kennedy, 1991, p.167), Savchenko A., 2000. p.98

⁵³ More is investigated in “An Algebra of Soviet Power: Elite Circulation in the Byelorussian Republic, 1966-1986”, Michael Urban (1989)

various legislative bodies, for example to Belarusian Supreme Soviet, a practice that lasted until the last year of the Soviet Union's existence. As a consequence, the communistic nomenclature which was widely expanded during Soviet times was strongly against the independence of the Belarusian state, as it was associated with the cessation of economic relations with Russia including various subsidies which Belarus gained from the Soviet Union center before. Nevertheless, in an atmosphere of Soviet Union disintegration the independence of the Belarusian Republic was proclaimed on August 27, 1991. Shortly after that leaders of the Russian SSR, the Ukrainian SSR and the Belarusian SSR signed an agreement of USSR termination and the foundation of the Commonwealth of Independent States in Belovezhskaya Pushcha (Belarus)⁵⁴.

Alternative Economic Strategies for Reform

Regardless of the low support among the population and the strong opposition of communistic nomenclature groups, the role of the Belarusian Popular Front was nevertheless large. Being in a minority position in the first BSSR parliament the party was still able to initiate a number of important laws and to influence political decisions, taken by the passive communistic Parliament⁵⁵. Thanks to the BPF, national symbols⁵⁶ of statehood were re-introduced and the first years of independence can be rightfully called years of national revival. Nevertheless, during its presence in Parliament, the BPF was continuously accused by the official nomenclature for its "forced Belarusization", and its low interest in economic issues. But as a matter of fact, the program of economic reforms, prepared by BPF experts was one of the most consistent and liberal which were created at that time. It introduced a concept of transforming the Belarusian economy into a market economy, with emphasis on economic and political independence of the country. In some sense it was considered even radical, as the Belarusian population had little knowledge about the functioning of markets. The key points of the BPF's economic program were the introduction of a national currency, the protection of property rights and the support of private sector development. Also a gradual large-scale privatization and a "harmonious integration of Belarusian economy into the European economic structure⁵⁷" were brought on the way.

The BPF understood that energy dependence on Russia posted a serious threat for Belarusian independence and tried to find ways to diversify energy resources supply. That is why in 1993 in

⁵⁴ On December 8th, 1991, the presidents of Russia, Belarus and Ukraine signed the Belovezha Accord which declared the Soviet Union dissolved. Instead the Commonwealth of Independent States (CIS) was established. But the actual disintegration of the Soviet Union happened on December 25, when Gorbachev resigned as a president of USSR.

⁵⁵ More about the role of the BPF in the establishment of Belarusian independence can be read in S. Navumczyk "Sem Hadou Adrazhennia, albo Frahmenty nainoushay historii (1988-1995) / Seven Years of Revival or Fragments of Contemporary Belarusian History (1988-1995)", Warszawa-Prague, 2006

⁵⁶ In 1995, during the republic referendum, - initiated by president A. Lukashenka, national symbols (the white-red-white flag and the emblem with a horseman) were changed back to the Soviet one. The results of that referendum were widely questionable.

⁵⁷ "Conception of Economic Reforms in Republic of Belarus"(BPF Reform program), Popular Newspaper/ Narodnaya Gazeta, October 16, 1992

co-operation with the Ukrainian opposition party “National Ukrainian Movement” the BPF organized a conference in Minsk, where the possibility of creating a Black-Baltic Sea energy union was discussed. The idea focused on a connection of Baltic and Black Sea ports and the delivery of oil from the Caspian region to Ukraine, Belarus and Lithuania (and later Poland). It was a real possibility for involved countries to diversify their oil deliveries and to reduce their high energy dependence on Russia. A realization of that project would have put Russia under the threat of an economic isolation from western countries. But because of the concurrence of different circumstances the possibility of a Baltic –Black Sea project was never realized. The pro-Russian Belarusian nomenclature didn’t take the project seriously and it was soon forgotten after the presidential elections in 1994. The Belarusian president Aliaksandr Lukashenka set the course for a political and economic re-integration with Russia that undermined any attempt to diversify energy suppliers. However, the idea of a Black-Baltic Sea energy union was suddenly revived in 2005, under the initiative of the new Ukrainian president Viktor Jushchenko. The political leaders of Poland, Ukraine and Lithuania agreed to work on a realization of that concept. In particular, it was agreed to finish the building of the oil pipe-line ‘Odessa-Brody’, which should direct oil from the Caspian region through Ukraine to Poland and Lithuania. Up till now, Belarus was left out of that negotiation. The Belarusian government, which for a long time enjoyed cheap Russian energy resources hadn’t even considered that opportunity seriously⁵⁸.

The Failure of Transition Reforms and the Return to the Past

The socio-political situation established in the early 90ies became a serious barrier for economic restructuring in Belarus after the dissolution of the Soviet Union. The most problematic issue was the restructuring of large enterprises. Those enterprises were highly dependent on Russian energy inputs and on the Russian export market. They proved to be the most influential factor to oppose market reforms and the rupture of economic ties with Russia. This was even more problematic as the success of market transformation preeminently depended on the success of the restructuring of the large industrial enterprises. ”For the managers and employees of the state-controlled, mostly large enterprises, measures for economic stabilization and liberalization were detrimental, at least in the short run. They would expose these enterprises to the competition of foreign and then domestic producers. They would eliminate the soft budget constraints and toleration of insolvency. This would effectively terminate the state policy of full employment and protection of all enterprise from bankruptcy. Even the relatively gradual encroachment of market forces on the comfortable monopolist position of the state-controlled enterprises was not welcomed by their employees and managers.” (Savchenko A., 2000)

Whereas in the Baltic States the new political leaders were able to exclude enterprise managers from political life and successfully reduced their influence on political and economic decision-making during the transformation the situation in Belarus was totally different. In Belarus, at least during the early 90ies the interests of the large industrial enterprises remained represented not only in legislation, where more than 30% of the deputies were managers of state-controlled firms, but also in the executive branch of government (Savchenko A., 2000). Thus, it

⁵⁸ In 2007, the conditions of Russian energy deliveries changed for Belarus. The price for gas increased from 47 US \$ per 1000 cubic meters to 100 US\$ and was expected to reach the world level until 2011. More about energy issue is discussed in Chapter 10, Inevitability of market transformation in Belarus, p. 104

was almost impossible to eliminate enterprise lobbying from the decision making process during the transformation in Belarus.

In 1993, throughout the entire post-Soviet area the system crisis deepened. Inflation reached its highest level - in Belarus it was measured in four digit numbers. The process of privatization that had been brought on the way was inconsistent and nontransparent. Difficulties with oil delivery which had began in 1993, worsened the overall negative economic atmosphere. In this situation the old nomenclature represented in government began to exhort that "Belarus can't exist without Russian aid". From the middle of 1993 on managers of large industrial enterprises which - with the support of Soviet Ministers had united into the so-called "Belarusian scientific and technical congress" - began a campaign for the 'renovation of interrupted economic relations with Russia (Navumchyk S., 2006, p.89).

Alexander Lukashenka's Economic Program

In the first presidential elections, held in summer of 1994, the national and reformist forces were not able to gain the majority of votes. The elections were won by a little known deputy, the head of the anti-corruption committee, Alexander Lukashenka. His election could be considered as merely accidental if not for the preconditions which motivated Belarusians to make such a choice. For average citizens, which were used to Soviet state paternalism, market economy was associated mainly with uncontrolled speculation and increased poverty. There was also provided purposeful anti-market state propaganda which led to a negative perception of market reforms by the majority of the population. The "perfect leader" was conceived as someone with a "strong hand" who would bring economic stability. Being a talented populist, Alexander Lukashenka promised to stop the impoverishment of the population and to take control over economy. Lukashenka and his aides considered the main reasons for the economic recession to be rooted in the broken economic ties with Russia, and not in the distorted economic arrangement and the absence of private property rights. Therefore, the key point of Alexander Lukashenka's election program was the renewal of the interrupted ties with Russia. Other points of Lukashenka's economic program were the following⁵⁹:

- to stabilize prices by establishing state control over price formation, combating unsubstantiated price hikes, and enforcing penal liability for violations of state price policy;
- the strict oversight over the economy via direct control of state-owned enterprises;
- an investment policy based on the gradual increase of long-term bank lending, setting interest rates in line with state priorities, designating economic sectors and investment projects for state support;
- to consolidate state control over the foreign exchange market by closing all convertible currency outflows abroad, establishing control over convertible currency assets of Belarusian commercial banks abroad, instituting penal and administrative punishment for illegal foreign exchange transactions and illegal convertible currency exports;

⁵⁹ "Belarus: Reform Scenario", Bathory Foundation, Warsaw, 2003

- to prioritize agriculture in state investments by short- and long-term lending, and to preserve the system of collective (*kolhoz*) and state (*sovhoz*) farms;
- to designate housing construction as a priority sector for financing, in close state focus;

The program did not even mention a word about the transformation to a market economy. The start of Lukashenka's presidency hence adumbrated the return of central administrative control not only in the economy, but in all spheres of public life.

5.2 Economical Pre-Conditions

Being still a part of the Soviet Union, Belarus enjoyed one of the most preferable positions among the Union republics. In the years of 1985-1989 rates of economic growth were higher than the USSR average (only Russia had a somewhat higher GDP)⁶⁰. Nevertheless, the Belarusian economy was highly distorted by large investments into military and heavy industry sectors and a poor development of consumer industry. The situation was also worsened by the impact of the Chernobyl nuclear accident in 1986. According to De Melo (1997) these significant macroeconomic and structural distortions were the main factors which impeded the market transformation in Belarus⁶¹.

⁶⁰ "The economic prospects of the CIS: sources of long term growth", 2004, p.57 (Bakanova)

⁶¹ Ibid." De Melo et al. (1997) identified eleven variables characterizing the initial conditions and on the basis of principal components analysis reduced them to two clusters: PRIN1 - macroeconomic distortions and unfamiliarity with market process and, PRIN2 – level of development and overindustrialisation (structural distortions). The ranking of 29 transition economies according to these principal components revealed that according to its initial conditions, Belarus had a relatively high level of development and significant structural distortions. Moreover, Belarus had extremely adverse initial conditions with respect to PRIN 1 - among all 29 countries in the sample only Uzbekistan had a somewhat similar level of macroeconomic distortions and the worst case was Turkmenistan. But these two countries were substantially underindustrialised, so that among overindustrialised countries Belarus was the most distorted."

Table 2.1: Belarus among USSR Countries

	% from GDP, 1990			
	Expo rt	Export Union	Non- ry	Indust ry
AZERBAIJAN	36	2,90		44
ARMENIA	22	0,7		55
BELARUS	50	5,5		49
GEORGIA	21	1,9		43
KAZAKHSTAN	20	2,2		34
KYRGYZ REPUBLIC	22	0,7		40
MOLDOVA	27	2,2		37
RUSSIAN FEDERATION	28	10,1		48
TAJIKISTAN	27	4,9		34
TURKMENISTAN	35	1,4		34
UKRAINE	30	5,4		44
UZBEKISTAN	27	3,0		33
LATVIA	33	1,7		45
LITVA	37	3,3		45
ESTONIA	29	1,7		44
USSR	25	18,8		44

Source: De Melo, Denizer, Gelb, Tenev (1997).

The main features of Belarus' economic structure before the start of the transition were the following:

- Belarus was (and still remains) a highly industrialized country. The share of industry within the GDP was 49 % in 1990. Compared to other Soviet republics only Armenia had a higher share of industry within its GDP – 55 %. The share of agriculture, typically high for all Soviet republics, amounted to 22 % of the GDP. The share of services was only 29 % - one of the lowest among transition countries⁶².
- The Belarusian economy was highly dependent on trade and on inter-republican trade particularly. Most of its industrial capacity was intended for export. The total intra-

⁶² Ibid.

regional trade accounted for 47.3 % of Belarus' GNP- the highest figures among CIS, Baltic States and even among CEE's⁶³.

- Belarus was highly donated by the Soviet Union center. Taking into account the method of setting prices in the Soviet Union, Belarus could be considered even a 'double' recipient of transfers. It received underpriced energy resources used in industry and produced output which was ordinarily overpriced. Belarus' potential costs caused by the disruption of trade links with the rest of the Union's republics are estimated at 52.9% of its Net Material Product, the highest among the 15 republics⁶⁴.
- Belarusian industry was (and remains) highly dependent on energy resources supply from Russia (gas and oil). Taking into account the overall high energy intensity of Soviet industry such dependence was detrimental for Belarusian economy.

In the early 1990ies Belarus experienced an economic recession similar to other transforming countries. Nevertheless, the output decline was not so deep and the recession was overcome surprisingly fast. The inheritance of a large industrial base and the preservation of former trade channels enabled Belarusian enterprises to produce and export in a situation of economic turbulence. The slow path of transition reforms eliminated asset stripping and the emergence of interest groups which usually occur during privatization processes and which were observed in other transition countries.

In Belarus, the task of post-socialistic transformation appeared to be much more complicated than initially expected. In her research of the competitiveness of the Belarusian industrial sector prior to independence Bakanova (2002) describes that only 40% of the industrial value added was produced in competitive industries. 45% were produced in non-competitive industries and 15 % in industries that even generated a negative value added at world prices⁶⁵. The author concludes that in a situation when almost 60% of the Belarusian industry was uncompetitive even an *elimination* of some industries would by itself contribute to GDP growth.

The socio-political and economic conditions described above put Belarus in an extremely unfavorable initial position compared to other transition countries. The weakness of national and reformatory forces caused the suspension of market reforms in Belarus. Instead, a questionable economic 'stability' was introduced without full-fledged economic development, but with an autocratic political regime and administrative control over the economy.

⁶³ Ibid.

⁶⁴ Ibid.

⁶⁵ "Trade and Growth under Limited Liberalisation", Bakanova, M. and L. Vinhas de Souza, 2002

6. Transition Recession and the First Reforms

The first years of transition were accompanied by rapid output decline induced by increased prices of input, contraction of demand and disintegration of the usual trade channels. Market liberalization, starting with liberalization of prices, led to a rapid increase of inflation and its further acceleration. The necessity to create an independent financial system lessened the possibility to restrain inflation in the states of the former Soviet Union. Transition economies challenged the disintegration of former institutional base and the creation of a new (or renewed) socio-economic model of society. For countries where more than 70 years under communism destroyed all traditions and memories of the past it was rather a complicated issue.

The process of market transformation in Belarus started with the same range of reforms as in other post-socialistic countries. Nevertheless, their implementation was characterized by uncertainty and inconsistency. Early liberalization and the beginning of privatization, however, created a favorable environment for the expansion of private initiative. But since 1994, with the election of the 1st Belarusian president, the development of a new political order, characterized by authoritarian power and administrative control over the economy began in Belarus. The private sector emerged under the continuous pressure of overregulation and control.

6.1 Output Decline

Structural disproportions inherited from the socialist era conditioned output decline and overall economic recession in most of the transition countries. Belarus was not an exception. The increase of energy resource prices was a serious blow to Belarusian enterprises. Nevertheless, output of labor intensive industries declined to a lesser extent in Belarus compared to other transition countries⁶⁶. Belarusian enterprises were able not only to preserve most of their production capacity, but even to export their goods to former Soviet republics. This was due to the slow pace of transition reforms and enterprise restructuring. Being highly incorporated in Soviet Union's economy, Belarus managed to preserve trade relations with companies in other former Soviet republics.

The output decline in Belarus was 3 % in 1990, and 1.2 % in 1991, which was the lowest result among FSU countries. In 1992-1995 the rate of output decline had accelerated and the cumulative output decline for the period 1990-1995 reached 35 %. It was the second best record among CIS (the smallest contraction had been recorded in Uzbekistan – 18 %)⁶⁷. The average annual GDP decline in Belarus in 1992-1995 was 10.1 %. The contraction of output in industry

⁶⁶ See **Table 1.1: The Transition Recession**, Cumulative output decline in neighboring countries to Belarus was- in Lithuania 44 %, in Latvia – 51 %, in Ukraine – 59 %, in the Russian Federation – 40 %. Cumulative output decline in Belarus was – 35 %.

⁶⁷ The used data are from the studies: “The Economic Prospects of CIS: Sources of Long Term Growth” and “Ten Years of Transition” World Bank. Data of cumulative decline differ among different resources. In this study are data from World Bank survey are used.

was 11.3 %, in agriculture 12.2 %, in construction and transport 25-30 %, in trade – about 20 %⁶⁸.

High inflation and expansions monetary policy conditioned high devaluation of the national currency. It caused an increase of dollarization, but at the same time had also stipulated recovery of export and its growth after 1993 and during 1998-1999. And export had been always the main contribution factor of economic growth in Belarus.

6.2 Employment and Productivity

Employment

Output decline was inevitably accompanied by contraction of the labor force in enterprises in all transforming countries. The Belarusian government tried to avoid mass layoffs and preferred the existence of hidden unemployment – the cutting down on working hours and the sending off of employees on unpaid leaves. During 1995-2005 employment in industry reduced by 15%, in agriculture almost by 48% (even more than in other transition countries!) and in construction by 11%⁶⁹. At the same time employment in trade, catering, education, banking and budget spheres increased. The new emerging market created new spheres of employment. For comparison - in CEE countries, between 1990-2002, employment in agriculture dropped by 23%, in industry almost by 30%, while employment in services increased by almost 50%⁷⁰.

During the period of industrial decline (before 1996) the enterprises' restructuring was predominantly passive, and was driven by a short-term survival strategy. In most of the transition countries enterprises tried to cut off the labor force in line with the decline of output. But in Belarus employment contracted at a slower pace than output declined and industrial productivity decreased by about 20 %. The private sector was too underdeveloped to absorb the free labor force.

The official unemployment rate was extremely low in Belarus and it did not reflect reality. Since 1990 about 800 000 jobs were lost, but among those unemployed by state institutions only 100000 people were registered or 2 % of the total labor force⁷¹. The overly complicated procedure of registration and the extremely low level of financial assistance discouraged the unemployed to register with state institutes. Thus, the share of hidden unemployment has been always high in Belarus.

⁶⁸ “Belarusian Economy: Tendencies of Development and Main Challenges/ Экономика Беларуси: тенденции развития и основные вызовы”, IPM, Minsk, 2006

⁶⁹ “Labor Market in Belarus: the Overall Review/ Рынок труда в Беларуси:общий обзор”, Haiduk K., Chubrik A., Pachevskya S., Valevsky M., CASE, Warsaw, 2005

⁷⁰ Ibid.

⁷¹ Ibid.

Throughout the 1990s the number of economically inactive people increased significantly. It is one of the main indicators of hidden (non-registered) unemployment. About 1.5 mil economically inactive people were registered in 2004. It was 25.1 % of the total labor force. This group of people became economic migrants or found employment in the shadow (underground) economy. The research provided by the Belarusian Independent Institute of Socio-Economic and Political Studies (IISEPS) found that about 6.7 - 8.9 % of the economically active population was employed in shadow market in 2003⁷². Statistical evidence of the number of people working abroad didn't exist, but independent surveys speak about 300-400 thousand people working in Russia (mainly in Moscow on construction) in 2003. The existence of the Union Treaty between Russia and Belarus provided Belarusian citizens with better access to the Russian labor market than to the rest of the CIS. The alternative estimates of unemployment provided by independent analysts, speak of about 8 % of the average unemployment rate during the period of 1996-2002⁷³.

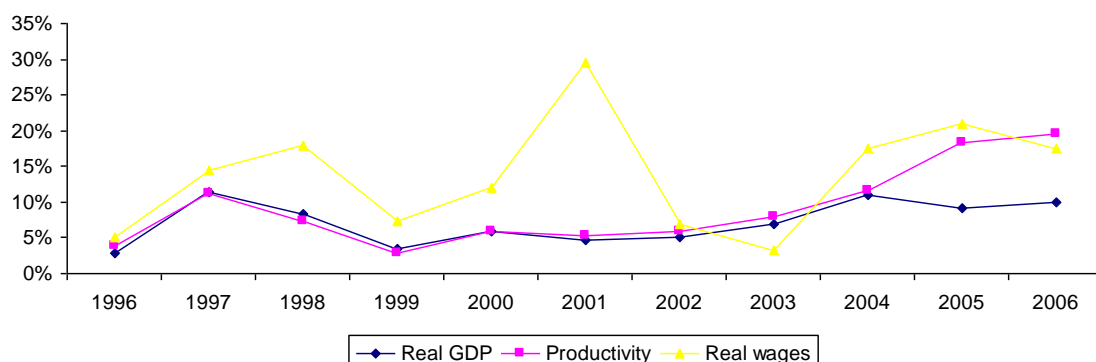
Wage and Productivity

Considerable contraction of real wage had been observed in the early 1990s in Belarus. However, the average wage began to increase from 1996. Since that period the government began to regulate the size and structure of wages. The wage rate was formulated according to the tariff net developed by the respective state institute. Such a system of wage determination limited the possibilities for additional material stimulation of perspective employees and discouraged those who performed better. In July 2002, the president passed Decree № 17, which directed to couple wage increase with the rate of output growth. The administrative target of rates of output growth caused considerable wage increases, which hadn't reflected the same increase of labor productivity. To equalize the wage-productivity gap, the rate of wage growth was also coupled to additional indicators of enterprise efficiency – profits increase, and a decrease in debts or losses. However, it did not improve the situation significantly as most of the enterprise indicators were not reliable. Figure 2.1 illustrates the dynamics of labor productivity, real wage and real GDP. The productivity-wage gap became an additional cost for enterprises and threatened their competitiveness on external markets. The obligation to pay higher wages to employees also limited the possibilities for investments into modernization and enterprise restructuring.

The wage policy in Belarus was also extremely dependent on the political- business cycle. The highest wage growth was observed in periods of the most important political events – presidential elections or republican referendums. The highest wage increase occurred in 2001, when the presidential election was held. A target average monthly wage increase of the equivalent of 100 USD was set up. In 2.5 years the wage had trebled. Thus, wage policy in Belarus has been always dependent on government populist decisions.

⁷²“National Economic Newspaper/ Национальная экономическая газета», №21 (638), 21 of March, 2003, http://www.neg.by/publication/2003_03_21_2015.html

⁷³ “Labor Market in Belarus: the Overall Review/ Рынок труда в Беларуси:общий обзор”, Haiduk K., Chubrik A., Pachevksya S., Valevsky M., CASE, Warsaw, 2005

Figure 2.1: Real GDP, Productivity and Real Wages

Source⁷⁴: created on the basis of the data taken from the Ministry of Statistics and Analysis of the Republic of Belarus

6.3 Inflation

The start of the market liberalization process was accompanied by extremely high rates of inflation (or hyperinflation) in Belarus and other post-socialist countries. Inflation in the post-Soviet area was caused not only by price liberalization but also by **crisis of arrears**. Lack of cash currency in circulation led to the acceleration of credit operations between enterprises. The Russian National Bank, which was a successor of the USSR Central Bank, was the only institution which could issue notes, while non-cash money emission was controlled by each independent national bank. To combat inflation the Russian Central Bank tightened the money supply, which only added inflationary pressure on the whole ruble zone.

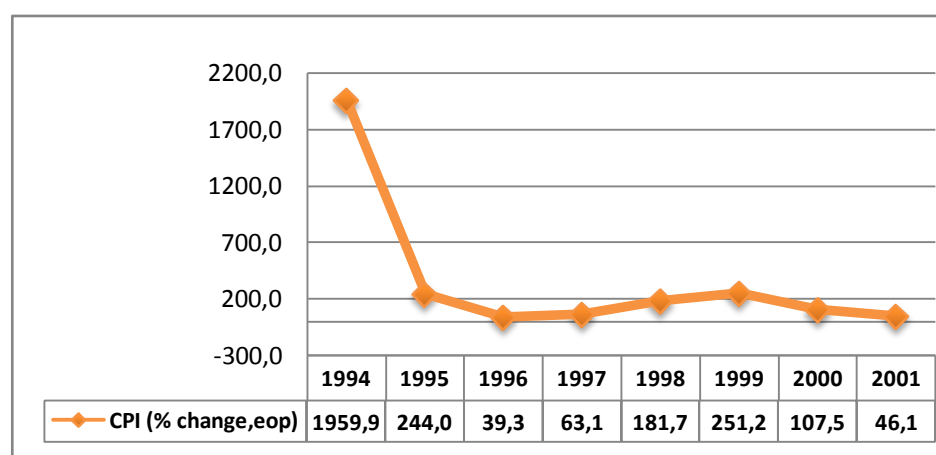
Similar to other former Soviet republics, during the first years of independence Belarus remained in the ruble zone and couldn't control the issue of the necessary amount of cash money. The Belarusian government (mainly consisting of the Communist nomenclature) delayed the decision to impose a national currency as they hoped that former relations with Russia would be restored. But inflation was uncontrollable and continued to accelerate. To regulate at least cash operations with consumer goods the Belarusian government imposed home currency or 'payment coupons' of the National Bank in 1992. That payment coupon (which later became Belarusian ruble) was intended to supplement the Russian ruble during the temporary shortages of the latter on the Belarusian territory. The Belarusian ruble was to be used only in cash transactions – all non-cash operations were still provided in Russian rubles. Until 1994 the Belarusian ruble was still not yet the sole legal tender in Belarus.

⁷⁴ "Can the Stronghold Withstand an Economic Attack? The Challenges and Prospects of the Belarusian Economy in the Near Future", Minkov Y., 2007

After the imposition of a national currency, inflation was still measured in four-digit numbers. Inner economic distortions were increased by state soft monetary policy – under the conditions of economic recession the National Bank continued to increase the money supply. The rate of monetization contracted from 13.6 % of GDP in 1992 to 5.6 % in 1994⁷⁵. The interest rates had been also negative, which seriously undermined confidence in the national currency. Such situations led to an excessive demand for foreign currency and the spread of dollarization.

Despite the fact that most prices were liberalized, price control over some groups of commodities remained in Belarus. For example, the government still controlled prices for energy resources delivered to enterprises and prices of heat and electricity used by households. There were also limits on price increases for certain products of the state-owned enterprises considered to be monopolists in their sectors. Other prices were free to be set up. The regulation of prices on a number of consumer goods was actively used by government in subsequent years as a tool to suppress inflation (More about Price Control in the part about Monetary policy- p. 20). Price controls seriously undermined the reliability and descriptive function of inflation indicators in Belarus (see Quality of Belarusian Statistics-Monetary Policy). Figure 2.2 illustrates the approximate development of inflation.

Figure 2.2: Inflation, Measured in CPI (% change, end of period)



Source: IMP data collection (EBRD)

6.4 Stabilization

For many years Belarusian authorities boasted of stability and prosperity in the country, reached though “wise management”, administrative control and the suspension of “ruining” market reforms. But a close analysis of Belarusian macroeconomic situation leads to totally different conclusions. Actually, the stability of the political system was reached at the expense of intensified vulnerability of the economy as a whole. The maintenance of administrative methods

⁷⁵ “Belarusian Economy: Tendencies of Development and Main Challenges/ Экономика Беларуси: тенденции развития и основные вызовы”, IPM, Minsk, 2006

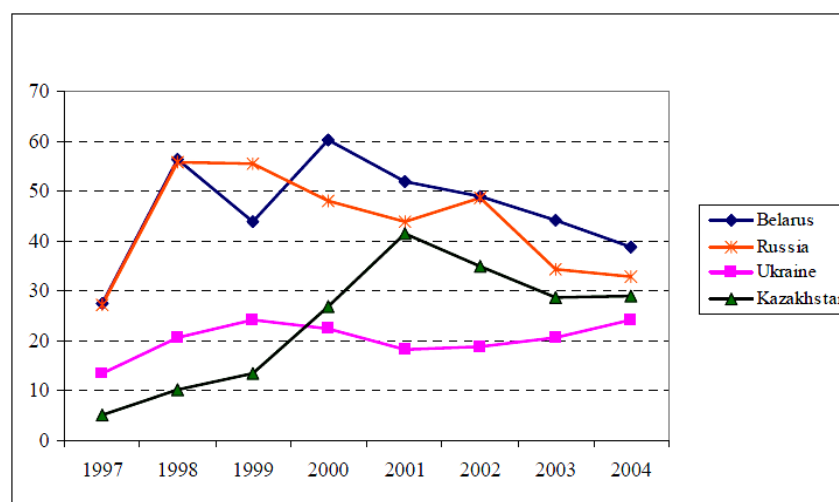
of governance, the prevalence of state ownership and soft budget constraints became a clock-work mechanism, which only intensified the structural crisis which Belarus faces today.

For almost all its independent history the Belarusian government has implemented an anti-stabilizing policy. Only two short periods can be identified, when state macroeconomic policy had a stabilizing effect. The **first period** started in **1994** and lasted till **July 1996**. It was a period of the tightest monetary policy ever provided in Belarus. The program of macroeconomic stabilization was started by National Bank of Belarus (NBB) in 1994. That program was based first on floating exchange rate and then on fixed exchange rate. The outcome was a decrease of the inflation rate. The annual rates of inflation increase were below 40 % and inflation became moderate by 1996. The money supply had decreased and devaluation of the national currency had stopped. The Belarusian ruble had stabilized and the rate of monetization increased. Nevertheless, compared to other transition countries inflation had still been too high in Belarus.

Since 1995 a presidential program of preferential crediting of several economic sectors has been in effect. Active soft monetary policy, provided by the government, became a factor which put pressure on the devaluation of the national currency. However, the success of the previous year was so attractive, that the government decided to keep the national currency rate stable with administrative measures. Two exchange rates- the official (or declared) exchange rate and the market exchange rate have existed since that time. The difference between the two rates was threefold in several periods of time.

The **second period** of stabilizing policy began after the drastic economic decline in **1998-1999**, which was a result of the financial crisis in Russia in 1998 and the expansionist monetary policy, provided by government and NBB. In 1999 the rate of GDP growth lowered to 3.4 % (according to official data) and the poverty rate reached 46.7%⁷⁶. The deepening of economic recession compelled the Belarusian government to reconsider previous economic policy and to take a number of steps towards macroeconomic stabilization. The National Bank liberalized the exchange market in 2000 – the multiplicity of the exchange rate had been reduced and the Belarusian ruble became convertible. There was also a tightening of monetary policy - the pace of money emission was lowered, a number of quasi-fiscal operations were reduced and the National Bank began to implement positive interest rate policy. The undertaken measures helped to lower the rate of inflation, stabilize the financial market and back the confidence in the national currency. The amount of ruble deposits in banks increased and **dollarization** began to lower. Nevertheless, it still remained higher than in other transition CIS economies (see Figure 2.3).

⁷⁶ Chubrik A. "Ten Years of GDP Growth in Belarus: Factors and Perspectives" / «Десять лет роста ВВП: факторы и перспективы», "Belarusian economy: tendencies of development and main challenges/ Экономика Беларуси: тенденции развития и основные вызовы", IPM, Minsk, 2006

Figure 2.3: Dollarization: Foreign Currency Deposits/ M3, 1997-2004 (%)

Source (WB (2005)): NBB, NBU, NBK, IFS

Macroeconomic stabilization occurring after 2000 was one of the key factors of economic growth after the Russian crisis. Nevertheless, state macroeconomic policy was not consistent and stabilization was reached only for a short period of time. Soft budget constraints on enterprises were not reduced, privatization was suspended and government still continued to support preferential economic sectors. In detail in Chapter 9, Macroeconomic policy, p. 91.

6.5 Privatization and the Transformation of Property Rights

On September 23, 1991 the Council of Ministers passed a law “On Denationalization of the Economy and Privatization of State Property of the Republic of Belarus” which gave a start to the process of privatization in Belarus. However a proper enterprise valuation scheme did not exist yet, at this early stage of the privatization process. The method of depreciated cost was used to evaluate property, which caused undervaluation of privatized assets. The imperfectness of the privatization legislation caused the slow pace of property transformation in its initial stage. Only 19 national enterprises and 33 municipal enterprises were privatized in 1991⁷⁷. Only one enterprise was privatized through a tender offer at that period. The main method of privatization was enterprise incorporation and its following transfer to ownership of labor collectives. At its initial stage privatization was realized **from below (bottom-up principle)** and was initiated by employees or the management of state-owned enterprises. Since 1993 the transformation of state property could be also initiated by government institutions (**privatization ‘from above’**), which began to dominate in the privatization process⁷⁸. Privatization of enterprises in industry, trade,

⁷⁷ “Problems of Economic Reforms in Belarus /Проблемы экономических реформ в Беларуси”, Леонид Злотников, Наталья Злотникова/ Zlotnikov L., Zlotnikova N., CASE, 1996

⁷⁸ “Belarusian Economy: from Market to Plan /Белорусская экономика: от рынка к плану: Denationalization and Privatization of Industry in Belarus /Разгосударствление и приватизация в Беларуси”, Rakova E., 2002

domestic service and catering was most intense. At the same time housing and communal services, transport and contraction companies were transformed at a slower pace.

In 1992 the Committee for State Property Management was set up in order to take control of privatization deals⁷⁹. New laws – “On denationalization and privatization of state property” and “On personalized vouchers” were adopted in 1993 and changed the legislative basis of privatization. According to the State Program of 1993 it was stipulated that two-thirds of state assets would pass into private hands by the end of 1999 (infrastructure facilities were supposed to remain in state ownership); and 50 % of state property was envisaged to be privatized through voucher privatization. A list of enterprises and other property facilities which could not be privatized or whose denationalization required special permission of the Council of Ministers was also prepared. In subsequent years that list was expanded.

Voucher privatization in Belarus had features of management-employee buyout privatization – workers and managers were provided with benefits to obtain shares of the enterprises they work for. While the privatization law was introduced in 1993, the issue of vouchers started only in April, 1994. 427.6 million vouchers were issued. Of the 7.833 million people, who had been granted a right to obtain personalized vouchers, only 4.898 million did it. The other 2.935 million (or 37.5%) did not even apply for vouchers. It illustrates not only the low confidence of Belarusians in government decisions, but also the low perception of private property rights by the population. To avoid speculation, vouchers were made personalized, which complicated the process of their exchange on the capital market. It was possible to sell or transfer vouchers only to close relatives and only in limited numbers (not more than 250 vouchers).

The most active period of state property transformation was 1994-1996. Actually, only those enterprises that started that process of incorporation prior to 1995 were privatized. The following table illustrates the dynamics of state property transformation in the years 1991-2001.

⁷⁹ “In 1993, it was transformed into the State Committee of the Republic of Belarus for State Property Management and Privatization; in 1994 – into the Ministry of State Property Management and Privatization; in 2002, the Ministry was reorganized into the Property Fund under the auspices of the Ministry of Economy of the Republic of Belarus. Finally, in 2006, the Fund was reorganized again to become the State Property Committee. Now it incorporates the Fund for State Property and the Committee for Land, Geodesy, and Cartography under the auspices of the Council of Ministers. At the same time, there is a new department established in the Ministry of Economy to develop policies towards property relations and privatization strategy.” - “Privatization in Belarus: Legislative Framework and Real Practices”, BISS, 2008

Table 2.2: Forms of Enterprise Transformation, 1991-2001

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total	61	189	239	641	466	473	497	405	201	124	94
Conversion into stock company (Incorporation)	3	4	71	217	269	221	178	89	94	81	63
Buy outs of companies under lease	34	47	56	152	35	58	76	53	33	12	5
Trade auctions or tenders	11	50	88	260	171	208	223	187	74	31	24
Other	13	88	24	12	-	-	-	-	-	-	2

Source⁸⁰: IMF, WB, Belarusian Ministry of economics

647 enterprises were privatized in 1994 - the highest number through the whole process of privatization. Since 1996 and onward, economic policies were reversed and the number of privatization cases declined dramatically – from 497 enterprises (in 1997) to 94 enterprises (in 2001). At the end of 1995 the Program for Denationalization and Privatization for 1996 was adopted. The Program stipulated the transformation of state-owned companies into open joint-stock companies. However, the list of enterprises which had to be privatized over the period of 1995-1997 was not adopted. Prior to 1997 annual privatization programs were adopted by the Council of Ministers, since 1997 this role was taken by President. In 1998, the President's Edict stopped the practice of development and adoption of annual denationalization and privatization programs⁸¹. In 1999 the government passed the amendments to the law "On privatization" according to which a moratorium was placed on the on the disposals of shares acquired by enterprise workers and managers (insiders) or ordinary citizens (outsiders). Therefore, the economic rationale for exchanging vouchers for shares of enterprises was undermined.

As a rule only loss-making and unprofitable enterprises were privatized with vouchers. Impediments imposed by the government did not allow the exchange of vouchers for shares of strategically important and profitable enterprises. Thus, the activity of Belarusian Specialized Investment Funds (SIF), which served to ease the process of property transformation, was also limited. The activity of SIF was restricted to the participation in special auctions, where vouchers were exchanged for shares of enterprises according to the fixed quota. Low investment opportunities led to people having a negative attitude towards vouchers, which began to be considered as 'meaningless pieces of paper'. Only three of such auctions were organized in 2001. Most investment funds ceased to exist due to such unfavorable conditions. While 54 funds

⁸⁰ Belarusian Trade Union Movement (Belaruski prafsaizuzny ruch):
<http://www.praca-by.info/site/index.php3?l=rus&v=page&id=irabook>

⁸¹ "Privatization in Belarus: Legislative Framework and Real Practices", BISS, 2008

were initially created only 5 funds were in operation in 2003. By January 1, 2006, almost all SIFs were liquidated, including the largest one, 'PRIF', with 60,000 participants⁸². By 2008, more than 40% of issued vouchers remain unused.

Thereby, from the end of 1990s voucher privatization was virtually stopped. Voucher privatization was crowded out by the formal incorporation of enterprises. In all companies, where state institutions initiated the process of incorporation the major stake belonged to the state. The set up of the "golden share" rule made nationalization practices more probable (in detail in Chapter 7.1, State Control over Means of Production).

While voucher privatization had failed in Belarus, the question how to finish it remained. The privatization law "On personalized vouchers" stipulated the compensation of the value of vouchers to citizens if the term of vouchers circulation would expire or if they were not used. The Belarusian government was reluctant to continue privatization and to repay compensations to citizens. The repayments for unused vouchers require large budget expenditures, what could have resulted in a higher tax burden and fiscal instability in the economy in general. On the other hand, to cease privatization without compensations would seriously betray people's trust in government decisions. In December 2002, the Presidium of the Council of Ministers approved the amendments to the privatization law which abolished money compensation for unused vouchers. The amendments caused long parliamentary debates, which blocked the proposition and recommended to find another way for using vouchers. Thus, not able to finish voucher privatization, the government extended the validity of vouchers in circulation. Since privatization started voucher privatization was extended five (!) times and remains formally unfinished until today. Most recently the validity of vouchers in circulation was extended by the Council of Ministers in 2007 until 30.06.2010⁸³.

Conclusions

Market transformation has been almost suspended in Belarus since 1995. Instead the model of so called "socially oriented market economy" was suggested. It consisted of the preservation of state-ownership over means of production, stimulation of growth by administrative methods, the existence of a shallow private sector, reliance on traditional industrial basis and the preservation of tight economic relations with Russia. In the next part the main features of Belarusian economic identity (or model) are discussed and its further transformation under the conditions of semi-authoritarian political power.

⁸² "Voucher privatization in Belarus", BISS, 2008

⁸³ Resolution of Council of Ministers of Republic of Belarus - <http://gki.gov.by/info-center/state-property-fund/share/comments/b8fb52d99ea22fbf.html>

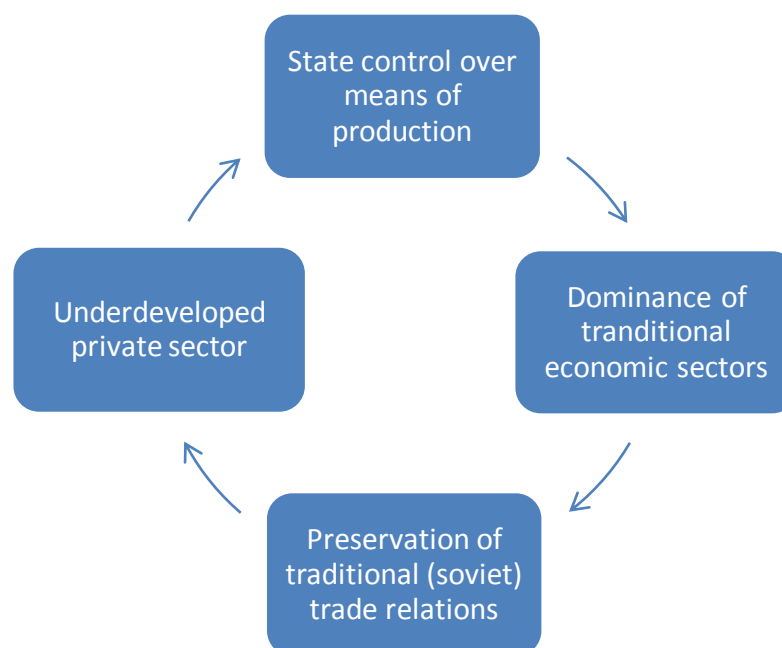
7. Belarusian Economic Identity and Its Transformation

The national and economic identities have the same basis – both identities are determined by cultural and historical development of the country and its people. The formation of national identity went in line with the creation of civic society, the establishment of democratic order and the development of a capitalistic economy. Rule of law and property rights protection are essential institutions of every well functioning market economy. A country's economic identity is formed by market (or non-market) institutions, its economic structure, the relations between the state and economic players and international trade relations.

In contrast to CEE countries, market transformation in the CIS occurred rather spontaneously. As it was discussed in Part I of the study, most of the former Soviet republics lacked legal traditions to develop new market institutions in a short period of time. Thus, market reforms implemented in these countries did not have a desirable effect on the economy. Today most of the CIS countries are characterized by political instability, or an authoritarian government, tight interrelation between large businesses and government, and wide-spread corruption.

According to EBRD annual survey of transition countries, Belarus is listed among the least transformed post-Soviet countries, between Tadzhikistan and Uzbekistan. Being too incorporated into Soviet economy, Belarus was not able to break its economic and political ties with Russia and reorient its trade towards western capitalist countries. A lack of national consciousness and legal traditions caused the weakness of reform and liberal forces to seize power. Instead a pro-Russian authoritarian regime was introduced, with a propensity for command-administrative methods of governance. The market transformation was suspended in Belarus. Nevertheless, some visible structural changes have occurred even under semi-authoritarian government. Despite the dominance of large industrial state-owned enterprises in the Belarusian economy, the importance of services and informational technologies has increased. Being highly concentrated in Russia and the CIS countries Belarusian export nevertheless has begun to diversify in the direction of EU countries in recent years. The implementation of transformation reforms during the early stage of transition became a stimulus for expansion of private initiative and development of business. Despite high restrictions imposed by the government and little possibilities for further development, Belarusian business managed to survive.

Thereby, the Belarusian economic identity (or economic model) can be characterized by the following: 1) *state control over means of production*, 2) *the dominance of a traditional (inherited from Soviet times) economic structure*, 3) *the preservation of former traditional relations with CIS countries (Russia)*, 4) *underdeveloped private sector*.

Diagram 1.1: The Main Characteristics of the Belarusian Economic Identity

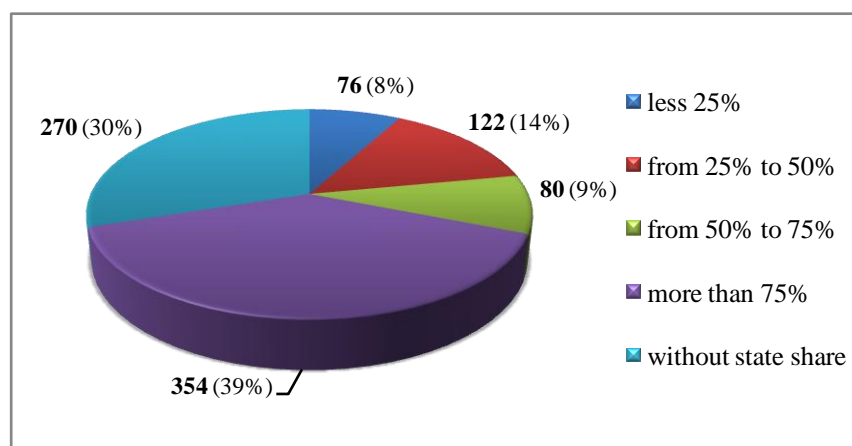
7.1 State Control over Means of Production

The atmosphere of political uncertainty and distorted economic structure caused the slow path of transition reforms in Belarus. Political unwillingness to continue the process of privatization resulted in the preservation of state-ownership over the most strategically important enterprises, which eased administrative control and management over the economy. It has already been mentioned that privatization was virtually suspended and substituted by the process of incorporation. In most cases the state was the owner of the major stake (up to 99.9 %). During 2006-2007 incorporated less than 6 enterprises were incorporated in a year⁸⁴. During 1991-2005 only 4100 enterprises were transformed -- 1088 or (35 %) of national and 3012 (48 %) of municipal property⁸⁵. Only 72 % of enterprises in trade, food and consumer services have been transformed. The state was the owner of 69 % of the shares of those enterprises. Figure 2.4 illustrates the distribution of enterprises according to the share which belongs to the state.

⁸⁴ "Perspectives of Privatization in Belarus", Kostuhova V., BISS, 2008

⁸⁵ "Privatization in Belarus: Challenges and Limitations", Rakova L., 2006

Figure 2.4: Transformation of State property, the Share of the State in the Incorporated Companies, in %, 2006



Note: From the beginning of privatization process 902 enterprises were incorporated.

Source: V.Kovalevski (deputy director of Property Fund),

<http://research.by/rus/seminars/2006/f015f95d85f2c739.html>

Property rights protection in Belarus is extremely weak. Belarus has one of the weakest legal frameworks for shareholder protection in the region. On the disclosure index, Belarus has a score of 1 (on a scale of 0 to 7, with higher values indicating more disclosure), compared with the regional average of 3.6 (4 in Poland and 3 in Ukraine) and 5.6 for the OECD (WB(2005)). Proper legislation has not been introduced not only on shareholder protection, but also on private land property rights. A number of legislation acts created impediments for the fully fledged implementation of private property rights. Among those laws the most controversial was the “golden share” law, which was abolished in 2008 with the start of overall economic liberalization.

The “Golden Share” Rule

From 1997 until March 2008 the “golden share”⁸⁶ rule existed in Belarus, which eroded the business environment and scared away a lot of potential foreign investors. According to Presidential Decree, which has a legitimacy of law, the “golden share” could be introduced in the following situations:

- wage arrears in excess of three months
- serious weakness in the financial performance of a business entity over a six month period

⁸⁶ Presidential Decree No. 125 of March 1, 2004, “On the Special Right (“Golden share”) of the State to participate in the Management of Business Entities”, replaced the previous Decree of 1997, stipulated that ‘golden share’ can be introduced in economical entities created through incorporation, privatization and further restructuring of state enterprises.

- a need to address the defense and security concerns of the state
- and the need to protect the economic interests of the state

According to the “golden share” law it could only be introduced in former state-owned companies, created during the process of privatization. Thus, nominally it could not affect the greenfield FDI. The existence of the “golden share” rule became an indicator of government propensity towards interventionist policy, which could be implemented for private enterprises. It was a serious impediment not only for FDI inflow, but for private investments as well.

During the period the “golden share” rule existed it was implemented on five joint-stock companies of national property (a refrigerator company, two shoe manufacturing companies, a confectionary company, and a textile company) and on five joint-stock companies in municipal ownership (two retail trade companies, a textile company, a dairy company, and a machinery company)⁸⁷.

The existence of the golden share was a corner stone of negotiations between the Russian company “Gazprom” and the Belarusian government concerning the privatization of state-owned “Beltransgas” company, which controls the main transportation channels of Russian gas to Europe. “Gazprom” tried to obtain the majority stake of “Beltransgas” since the mid-1990s. “Beltransgas” is considered a company of strategic importance for Belarus, thus the government has tried to keep it in state ownership for as long as possible. During the “gas conflict” between Russia and Belarus at the end of 2006 (see section Dependence on Russia/Energy) the Belarusian government agreed to sell the major stake of “Beltransgas” to Russian company “Gazprom”. It was agreed that the “golden share” rule would not be applied in this case⁸⁸.

In 2008 the government headed towards the gradual and uneven liberalization of the Belarusian economy with the main purpose of attracting foreign direct investment and covering the current account deficit. One of the first steps towards liberalization was the abolishment of the “golden share” rule by Presidential Decree in March 2008. Unfortunately, this step has not improved the business environment significantly. Most investors still meet with too high requirements from government in case they want to invest in Belarusian enterprise. The most usual requirements which are introduced to investors are maintenance of working places, maintenance of social assets and assignments to national budget funds- Social Protection Funds and Innovation Fund⁸⁹.

⁸⁷ “However, the recent case of Mozyr NPZ plus Ltd. - a private company that is not a former state-owned enterprise, where the golden share was introduced through the decision of the regional government in early 2005 - casts serious doubts on the strict adherence to the Decree. Moreover, it highlights a broader problem, which is a degree of exposure of any business in Belarus to local government harassment.” Box 1.2 “Golden share” rule in Belarus, WB (2005)

⁸⁸ More in <http://www.kommersant.com/p767073/gas/>

⁸⁹ <http://www.finmarket.ru/z/wns/news.asp?fid=6496&id=809617&ref=AnketaOrg&rid=1>

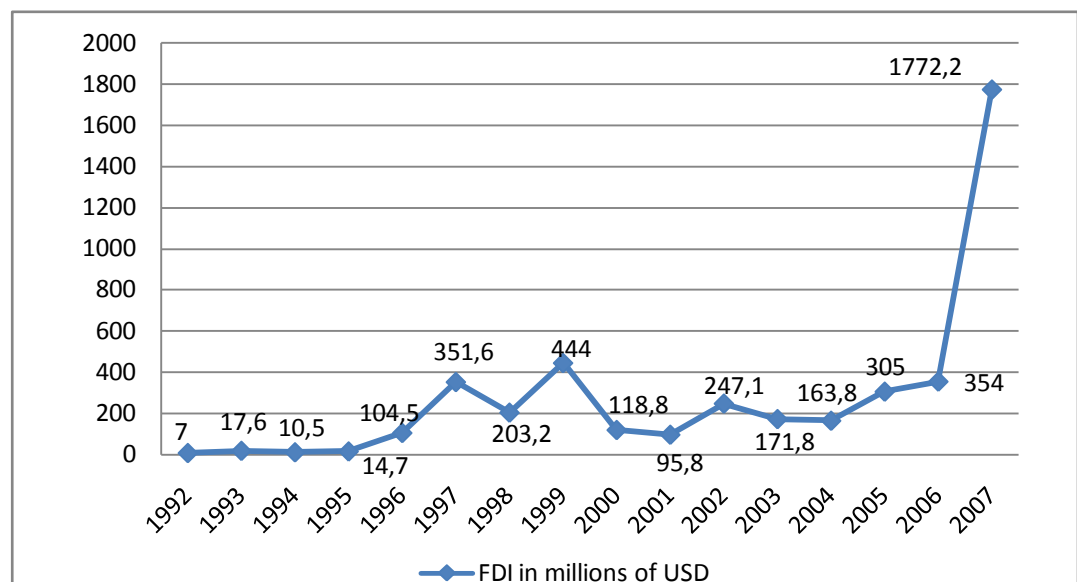
Foreign Direct Investments Inflow

Belarus inherited high investment potential, which unfortunately has not been fulfilled. The rate of FDI has been one of the lowest among transition economies. It was caused by an unfavorable business environment, imperfect laws on property right protection and general government interventionist policy.

The sharp inflow of FDI was observed in 1996 and lasted for the next few years. The increase of investments was related to the start of contraction of transit pipe-line ‘Jamal-Europe’. That project composed 70 % of all investments in 1996, 60 % - in 1996 and more than 40 % in 1998. But in other periods of time the share of FDI per capita did not exceeded 8.6 USD.

The share of foreign direct investments increased in 2007, with privatization (or sale) of a few Belarusian enterprises and the realization of a number of projects with the participation of foreign capital. The sharp increase of prices on gas and imposition of custom duty on oil caused substantial growth of current account deficit and budget deficit. Extremely low foreign reserves and shortages of foreign currency forces Belarusian government to seek for foreign capital. Thus, during 2007 there was sold to foreigners (or privatized) the following Belarusian enterprises and companies: “Motovelo” plant was sold to Austrian firm, mobile operator “Velcom” was sold to Kipr company and then resold to Austrian company “Mobilikom”. There were also privatized a number of Belarusian banks by Russian investors. The total amount of FDI in 2007 reached 1772.2 mil.USD compare to 354 mil.USD in previous 2006 year. Figure 2.5 illustrated dynamics of FDI during period of 1992-2007.

Figure 2.5: FDI Inflow to Belarus in 1992-2007, in mil. USD



Source: FreedomHouse, world statistics

7.2 Dominance of the Traditional Economic Structure

Industry

The Belarusian economic structure is represented by 170- 200 large enterprises, forming industrial company cities, which employ more than 1000 people each. During the Soviet era most Belarusian enterprises were the last elements in the production chain and produced the end product, while the input was delivered from union republics (mostly from Russia). The most characteristic feature of Belarusian industry which complicated enterprise restructuring was its high incorporation into the economy of other union republics (mainly Russia).

The existence of large industrial city-companies was characteristic for most of the Soviet republics. It eased management and control over the Soviet economy from the center, but was devastating for the economy of separate countries. The most problematic issue for transition countries, especially in the post-Soviet area, was restructuring of large city-companies, as they employed about 30% of the working population in the city (town)⁹⁰ and bore the burden of social infrastructure. The collapse of such enterprises inevitably led to enormous unemployment, social tension in the cities and disintegration of major economic structures.

- **Restructuring**

The slow path of enterprise restructuring in Belarus helped to avoid a sharp increase in unemployment. State ownership, the former economic structure, employment and management of enterprises was maintained. State subsidies and bank credits (or soft budget constraints) helped to keep loss making enterprises afloat, but did not solve the most urgent problems, which Belarusian enterprises continued to face – unprofitability, lowered productivity, increased competitiveness and the need of investments in modernization. Disregarding the fact that the inefficiency of state management had been already been proven in Soviet times, the Belarusian government continued to use command-administrative methods of economic management.

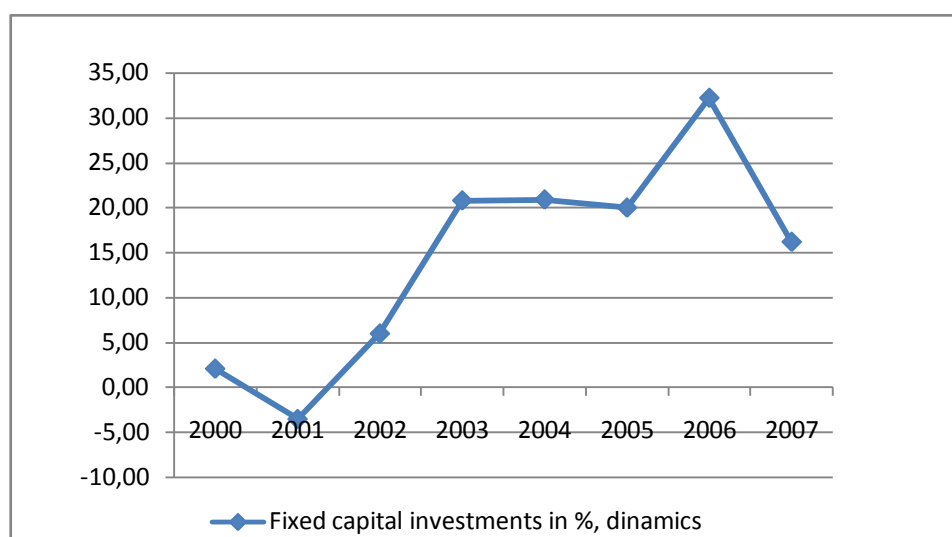
The Belarusian market transformation has been almost suspended since 1996 and the government had proclaimed the necessity to preserve former Soviet industrial and intellectual resources. Nevertheless, the early years of transition initiated spontaneous enterprise restructuring, which could hardly be suspended by administrative measures. Being a small and open economy, extremely dependent on trade, Belarus was forced to provide albeit slight restructuring of enterprises under the influence of external factors – foreign competition and changes in price factor of export commodities.

In contrast to Belarus, market transformation in Russia has not been suspended. Following the financial crisis in 1998, the Russian economy has been undergoing a robust recovery since 2003. Increased oil prices had an extremely positive impact on the Russian economy that became an

⁹⁰ Russian law defines city-company as a company which employs 30 % of the population of the city. In Belarus a city-company is defined as a company, which employs 25 % of the city population.

impetus for structural changes of the Russian market. A number of Russian enterprises got to the phase of deep restructuring. The sharp increase of FDI inflow stimulated an increase of investments in modernization and new technologies. Being highly dependent on trade with Russia, Belarus was also forced to restructure some enterprises in order to improve their efficiency and competitiveness on the Russian market. Thus, investments in fixed capital have considerably increased since 2003 (Figure 2.6).

Figure 2.6: Dynamics of Fixed Capital Investments, in %



Source: Ministry of Statistics and Analysis of Belarus

• Structural Changes

The start of the transition was accompanied by contraction of the industrial and agricultural sectors and expansion of services in all post-socialist countries. Belarus was not an exception. However, the reduction of industry in GDP during 1996-2004 was relatively small (only 1.6 p.p (percentage points)) and the increase in the share of services relatively moderate (5.3 p.p) (Table 2.3) (WB (2005)). The average contribution of services to GDP was about 50 %, which is lower than in other transition economies. In 2000-2004 a reverse in sectors' contribution trend was observed – from 2003 the share of industry increased and the share of services declined. Thereby, traditional manufacturing enterprises continue to dominate Belarusian economy, despite increased significance of services in the overall economic structure.

The contraction of the agricultural sector and forestry was in line with the contraction of this sector in other transition countries. However, employment in agriculture sharply dropped in Belarus, compared to other transition economies. During the period of 1990-2004 contraction of the labor force in agriculture was 53 % and in industry only 27.3 %⁹¹. Despite high state subsidization of agriculture, its contribution to GDP growth remained negative during the period 1996-2004.

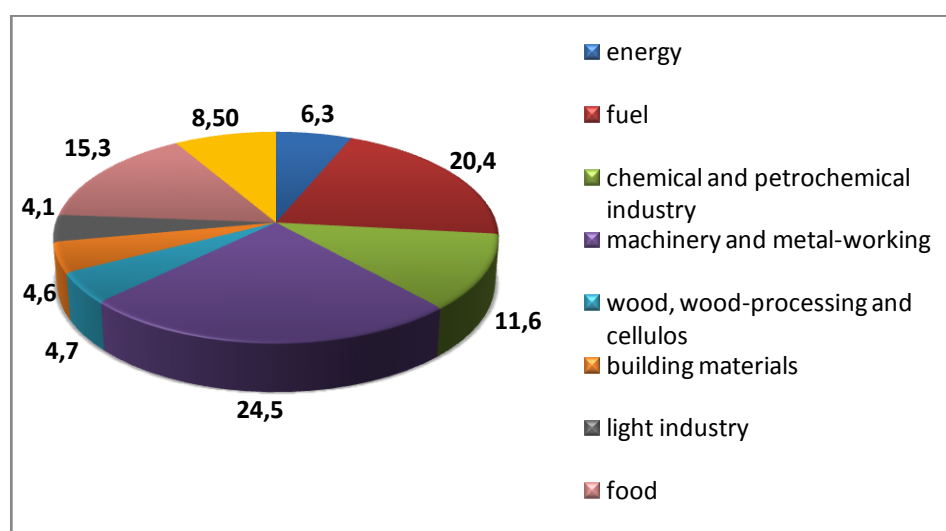
⁹¹ Four other CIS countries registered falling employment in agriculture: Moldova (-24 %), Russia (-21%), Uzbekistan (-24 %), and Armenia (-9 %)- IMP data collection and WB(2005), p. 22

Table 2.3: GDP by Sector, 1996-2004 (in% of nominal GDP as factor growth)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	1996-2000 change	2001-2004 change	1996-2004 change
Industry	32,8	34,3	33,4	31,9	31,0	29,9	29,6	30,8	31,2	-1,8	1,3	-1,6
Agriculture and forestry	17,0	15,4	13,9	14,6	14,2	11,9	11,8	10,2	11,0	-2,8	-0,9	-6,0
Construction	5,3	6,3	6,7	6,7	7,5	6,7	6,8	7,2	7,6	2,2	0,9	2,3
Services, etc.	44,9	44,0	46,0	46,8	47,3	51,5	51,9	51,8	50,2	2,4	-1,3	5,3
Total	100	100	100	100	100	100	100	100	100			

Source(WB (2005)): Ministry of statistics and analysis.

The industrial sector remains critical to the Belarusian economy and its performance largely defines overall economic trends in the country. Its importance exceeds by far the nominal share of the sector in output (30 % of GDP) and employment (26 % of jobs). Companies with more than 1,000 employees contribute over two-thirds of the total industrial production and employ about 73 % of the industrial labor. Their output share has remained practically unchanged since 1991. More than a half of all consolidated budget revenues and exports of goods and services belong to the industrial sector. The industrial contribution to the GDP growth also was very high: in 1996-2000, more than 51 % of the overall GDP growth was generated by industry, and this share amounted to about 42 % in 2001-2003(WB (2005)).

Diagram 1.2: Contribution to Industrial Growth by Sector, for 2007(%)

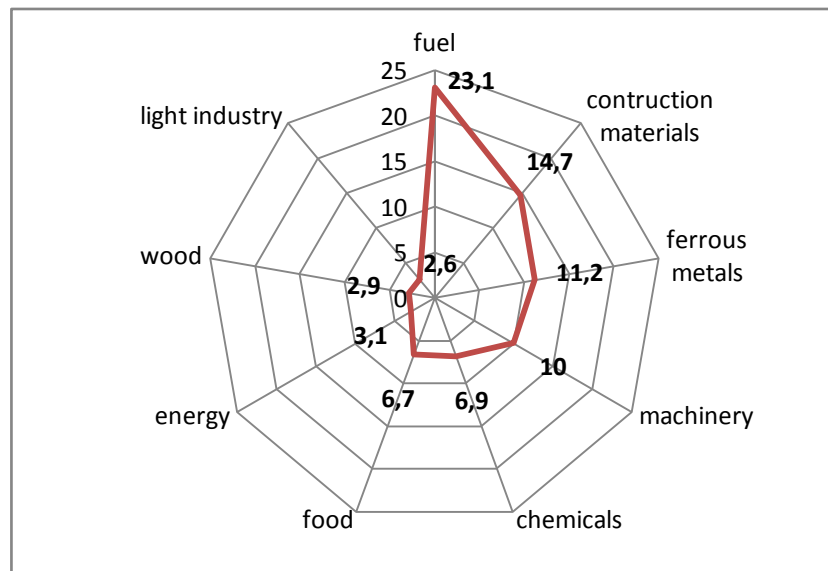
Source: Ministry of Statistics and Analysis of Belarus

As it is evident from the data statistics (for 2007), the largest share of total output belongs to **machinery and manufacturing production**⁹²- **24.5 %** of total output, **products of oil**

⁹² trucks, tractors, mainframe computers, television sets, refrigerators, and other consumer durables

refineries (fuel)-20.4 %, **the food industry – 15.3 %** and the **chemical industry-11.6 %**⁹³. Improvement in terms of trade in oil products (and preservation of low import prices of Russian crude oil) conditioned the increase of output in the fuel and chemical industries, compared to previous periods.

Diagram 1.3: Dynamics of Economic Sectors in Belarus in 2006, changes compared with 2005, in%



Source: L.Zaika "Belarusian Challenge- Democratic Decision/ Белорусский вызов- демократический ответ"⁹⁴,

Diagram 1.3 represents the dynamics of economic sectors – the pace of output growth. The dynamics of output production depended not only on target indicators of output growth set up by the government, but also on changes of price factor.

The Belarusian economy can be characterized by passive structural changes, which were not initiated by inner consistent economic reformation, but rather by the influence of external factors.

- **Profitability across the Sectors of the Economy – Losers and Winners of Belarusian Economic Policy**

One of the characteristics of the Belarusian economic system is that it has a large share of loss-making and low profitable enterprises. Preservation of soft budget constraints and very occasional implementation of bankruptcy law (especially on state-owned enterprises) has led to the high number of insolvent companies, which has only accumulated debts. According to estimates by the Supreme Economic Court, bankruptcy cases could be initiated against about

⁹³ During the period of **1999-2003**, contribution to industrial growth by sector was the following: machinery and manufacturing production- **39.9 %** of total output, products of oil refineries (fuel)-**13.8 %**, food industry – **18.7 %** and chemical industry-**8.7 %**.,WB (2005)

⁹⁴ <http://www.nmnby.org/pub/0704/16m.html>

half of all existing state enterprises (as about 60 % of them were considered insolvent); yet only 91 enterprises were in the bankruptcy process at the beginning of 2003 (WB 2005).

State control and administrative redistribution of credit resources led to uneven development of the sectors. Thus, from the point of view of profitability Belarusian sectors losers and winners of government economic policy⁹⁵ can be distinguished.

The **winners**, or sectors, which have the **lowest number of loss-making enterprises** (results for the first half of 2008) is the automobile industry (8.5 %), the chemical industry (including the petrochemical industry) (7.9 %), telecommunications (5.2 %) and agriculture (1.5 %). The results for agriculture do not reflect the real state of this sector as all losses are transferred to the food industry, which remains highly unprofitable.

The **losers** or **sectors with a high share of loss-making enterprises** include the fuel industry (25 %), light industry (24.5 %), the food industry (15.1 %), machine building (12.5 %) and construction (11.6 %). Fuel and light industry have had permanent financial problems throughout the last ten years. Nevertheless, it is worth mentioning, that private companies, working in light industry are quite successful. Most of all state owned enterprises suffer, which lack investments in new technologies and marketing. The unprofitability of the food processing industry is engendered by poor management of the agricultural sector and price regulation of food products. Data for the construction industry can hardly reflect reality as this sector had expanded in recent years and is characterized by rather high property prices. Thus, it might be supposed that companies practice skimming.

The average profitability of Belarusian enterprises in all sectors is about 15.1 %. The most profitable sectors of the Belarusian economy are the chemical and petrochemical industries, telecommunications (37 %), ferrous metals (26 %) and logistics (maintenance supply) (25 %). The last sector includes whole sale trade, which is controlled mainly by state-owned firms.

Sectors with the **lowest profitability** include construction (9.8 %), light industry (9.8 %), agriculture (8 %), public utility (5.9 %) and housing and communal services (4 %). About 42 % of Belarusian state agricultural enterprises reports profits in a range 0-5 %, 21.8 % have profitability of 5-10 % and the remaining agricultural enterprises are relatively profitable and competitive (L. Zaika(2008)).

In recent years the effect of government growth targets on output production has become apparent. High rates of industrial growth are accompanied by **accumulation of stocks**. The low competitiveness of Belarusian products on domestic and external markets has led to production to stock, not to market. On May 1, 2007 the value of unsold goods reached 1 billion USD (or 2.3 trillion BYR). The directive system of economic management has already proven to be inefficient.

⁹⁵ The definition and subsequent analysis taken from Zaika L. article "Winners and Losers of National Economy/ Победители и проигравшие национальной экономики", 2008

Agriculture and Rural Areas

The share of the agricultural sector significantly contracted during the early stage of transition. While in 1990 agriculture employed 19.1 % of the total workforce and generated 22.9 % of the GDP, in 2000 14.1 % of labor force was employed in agriculture, which generated 11.6 % of the GDP. A positive trend in the correction the Belarusian economic structure had been observed in the last years. Nevertheless, the share of agriculture in the total share of GDP still remains too high for an industrial country – 8.4 % of the GDP (MSA, 2008). Just as the industrial sector, agriculture is highly regulated by the government. Little structural changes have occurred in this sector since Soviet times. Despite high state support, the agricultural sector remains one of the most problematic in the Belarusian economy.

The early years of market transformation created favorable conditions for emergent private farmers albeit the private property right to land had not been introduced yet. But after suspension of transition reforms in 1995, the restructuring of the agricultural sector ceased. Tighter regulation and control over farm production was introduced. Preference was given to traditional Soviet large agricultural enterprises – kolkhozes (collective farms) and sovkhozes (state farms), which have become the main recipients of state subsidies and direct credits since 1996⁹⁶.

Thereby, in Belarus three groups of producers of agricultural output can be identified – state agricultural enterprises (kolkhozes and sovkhozes), households (private plots) and private farmers. A large portion of agricultural production (40 % on average) is produced by households on private plots and farmers, which use only 15% of the total agricultural land area. As much as 93 % of wool, 89 % of potatoes, 85 % of vegetables, 40 % of eggs, 39 % of milk, 26 % of meat and poultry are produced by households (WB(2005)). The total number of private farmers reached 3000 in 1996, but in 2003 their number contracted to 2400. The number of private farmer remains substantially less in Belarus than in Russia and Ukraine.

Table 2.4: Structure of agricultural output in Belarus (%), 1990-2001

Year	1990	1995	1996	1998	1999	2000	2001
SAEs	76.3	51.6	51.1	60.6	54.5	61.2	60.6
Households and private farmers	23.7	48.4	48.9	39.4	45.5	38.8	39.4

Source⁹⁷: Ministry of Statistics and Analysis

• Subsidization

The agricultural sector is one of the most subsidized sectors in the Belarusian economy. Despite the vast support of the sector, state agricultural enterprises perform worse than private

⁹⁶ The preferential sectors, which require state support, had been first defined in The Program of Socio-Economic Development, 1996

⁹⁷ Subsidizing Agriculture in Belarus: Declared Objective and Actual Outcomes, IPM & GET, 2003

farms or private plots. Every year the Belarusian government spends state funds equaling 3-4% of the GDP (10-12 % of the consolidated state expenditures) to support agricultural enterprises. It is about 30 % of all budgetary support of the national economy. But it is only the visible portion of the subsidies. There are about 27-30 different subsidy schemes, which do not always appear on the budget. There are two main sources of budgetary funding for the agro-food sector: regular state budgetary allocations and the proceeds of the National Fund for the Support of Agricultural Producers, Food and Agricultural Science (the “Support Fund”). The Support Fund has been the single largest source of funding and has accounted for about two-thirds of all funding in the sector for the past five years⁹⁸

Table 2.5: Selected Indicators of the Agricultural Sector in Belarus, 1998-2003

	1998	1999	2000	2001	2002	2003
Total budget expenses for agriculture, m. USD	170.6	148.7	372.2	452.8	418.1	107.5
Share in GDP, %	3.0	2.6	4.3	3.8	2.9	4.3
Share of loss-making enterprises	33.3	36.9	39.4	54.2	58.7	n.a

Source⁹⁹: Ministry of Statistics and Analysis, own calculations based on the MSA data

The other very important channel of agriculture subsidization is the banking sector. State-owned and commercial banks grant preferential credits to large state agricultural enterprises on government guaranties and on interest rates half lower than refinancing rates. Most of such credits had been never repaid. As of December 1, 2004, the total level of outstanding credit to agriculture from commercial banks amounted to 1.1 trillion BYR (equivalent to about 16 % of the total commercial bank lending) (WB(2005)). According to the estimates of the Belarusian Institute of Privatization and Management (IPM) in 2003 about 73 % of all lending to agriculture was extended through direct credit. Credit subsidies comprise two main elements: an interest rate subsidy and debt cancellation. In details more is in the Chapter 7, Macroeconomic Policy.

It is evident from the Table 2.5 that large subsidies for the agricultural sector cannot be justified by increased profitability. The share of loss-making enterprises continued to increase and reached about 60% in 2002. Continuous support of inefficient agricultural enterprises has one more reason except securing food. Subsidies not only support collective farms as organizations, but also allow the collective farms to support large “social spheres” and the rural infrastructure as well as individuals who work or live in rural areas¹⁰⁰.

⁹⁸ Ibid.

⁹⁹ Ibid.

¹⁰⁰ Ibid.

- **Attempts to Restructure the Agricultural Sector**

The first attempts to restructure the agro-food sector were introduced in 2000. In 2003 most kolkhozes and sovkhoses were transformed into agricultural production cooperatives or corporatized. The change of legal form did not reduce state control over the new legal entities. The major positive element of the restructuring was the transfer of responsibility for the provision and maintenance of social infrastructure from agricultural enterprises to local authorities.

Further measures have been introduced to reduce the number of loss-making enterprises. As of January 1, 2005, 48 enterprises have been sold to private investors and 27 enterprises have also been leased to private farmers. A further 511 loss-making enterprises were merged with other entities¹⁰¹. The imperfectness of bankruptcy procedures has not allowed for the possibility of efficient restructuring. The number of loss-making agricultural enterprises has lowered, but it has done little for the underlying profitability fundamentals.

- **Agro Towns**

Restructuring of the agro-food complex was accompanied with an attempt to reform the organization of rural areas. The program of socio-economic development and village revival for 2005-2010 stipulated the creation of agro-towns¹⁰². The idea was to create social area for production and a technical base in rural areas. About 1500 agro towns have been created through 2009 in Belarus. The outcomes of the program are doubtful. Most allocated funds have been spent on housing, road building and creation of social buildings, but not on the creation of production and processing enterprises¹⁰³.

7.3 Preservation of Traditional (Soviet) Trade Relations

Importance of Trade

Belarus inherited a large industrial capacity with a high share of intellectual and technological production from Soviet times. Nevertheless, most Belarusian enterprises produced end products and were highly dependent on input of raw materials and energy. Thus, suddenly gained independence brought a lot of distortions to the Belarusian economic system. If before Belarus

¹⁰¹ “As of January 1, 2005, 48 enterprises had been sold to private investors and 27 enterprises had also been leased to private farmers. A further 511 loss-making enterprises were merged with other entities.” WB (2005)

¹⁰² Agro town- a term developed by Nikita Khrushchov in 1949. One of Nikita Khrushchev's projects that was part of the planned 'transition of the village to Communist social relations.' Khrushchev first proposed the idea in 1949 .when he was a secretary of the Central Committee of the Communist Party of the Soviet Union responsible for agriculture. The aim was to amalgamate several collective farms into larger economic units and to relocate the collective farmers in large urbanized settlements (rural cities) with socialized services, such as cafeterias and laundries, and cultural amenities. <http://www.encyclopediaofukraine.com/pages/A/G/Agrotown.htm>

¹⁰³ http://www.government.by/en/eng_dayevents20090317.html

was part of a large relatively self-sufficient economy, after the Soviet Union's collapse it became small and open economy, and extremely vulnerable to external shocks.

Trade was always extremely important for Belarus as about 80 % of Belarusian industry was intended for the external market. Export is an essential factor of economic growth in Belarus. But to ensure export of its production Belarus has to import all necessarily inputs, and mainly from Russia. The inherited industrial structure oriented Belarusian trade predominantly towards the CIS market and Russia in particular. A phantom political entity was created – the Commonwealth of Russia and Belarus (or Belarus-Russia Union State) in 1996, which provided Belarus with two main benefits - free access to the traditional Russian market and low prices on energy resources. Products of the Belarusian machinery and food industry were highly competitive on the CIS market especially through the 1990s, but difficult to export elsewhere.

During 1996-2006 the annual GDP increase in Belarus was 7.2 % on average. Export of goods and services provided 5 p.p (percentage points) of the average GDP growth. It was more than household consumption which accounted for 4.9 p.p and more than contribution of investments in fixed capital – 2.7 p.p¹⁰⁴. Export began to recover in 1994-1995 and then increased significantly since 1996. Export growth was driven largely by Belarusian ruble (BYR) depreciation and free access of Belarusian products to the Russian market (thanks to the existence of the Custom Union between the two countries). At the same time administrative control over prices and wages gave a competitive advantage to Belarusian producers on the Russian market.

Export oriented towards the Russian market was beneficial for the Belarusian economy but only in middle-term perspective. In the long-term the obsession with the Russian market had had a rather distortive effect on the economy. The analysis of Belarusian trade, provided by M.Bakanova¹⁰⁵ (2004), indicates the negative effect of exports to Russia on economic growth. Whilst at a specific moment in time an upturn in exports to Russia could be seen as a driving force for reviving economic growth (especially at state-owned enterprises, previously oriented towards this market), in the long run the preservation of existing trade structure will have negative growth and welfare effects¹⁰⁶. M.Bakanova points out that export to the Russian Federation affects negatively and significantly Belarusian GDP, while imports from Russia have also a negative sign, but are non-significant. On the other hand, exports to the EU affect GDP positively and significantly, while imports are significant and negative, but with a coefficient far smaller than the one for exports.

¹⁰⁴ “Economics of Belarus: Research, Forecast, Monitoring / Экономика Беларуси. Исследования, прогнозы, мониторинг”, IPM report 2007

¹⁰⁵ “Trade and Growth under Limited Liberalisation”, Bakanova, M. and L.Vinhas de Souza, 2002

¹⁰⁶ “Exports to the Russian Federation affect negatively and significantly Belarusian GDP, while imports from Russia also have a negative sign, but are non-significant, but, on the other hand, exports to the EU affect GDP positively and significantly, while imports are significant and negative, but with a coefficient far smaller than the one for exports.” - “The economic prospects of the CIS: sources of long term growth”, 2004

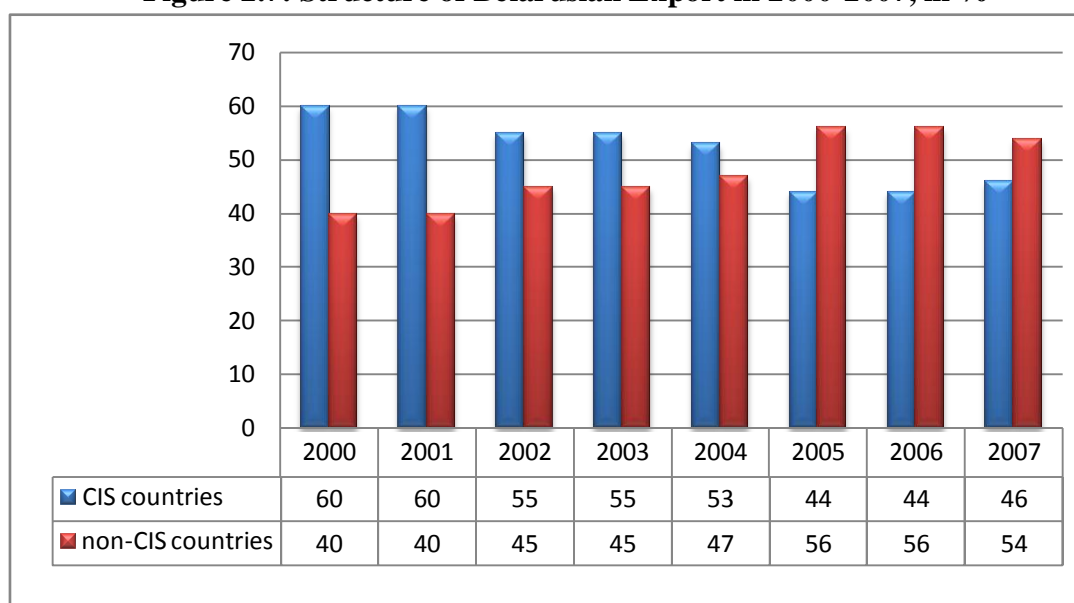
Worsening signals for Belarusian trade have been indicated since 2004 - Belarusian goods began to lose competitiveness on the Russian market. Through the late 1990s Belarusian exporters occupied the niche of cheap and mediocre quality goods. Low price was the main competitive advantage of Belarusian producers on the Russian market, especially in the environment of economic decline observed in Russia after the financial crisis in the 1998. But soon after 2004 the economic recovered and subsequent growth caused the structural changes of Russian market. With increasing incomes, the Russian population began to shift their preferences to more expensive and higher quality goods. Thus, Belarusian producers met with higher competitive pressure on the Russian market. In turn, competition stimulated restructuring of some state-owned export enterprises and increase of investments in modernization.

Diversification of Trade

After the dissolution of the Soviet Union Belarusian trade remained highly oriented towards the CIS and Russia in particular. The share of Russia in bilateral trade between Belarus and CIS countries made up 86.27 % in 2007. In spite of the high concentration of trade with one country, Belarusian export is much more diversified than import. After 2000 the share of export to Europe began to grow extremely. In 2005 the share of export to non-CIS countries exceeded its share to CIS countries (see the Figure 2.7). While the share of export to non-CIS countries made up 54 %, the share of CIS countries in export decreased to 46% (in 2007). The main non-CIS trade partner of Belarus remains the European Union. Mineral products and fuel are the main commodities of non-CIS export, which accelerated with increased of world prices of oil and oil products. The increase of export revenues considerably contributed to the increase of state budget revenues, especially in recent years. But to ensure export increase Belarus has consequently to increase import of necessary inputs. In turn it negatively affects the balance of payment.

Belarus has always had a trade deficit with Russia. But it has increased considerably since 2006, when Russia imposed higher prices on gas and customs duty on crude oil delivered to Belarus. Thus, import became more expensive for Belarus, what immediately affected the state of trade balance. Belarus' trade deficit with Russia reached 8326 mil.UDS, compared to 6254 mil. UDS in 2006. The share of Russian import reached 65.95 % in 2007, while the share of Belarusian exports to Russia decreased from 42.43 % in 1995 to 34.04 % in 2007¹⁰⁷.

¹⁰⁷ More information about trade on the pages of Ministry of statistics and analysis of Belarus:
<http://belstat.gov.by/homep/ru/indicators/fttrade.php>

Figure 2.7: Structure of Belarusian Export in 2000-2007, in %

Source: CIS statistics (<http://www.cisstat.com/eng/cis.htm>)

The Structure of Belarusian Trade

Table 2.6 represents the structure of Belarusian export and import. Belarusian export consists mainly of mineral products (37.9 %), machinery and equipment (19.2 %) and chemical production (18.8 %). The export share of mineral products and chemical products began to increase in 2003. Improvement in terms of trade had especially positive effect on Belarusian trade through the period of 2004-2007, when world prices on oil products and potash fertilizers were high. The timely upgrade of export capacity gave a chance for Belarus to answer the increasing demand and expanded opportunities of the world market. Especially important were investments in modernization of oil processing plants: Mozyr Refinery Plant in the south and "Naftan" in the northwest - the largest taxpayers of the consolidated state budget¹⁰⁸.

¹⁰⁸ Naftan was corporatized in 2002, but the state continues to be the major shareholder. The Mozyr Refinery Plant was corporatized in the early years of independence and became part of the large vertically integrated oil company "Slavneft" in 1994. Slavneft took an active part in the reconstruction of the Mozyr Refinery by directly investing in it, providing credit guarantees, and ensuring the guaranteed delivery of crude oil to the refinery (not less than 3.5 million tons a year). At the same time, modernization of the sector in general (and especially of "Naftan") has been undertaken primarily with domestic investments. WB(2005)

Table 2.6: Structure of Belarusian Trade, 2008

	Export,%	Import,%
Total	100	100
Agriculture and food production	6,5	7,6
Mineral products	37,9	39
Chemical production	18,8	11,7
Wood and pulp & paper	3,8	2,5
Light industry: textile and apparel	3	2,2
Ferrous metals and ferrous products	8,1	12,6
Machinery and equipments, vehicles	19,2	22,1
Other production	2,7	2,3

Source: Ministry of Statistics and Analysis

An important peculiarity of Belarusian export is its high **concentration** and **specialization**. Dependence on a limited number of companies makes Belarusian export highly **concentrated**. The 20 largest exporters contributed to 46 and 80 % of CIS and non-CIS exports, respectively in 2003¹⁰⁹. High export concentration makes the economy especially vulnerable to external shocks. Changes in price factor and other terms of trade can seriously affect Belarusian economy.

The other peculiarity of Belarusian trade is its high **specialization**. Specialization is considered to have a rather positive effect on the economy. It leads to economy of scale and hence to higher productivity (WB (2005)). Belarus exhibits strong export specialization in petroleum products, manufactured fertilizers, wood and wood products, textile fiber, iron-steel wires and bars, and optical instruments. At the same time, export specialization patterns differ from market to market. On the CIS market Belarus exhibits strong export specialization in a number of agricultural and food products (meat, dairy products, eggs, cereal flour, sugar confectionery) and also in tractors and transport vehicles. In the EU direction Belarus specialize in export of fuel and mineral products.

Low investments in modernization and enterprise restructuring caused rather negative trends in trade. The relative importance of natural resources and unskilled labor export had increased and the share of capital-intensive and skilled labor-intensive export decreased in recent years. The share of highly technology import had also declined (WB (2005)). Reliance on relatively low value-added exports gives fewer possibilities for the economy to generate new jobs, thus holding up both productivity growth and an increase in the standard of living. New EU members (EU-8) exhibited an opposite trend namely, an increase in the relative importance of labor-intensive and capital-intensive exports, which are generated by the sectors with greater growth potential and higher wages (WB (2005)).

¹⁰⁹ "Export Concentration and Specialization, Trade Complementarity and Intra-Industry Trade." WB (2005)

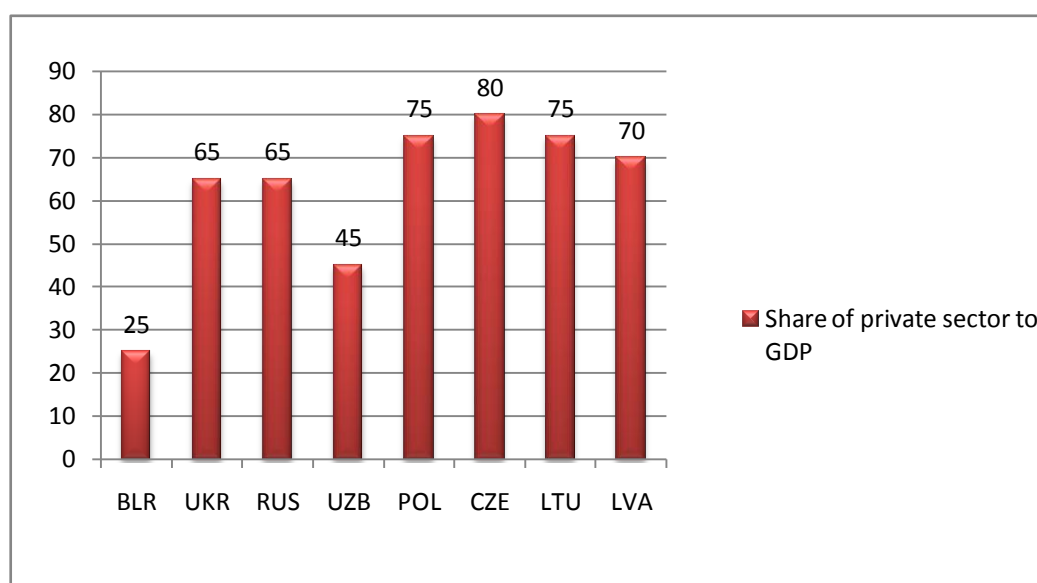
Energy Factor

“Special relations” with Russia helped Belarus to preserve low prices for energy resources until the end of 2006. The benefits for Belarus from such special relations could be estimated to be 8-11% of GDP¹¹⁰. The export of fuel and oil products began to dominate the Belarusian export structure since 2003 and onwards. Low energy diversification and high concentration of products from raw materials in trade made the Belarusian economy extremely vulnerable to changes in the price factor of energy resources (more in the section 10.1- The impact of price hike of energy resources on Belarusian economy).

7.4 Underdeveloped Private Sector

The level of private sector development is a main indicator of successful transformation to a capitalist market economy. The share of the private sector in Belarus is the lowest among CIS countries and creates only 25 % in GDP (in 2005). At the same time the share of private sector in neighboring Lithuania and Poland in GDP was 75 % (see Figure 2.8). Such weak development of the private sector in Belarus is explained by the high regulatory environment and low protection of property rights.

Figure 2.8: Private sector share in GDP, %, 2005



Note: BLR-Belarus, UKR-Ukraine, RUS-Russian Federation, UZB-Uzbekistan, POL- Poland, CZE-Czech Republic, LTU-Lithuania, LVA-Latvia

Source: IPM data collection, EBRD

High administrative control over the economy had extremely distorting effects on the economy. While small and medium private companies and entrepreneurs were burdened by high and complicated taxation, state-owned and privileged private companies (close to government

¹¹⁰ “Can the Stronghold Withstand an Economic Attack? The Challenges and Prospects of the Belarusian Economy in the Near Future”, Yakov Minkov, 2007

authority) enjoyed different forms of government support (direct subsidies, tax privileges, etc.). Such business environment eroded fair competition and redistributed the tax burden unevenly.

The Segmentation of the Belarusian Private Sector

The Belarusian private sector can be divided into several groups of representatives¹¹¹:

1. Individual Entrepreneurs

The group of individual entrepreneurs is concentrated mainly in trade and characterised by being under continuous government pressure and control. Their possibilities for doing business worsened after 2008, when, according to new presidential Decree No. 750 all individual entrepreneurs had to re-register as legal entities if they would like to employ people. The employment of people except relatives was forbidden for individual entrepreneurs. For small businesses the transition to a new legal entity meant large losses and new unfavourable conditions, which undermined their existence at all. Mass protests at the beginning of 2008 did not bring desirable results. Belarusian entrepreneurs had to adapt to new conditions and use shadow schemes or to shift their business to neighbouring countries (Russia or Ukraine).

2. Small and Medium Sized Businesses¹¹²

Small and medium-sized Belarusian businesses can be characterised as being to some extent successful and profitable. People have learnt to work under continual government control and unpredictable legislative conditions. Many of them use acquaintances with government officials to avoid pressure and sanctions. At the same time government control over the economy (the private sector especially) slows down their development and restrains investments. Among the main braking factors to development are the regulations on prices and salaries. The improvement of the business environment and the reduction of tax burden and legislative restrictions would become a stimulus for the expansion of Belarusian private companies.

3. Large Businesses

All large-sized businesses in Belarus are characterized as having noticeable government support. It is provided mostly by people close to government authority or by relatives of nomenclature officials. People working in large business are mostly interested in preservation of the status-quo. Any structural changes could be accepted by this group of business

¹¹¹ This part is used from the author's publication, prepared for AMO (Association for international affairs): Volha Dudko (2007) "The Wind of Changes in Belarusian Economy",

¹¹² "In Belarus, as in other CIS economies, firms with revenues starting from the equivalent of US\$150,000 become a target for the intensified enforcement of regulations and formal and informal payments. However, unlike their counterparts in other transition economies, Belarusian entrepreneurs report the existence of a second ceiling above which it is impossible for a private firm to operate (irrespective of readiness to pay regulatory costs) without strong political backing and connections. This revenue ceiling was reported at a level of **US\$3 million in 2004** but was lowered to **US\$1 million in 2003**, which point to the fact that, increasingly, smaller companies need political support to survive." WB (2005)

representatives only in a situation when they would be able to influence economic policy according in their interest.

In the early years of transition the atmosphere was very favourable for the expansion of entrepreneurial initiative. Slow transition reforms, however allowed to create some market institutions. But since 1994 the reverse in economic and political policy undermined previous achievements in market transformation and has seriously affected the business environment. The number of small enterprises reached a peak around 1999 when the total number of registered enterprises reached approximately 29,600, but it went into reversal during 2000-2001. By the end of the 2001, the number of small enterprises was down to about 27,800 or 94 % of the 1999 level. Small enterprise growth resumed in 2002 and by the end of 2004 the number of small enterprises reached 32,800 or 110 % of the 1999 level. However, overall employment in the small enterprises sector fell from 9.6 % to 8.8 % of the total (WB (2005)).

The number of individual entrepreneurs declined rapidly in 1995-1997, but then grew about 50 % between 1999 and 2002. Overall, the number of entrepreneurs in 2004 exceeded its 1995 level by only 11 % (WB (2005)). The rather hostile business environment had negative influence on business development in the country.

Characteristics of the Business Environment

The Belarusian business environment is characterized by high level of regulations, which restrain the emergence of new firms and investments in business expansion. Business registration procedure remains extremely cumbersome, although a number of attempts to ease the procedure have been made. It takes much more time to register new business (a firm) in Belarus than in neighborhood countries. For example, in 2004 new entrepreneurs had to go through 16 procedures to start a business in Belarus. In Poland and Russia the system of business registration is much simpler. On average, it requires 10 procedures in Poland and 9 procedures in Russia to start a new venture (WB (2005)). Moreover, the newly formed firms are at a disadvantageous position compared to large state-controlled and subsidized companies. The different position of private and state firms undermines fair competition and erodes the business environment, stimulates corruption practices and prompts low confidence in legal enforcement mechanisms.

Price and employment regulations, excessive tax burdens, corruption and low protection of property rights are the main characteristics of the Belarusian business environment.

1. Regulation of Price and Employment

Government policy intended to reach full employment and wage increase affect not only state-owned companies, but also private firms. The rigid system of firing workers discourages the rationalization of employment and its reduction to the levels justified by market conditions. The excessive labor force exists both in state-owned and privatized companies, and in small and medium sized firms. Such policies, which started in 2000, resulted in improvement in labor productivity being too slow compared to wage increase.

Price controls, used mainly to control the inflation increase rate, also have an extremely detrimental effect on the business environment. Price regulations increase regulatory costs on enterprises and affect their profitability. More about price regulation is discussed in the Chapter 10- Macroeconomic policy.

Table 2.7: State Intervention into Price Setting

Do State Agencies Exert Any Influence on Pricing? 2003 (%)

Organizational form	They do		
	2001	2002	2003
Individual entrepreneurs	45	29	34
Non-state unitary enterprises	49	60	62
State unitary enterprises	79	86	77
Limited liability company	56	66	63
Additional liability company	59	59	66
Closed joint stock company	75	80	68
Open joint stock company	85	76	76

Source: WB(2005)

2. Corruption

The research, provided by the World Bank to disclose the level of corruption in transition countries, has revealed that Belarus has a better score in the corruption perception indexes than the average CIS country. Nevertheless, high frequency of tax and hygiene control, which private firms face, make bribery payments a regularly phenomenon in Belarus. Corruption creates an additional tax burden on the private sector. It is a factor which lowers companies' profitability and competitiveness. Nevertheless, the imperfectness of business legislation makes private firms from the CIS region used to regularly bribery payments because in many cases it is the only way to avoid useless bureaucratic procedures.

3. Excessive Tax Burden

Belarusian tax legislation is inconsistent and ambiguous. Taxes are regulated by scores of frequently changing legal acts, which often contradict one another¹¹³. It is one of the main obstacles for business development. Belarusian private companies are burdened with a multitude of taxes, excessive tax inspections, the instability and complexity of the tax legislation and severe penalties for unintentional mistakes. At the same time there is a group companies (mainly state-owned), which enjoy the toleration of tax arrears and other exceptions from tax payments.

¹¹³ "For example, the State Taxation Committee's clarification of the procedure for levying income tax, of March 23, 1999, was amended six times over the next two years." WB (2005)

Excessive tax burden deprive Belarusian enterprises of free resources, which could be spend on modernization and innovations.

4. Passivity of The Belarusian Business Sector

Protectionist government policy made Belarusian small and medium business get accustomed to the existing order and low competition from foreign companies. Thus, opening up the country to foreign investors is not considered positive by many Belarusian entrepreneurs. Scale market liberalization could be associated not only with reduction of regulation but also with increasing competitiveness from outside. Recent research on the private sector indicates a rather negative phenomenon - small and medium sized Belarusian companies have gotten used to work under the present conditions and have little ambition to develop further¹¹⁴. Entrepreneurs have become satisfied with reached profits and have little impetus to invest in expansion of their business. Nevertheless, reduction of extensive government regulation would raise demand for market institutions and proper market enforcement mechanisms and thus, would become a catalyst for business development and expansion.

8. The Nature of Economic Growth in Belarus

8.1 Two Growth Models

Economic growth in Belarus has been accompanied by the overturn of market reforms and the strengthening of administrative control over the economy. Renewal of output production and GDP growth in the almost untransformed economy made some economists speak of the Belarusian economy as a “puzzle” or the “Belarusian economic miracle”¹¹⁵. 1996 was the first year of positive economic growth of 2.8 %. During the next year of 1997 the highest GDP growth for the whole period of transition, 11.4 %, was achieved. Indicators of economic growth in Belarus were even higher than those in the neighboring transition economies, which had been going through transition reforms. Nevertheless, in the subsequent years Belarus dropped into economic recession. The reason lay not just in the Russian crisis of 1998, but also in the expansion of monetary policy, which led to a drastic devaluation of the national currency in the unreformed economy. The financial crises in Russia revealed the most vulnerable aspects of the “Belarusian economic model” and made the government rethink the country’s macroeconomic policy. After the government introduced measures to stabilize the economy, economic growth renewed.

Such high rates of economic growth, peaking in the second half of the 1990s, gave an opportunity for the government to justify its command-administrative methods. Financial institutions such as the WB, IMF, and EBRD forecasted rapid economic decline and deep structural crisis in Belarus after the suspension of transition reforms. However, the Belarusian

¹¹⁴ ["Reforms and Private Practice", E.Rakova \(18.09.2007\), in Russian](#)

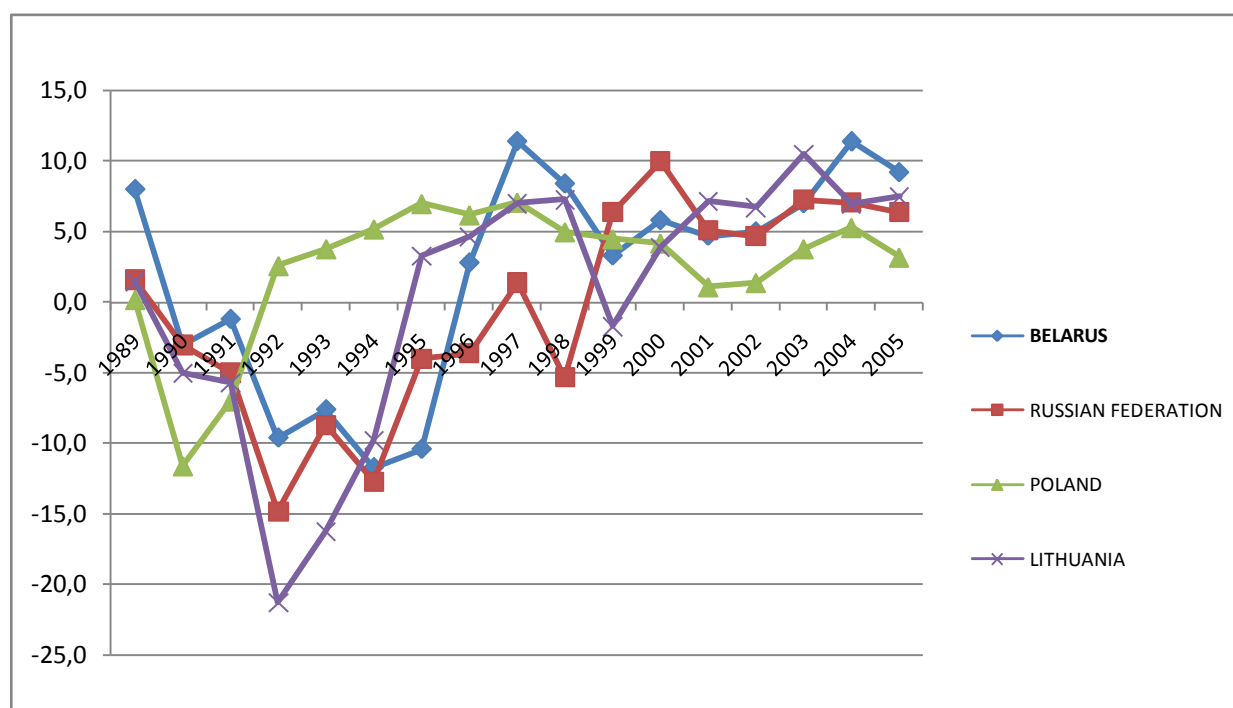
¹¹⁵ See, for example, Havrylyshyn and Wolf, 1999, Fischer and Sahay, 2000, IMF, 1999.

government managed to delay the process of market transformation and created an illusion of economic success and stability.

In this part of the work I will describe the nature of economic growth in Belarus. Belarusian economic growth has been achieved not due to an increase in efficiency and competitiveness, but because of the administrative stimulation of output, export and household consumption. It was growth “at any cost”, which undermined the previous attempts at reforms. The “socially oriented market economy” became an officially adopted model, which implied a specific transition path.

A number of studies by Belarusian and international analysts have tried to analyze the nature of economic growth in Belarus. Most of these studies agree that the strong industrial base, inherited from the Soviet Union, the proximity of the traditional Russian market, preferential prices on energy resources, and favorable external conditions of trade (high prices on Belarusian export commodities) were the key factors of growth of the unreformed economy.

Analysts distinguish two phases of economic growth in Belarus (WB (2005)). The first period, **1996-2000**, is characterized by overcoming economic decline and achieving rapid GDP growth and then its sudden decline followed by increased inflation caused by expansionist monetary policy. The second period, **2001-2007**, is noted for stabilization of the macroeconomic environment and further economic growth. A combination of several factors and measures undertaken by the Belarusian government form the basis of the economic growth in these two periods.

Figure 2.9: GDP Development in 1989-2005, in %

Source of Data: IPM data collection, EBRD

8.2 Period 1996-2000: Suspension of Market Reforms, Rapid Growth and Following Economic Decline

Starting in 1995 Belarus witnessed a gradual renewal of command-administrative methods of governance. The course of the 1st Belarusian president was set not up towards creating a competitive market economy, but rather it was drifting away from it. Nevertheless, during that period transition, recession was ended and the country achieved economic growth. What were the main factors that facilitated economic growth in the atmosphere of repressive financial policy and intensifying administrative control? During 1996-2000 growth was impossible without privileged access to the Russian market and having of temporary cost advantages, reached by administrative control of wages and prices, and high subsidies to exporters (WB (2005)).

1. Re-integration Process with Russia and Preferable Access to Its Market

The economic structure that Belarus inherited from Soviet times, made the country extremely dependent on trade with other former Soviet republics, in particular with Russia. Little attempts were made to diversify Belarusian exports after the dissolution of the Soviet Union. On the contrary, upon gaining power, the Belarusian president reinstalled the process of integration with Russia to ensure free access to the traditional export market for Belarusian products and preferential prices for energy resources. In 1996 the presidents of Russia and Belarus signed an

agreement to create the Commonwealth of Russia and Belarus.¹¹⁶ Multiple bilateral agreements that stipulated political and economic integration of the two countries have been signed in the subsequent years. The creation of the Customs Union facilitated preferable access of Belarusian goods to the Russian market. The political reintegration with Russia had also ensured the preservation of preferential gas import prices and tolerance of energy arrears. This ensured capacity utilization in the Belarusian oil refineries. In 1996 Russia also wrote off debts for energy resources¹¹⁷.

One of the important characteristics of trade operations between Russia and Belarus (and other CIS countries) during the entire 1990s was the preservation of barter payments. Such special trade conditions significantly contributed to export growth during the early years of transition. In 1999 the share of barter operations accounted for 52.4 % of Belarusian exports to Russia and 38.9 % of Russian exports to Belarus (See Table 2.8). Analysts point out that barter relations were critical to maintaining bilateral trade at a high level during the transition recession, since the market mechanisms needed time to fully develop (WB (2005)). Barter arrangements were centered on Russia's deliveries of gas and electric power, while Belarus supplied Russia with its manufactured goods. Barter payments for energy resources (in particular oil) can explain why during the 1997-1998 period transfers from oil imports were negative: oil import was paid not in real dollars, but in barter (Rusakevich I., 2002)¹¹⁸.

The period between 1996-2000 was also characterized by the multiplicity of exchange rates (more in the section 9.2 - Monetary policy). The official exchange rate was used to determine the value of barter transactions and was much lower than exchange rate existing on the black market. The difference between the market and official exchange rates multiplied by the volume of barter yields the estimates for the value of the resource transfers obtained by Belarus through this channel (WB (2005)). The multiplicity of exchange rates was reduced in 2000, when the government liberalized the currency market, unified the exchange rate, and made the Belarusian ruble convertible.

Measures to stabilize bilateral trade, taken by the Belarusian and Russian governments at the end of 1999 led to the contraction of barter. Barter operations of Belarusian exports to the

¹¹⁶ The basis of the union was strengthened on April 2, 1997, with the signing of the "Treaty on the Union between Belarus and Russia" at which time its name was changed to the *Union of Belarus and Russia*. Several further agreements were signed on December 25, 1998, with the intention of providing greater political, economic, and social integration.

¹¹⁷ In 1996 Belarusian parliament initiated an impeachment trial against president A.Lukashenko. But after Russia, in the face of its prime-minister A. Chernomyrdin, had intervened into the process, it was stopped. Thus, the write-offs of energy debt could be also regarded as payment of Russia for the political loyalty of Belarus.

¹¹⁸ "Belarusian Economy: from Market to Plan/ Белорусская экономика: от рынка к плану: Monetary Policy/ Монетарная политика в Республике Беларусь", Rusakevich I., 2002

Russian Federation accounted for 3.8 % in 2004, compared to 7.7 % during the same period in 2003, and imports from Russia – 2 % compared to 4.2 %¹¹⁹.

In summary, strong economic ties with Russia for many years remained the major factor in the relative sustainability of the Belarusian economic and political model. Russia's support through trade and special agreements played a significant role for Belarusian growth. The channels of Russian support can be summed up as the following (WB(2005)):

- Discounted prices for imported Russian energy;
- Re-export of Russian commodities by Belarus at higher prices (mainly oil products);
- Non-market arrangements on bilateral trade (such as barter and inter-government agreements on mutual direct deliveries);
- Unilateral violations by Belarus of provisions of the Russia-Belarus "Customs Union".

Table 2.8: Resource Transfers from Russia, by Selected Channels, 1997-2003 (US\$ million)

	1997	1998	1999	2000	2001	2002	2003
Import of Russian crude oil	-97.3	-200.9	212.8	285.8	181.1	430.5	398.9
Import of Russian natural gas	635.0	564.8	868.2	836.2	787.2	758.5	740.8
Resource transfer to Belarus through barter arrangements in energy trade, mil. USD	30.7	231.6	64.5	80.0	--	--	--
Total	568.5	595.5	1 145.5	1 202.0	968.2	1 217.7	1 139.7
Total, as % of GDP	4.1	4.1	10.3	9.2	7.9	8.4	6.4
Total, as % of GDP at factor cost	4.6	4.5	10.9	11.0	9.0	9.7	7.7
<u>Share of barter (%) in</u>							
Belarus exports to Russia, goods and services	34.3	n/a	52.4	44.4	30.2	15.9	7.6
Russian exports to Belarus goods only	45.7	36.7	38.9	26.7	17.8	8.9	4.1

Source (WB(2005)): Tomashevich and Elsukov (2004)

¹¹⁹ In 2004 barter operations of the Belarusian exports to the Russian Federation accounted for 3.8 % against 7.7 % on the same period in 2003, and imports from Russia – 2 % against 4.2%.

<http://www.mfa.gov.by/print/en/press/news/2005-01-20-3.html>

2. Temporary Cost Advantages

The period of 1996-2000 was characterized by expansionist monetary policy, which resulted in the devaluation of the national currency. Also, the interventionist policy of the government hindered growth of salaries and domestic prices, which resulted in the cost/price advantages of Belarusian products on the CIS market. In 1998 the average salary in Belarus amounted to only 30 % of that in Russia (WB (2005)). The price advantage appears to be fundamental in explaining Belarusian growth in this period. In the situation when the Russian economy experienced stagnation after the financial crisis in 1998, Belarusian low-cost and mediocre goods were very popular among Russian consumers. However, the cost advantage was achieved not through the increase in productivity, but through administrative intervention - restraining wage growth, therefore, had only a short-term effect. It only reduced the incentive of enterprises' management to provide restructuring and modernization. The existence of state programs to support exports (through the state budget or banking sector) has also contributed to export growth and helped to preserved cost advantages for a certain period of time.

However, reliance on cost advantage created a number of potential problems, which became apparent in the subsequent years. Since 2001, after the Russian economy started to recover after the economic recession and began to expand, the purchasing power of the Russian population increased and the demand for Belarusian goods went down. The increased competitive pressure from the Russian market triggered restructuring of a number of Belarusian enterprises during that period. The populist measure of the Belarusian government to increase wages before the presidential elections in 2001 undermined the previous cost advantage. The wage increase was not accompanied by the same rate of increase in productivity thus was an additional cost factor which limited enterprise investments in new product development and technologies (more in the section 6.2 Employment and Productivity).

To conclude, the nature of the macroeconomic policy of the Belarusian government during this period was destabilizing. A high rate of economic growth was achieved at high inflation. Excessive governmental interventions in the economy – price and exchange rate regulations – made it difficult for enterprises to initiate any long-term restructuring. Loose monetary policy with subsidized credits to some sectors of the economy (agriculture, housing, and manufacturing) stimulated aggregate demand and domestic consumption, but resulted in high inflation, negative interest rates and reduction in savings, thus depleting domestic sources for investments. The financial crisis in Russia aggravated the negative impact of the above described factors and was revealed in the drastic economic decline. The poverty rate in 1999 reached a dramatic 46.7 % of the population. To improve the situation the government was forced to undertake stabilizing policies.

8.3 Period 2000-2007 – Short-Term Stabilization and Improvements in Terms of Trade

This period is characterized by changes in the external and domestic conditions. The government began to provide a less market-distortive policy and undertook a number of steps

towards economic stabilization. This had a favorable, but short-term effect on the economic environment.

After the liberalization of the foreign exchange market in 2000 confidence in the national currency improved and investments increased. Nevertheless, crediting of the preferential sectors and price regulation were preserved, which undermined all the previous stabilization measures. The external favorable conditions of trade – high prices on main export commodities (oil products and potash fertilizers) – gave an opportunity to increase revenues from the export operations. The main factors, which stipulated growth during this period were macroeconomic stabilization, stimulation of domestic demand through wage increase, and favorable external terms of trade.

1. Improvement of Macroeconomic Policy

At the end of 1999 the government began to undertake measures to stabilize the economy. In September 2000 a unified exchange rate, that reduced currency operations on the black market, was established. The National Bank of Belarus (NBB), which in June 2000 regained formal independence, started providing a more tight monetary policy. The Central Bank started to pursue a policy of positive interest rates that contributed to slowing down inflation growth. During 2004 a slowdown in inflation was also supported by the cessation of the Central Bank's direct financing of the budget deficit. Such improvements in monetary policy led to growth in money demand and reduced the level of "dollarization". Nevertheless, the rate of dollarization in Belarus remained the highest among neighboring transition economies.

Some steps to improve the fiscal policy were also undertaken: the goal to attain full cost recovery in energy and utility tariffs was set up, and strict payment schedules were introduced. Nevertheless, even though the credit policy of Central Bank was tightened and cross-subsidization was lowered, the government still intervened to secure the credit allocation to preferential sectors.

2. Simulative Wage and Income Policy

During the period of 2000-2007 the government retreated from its policy of wage control and introduced a target of wage growth in the dollar equivalent. It was the key point Alexander Lukashenka's campaign during the presidential elections in 2001. Such policy undermined the previous cost advantages on enterprises. The real wage was growing faster than labor productivity, which had a major impact on the competitiveness of Belarusian enterprises on external markets. At the same time this policy led to increased domestic demand and household consumption, which contributed to general growth in aggregate demand. Growing income led to increasing demand in consumer import, which introduced additional pressure on the trade balance. The government tried to reduce the inflow of consumer imports through the imposition of custom duties and import substitution policy. However this had little effect, since the share of consumer imports in the total amount of imported goods was very low. The largest share of imports consisted of imports of commodities or raw materials, which represented necessary the inputs of Belarusian enterprises.

The rate of saving compared to the rate of consumption became rather low. The government policy of stimulating consumer demand made Belarusians consume more than they really earned.

Table 2.9: GDP by Demand Factors, 1996–2006 (change against the previous year in %)

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%

Source¹²⁰: IPM Research Centre (<http://research.by>), Ministry of Statistics and Analysis of the Republic of Belarus, various publications

Table 2.9 illustrates how increased household consumption contributed to GDP growth in 2001 and subsequent years. Capital investments have also increased since 2003, as a result of stabilizing measures and state support provided in the previous years. The increase of fixed capital investments was also excited by enterprises' need to provide restructuring and modernization in order to sustain competitiveness on external markets.

3. Improvements in Terms of Trade and Export Growth

Belarus has strongly benefited from the improvements in the terms of trade since 2001. These improvements were mainly driven by energy resource price increases: gas, oil and oil products. The timely investment in the refinery industry and higher capacity utilization of oil processing plants and chemical enterprises gave Belarus the opportunity to increase the reach of its exports outside of the CIS, in particular to the EU. The increase of revenues from exports became a significant triggering factor of growth during that period. At the same time authorities did everything possible to preserve the traditional Belarusian niche on the Russian market. During that period the number of barter operations with Russia was reduced. This initiated diversification of Belarusian exports and their growth towards the West.

¹²⁰ "Can the Stronghold Withstand an Economic Attack? The Challenges and Prospects of the Belarusian Economy in the Near Future", Minkov Y., 2007

8.4 The Quality of Belarusian Statistics

There are a lot of reasons why Belarusian statistical data can be considered unreliable. The descriptive scope of industrial output indicators, inflation, and GDP growth is influenced by a number of factors.

First of all, suspension of market reforms led to reinstalling the Soviet administrative style of governance. Since 1996 the Ministry of Economics of Belarus has been developing five-year plans of “socio-economic development” of the country, where main strategic sectors are defined and targets of main economic indicators are set up. The main planned indicators are annual output production, inflation rate, GDP growth, and state budget deficit. Under this system all ministries and enterprises concerned are responsible for the delivery of the targets to the President. During the existence of the Soviet Union planned targets pushed enterprise management to overestimate and exaggerate production output. The same thing is happening in Belarus, thus leading to distortion of the whole statistics of production. In particular, there is a strong temptation “to correct” economic information (especially inflation) and to represent the best “achievements” on the eve of important political events: referendums or elections.

The Russian economist G. Khanin, who studied the real performance of the Soviet economy and reliability of its statistics, named the main factors that lead to distortion of the economic information: first, rapid renewal of enterprise production and second – sharp changes in price level. During different periods of time both of these factors were present in Belarus. The change of production assortment is connected not only to market changes, but also to the inner economic policy of price regulation. The development of new products gives an opportunity to escape from such regulation. The second factor is also present in Belarus, as the average tempo of price increase of industrial production in 1996-2003 was 90 % a year¹²¹.

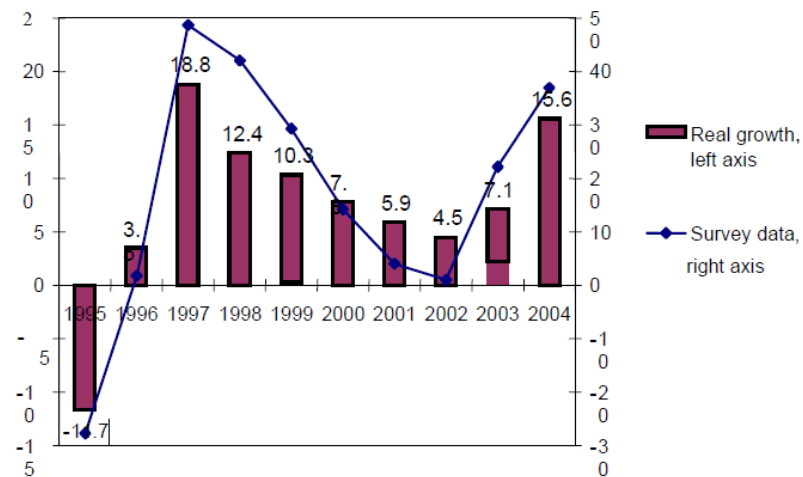
International financial institutions (IMF, WB) have criticized the statistical methods of output and GDP growth measurement used by the Ministry of Statistics of Belarus, saying that they do not correspond to international standards. Substantial improvement in regard to methodology has been made in recent years. Nevertheless, the problem of the reliability of data which comes to Statistical institute still remains.

Belarusian and international analysts have made several attempts to introduce alternative measurements of economic growth in the course of Belarusian independence. Although these measurements cannot be considered as an alternative to the current economic information, they can be useful in spotting the main economic trends in the country. There is an alternative dataset for the Belarusian economy in the World Bank which is based on the quarterly survey of business conditions done by the Research Institute of the Belarusian Ministry of Economy since April 1994 (WB(2005)). This survey consists of a block of qualitative questions on economic dynamics sent to Belarusian enterprises and related to their economic performance and

¹²¹ “Belarusian Economy: Tendencies of Development and Main Challenged/ Экономика Беларуси: тенденции развития и основные вызовы, Chubrik A. “The problems of Belarusian statistics/ Некоторые проблемы статистики выпуска в Беларуси”, Minsk, 2006

conditions of trade. Comparison of the survey results with the official growth data suggests a high correlation in identified growth trends. While the official growth data are likely to be somewhat biased, these surveys tend to reflect the direction of economic dynamics reasonably well. This means that there are substantial reasons to believe that economic growth in Belarus is real and is not just a “paper phenomenon” generated by statistical manipulation.

Figure 2.10: Trends in Industrial Output according to Official and Survey Data



Source(WB(2005)): Gotovsky and Zheltkov(2004)

9. Characteristics of Macroeconomic Policies

Macroeconomic policy provided by the Belarusian government has never been consistent because it has always intended to reach very contradictory goals. It was used to stimulate economic growth while macroeconomic stability had not yet been reached. As a result the provided macroeconomic policy became the main factor of economic instability. Fiscal and monetary tools were used to control and redistribute capital resources to economic sectors and households, but not to maintain economic stability and prosperity in general.

9.1 Monetary Policy

As soon as the government imposed control over the economy, instruments of monetary policy were used not to ensure economic stability, but to allocate capital resources instead. Compared to other transition economies the Belarusian financial sector is very shallow. A stock market has not been created yet and financial intermediates are underdeveloped. The activity of the financial sector is limited to the banking sector, which has also become a tool of government redistribution policy.

Banking sector

Though the National Bank of Belarus (NBB) formally enjoys independence, it is actually subordinated to the President and Council of Ministers. The Belarusian banking system is represented by six large banks, which in 1996 were officially defined as the state's agents for servicing priority state socio-economic projects and government debt. Thus, formerly state-owned specialized banks Agroprombank, Promstroibank, Vneshekonombank, and Belarusbank and two universal banks (Priorbank and Belbusinessbank) still dominate the banking system. These former state-owned specialized banks mainly lend to the agricultural sector, the industrial sector, and trading companies, respectively. These 'system forming' banks control over 90 % of total assets, 90 % of enterprise lending, almost 100 % of lending to households, and their capital accounts for 77 % of total banking capital¹²².

The largest non-state owned bank is 'Belarusbank'. Its assets amounted to about USD 9.8 bln – 40 % of the entire Belarusian banking system (for July 2008), comprising USD 24.5 bln. Another 35 % of the assets were kept by the three state-run banks: Belagroprombank, Belpromstroybank and Belinvestbank¹²³. The second group which possesses 10.4 % of the assets of the Belarusian banking system is represented by Russian banks or joint-venture banks with major Russian capital – Belrosbank, Moscow-Minsk Bank, Belgazprombank, VTB Bank and Belvneshekonombank. The third market share of the banking sector (9 %) belongs to Priorbank,

¹²² "Continuity over change: Belarus, Financial Repression and Reintegration with Russia", Korosteleva, J. A. 2004.

¹²³ <http://belarus.bel.biz/content/view/118/18/>

which is a member of the Austrian Raiffeisen Bank Group. The other 20 acting Belarusian banks share about 5 % of assets amongst themselves¹²⁴.

The Belarusian banking system was founded on the base of the Soviet banking system, through privatization of former specialized state-owned banks and the emergence of new private banks. The atmosphere of the 1990s was favorable for development of the financial sector, even despite the lack of proper market regulation mechanisms. However, starting in 1995 the gradual renationalization of banks and tightening of administrative control over the whole banking sector began. The first signals of the taking of the banking sector into state hands came in 1995 – when the state-owned National Savings Bank was merged with commercial Belarusbank, which had a bad loan portfolio. It can be considered that the bank was saved by the state, but the motivation was actually different. Soon Belarusbank together with other banks was incorporated into the government soft loan policy. The re-nationalization of banks proceeded with Presidential decree from 1996 ‘On measures on Regulation of Banking Sector of the Republic of Belarus.’ It approved the list of banks servicing the state’s programs. Moreover it envisaged the measures to be undertaken by the government to increase its share and the share of state-owned enterprises in the statutory funds of the banks¹²⁵. The process of renationalization of banks hadn’t been motivated by the attempt to save them from bankruptcy but to take control over financial sector.

Almost for the whole period of independence, for Belarus was characteristic continuous increase of money supply, pressure on devaluation of national currency and inflation. There are described the main features of government monetary policy below.

Expansionist Monetary Policy

With the exception of some periods of time the Belarusian government provided expansions monetary policy. It resulted in a continuous increase of broad money supply. Only two periods of relative macroeconomic stability could be identified in Belarusian history - **January-October of 1995** and the **first quarter of 2000**, when money supply increase decelerated. It was a result of implemented anti-inflation policy. Through the other periods money supply continued to increase. It led to the devaluation of the national currency and inflation. **August - October 1995** was the only period, when nominal money supply had increased only by 3.5 %. Thus, the national currency stabilized and inflation decreased (Rusakevich I., 2002)¹²⁶. It was a result of the standard measures of tight monetary policy, armed at suppressing hyperinflation. The supplementary effect of these measures was the stabilization of the national currency in 1995.

However, the period of relative stability (1995-1996) was over soon, when presidential decree on preferential crediting of housing construction and the agriculture sector was introduced in

¹²⁴ Ibis.

¹²⁵ “The Belarusian Case of Transition: Whither Financial Repression?” Korosteleva J. and Lawson C., University of Bath, 2005

¹²⁶ “Belarusian Economy: From Market to Plan/ Белорусская экономика: от рынка к плану: Monetary policy/ Монетарная политика в Республике Беларусь”, Rusakevich I., 2002

1996. From then on the Belarusian economy was administrated according to five-year plans, where the government defined “the main directions of socio-economic development”. The program also included preferential sectors, which require state support – agriculture, housing construction and export. Target economic indicators were also introduced in every annual program of economic development. Ministers, industrial concerns and even private firms were obligated to reach the targets. The main planned indicators were output production growth, price increase or minimum required profit margin. They were connected to targets of GDP growth, inflation and budget deficit. Penalties and sanctions for not achieving planned targets was ordinary practice in already post-Soviet Belarus.

To reach the target goals, the government actively used the administrative apparatus to stimulate economic growth. Credit policy was actively used by the government to redistribute capital resources and stimulate production. Credit resources were concentrated mainly in preferential sectors such as agriculture, household construction and industry. It seems that the Belarusian government did even consider the scale of the economic distortion of such policy. The first worrisome signals came after the financial crisis in Russia in 1998. The rate of monetization reached its lowest level in 1999 – 6 % of the GDP.

The main tools of implemented state monetary policy were *state redistribution of credit resources, administrative regulation of prices and regulation of exchange rates*.

1. State Redistribution of Credit Resources

A state program crediting housing construction was started in 1996. Together with the agricultural sector it became a sector of extensive state support. The result of highly crediting these two sectors was the acceleration in the money supply, devaluation of the national currency and increased inflation. The measures to stabilize the economy at the end of 1999 were not consistent. Even after the reduction in the number of quasi-fiscal operations the preferential crediting of agriculture and housing construction remained.

Money supply increase in Belarus can be characterized by seasonal fluctuations, which coincide with economic activity in the agricultural sector. A large portion of credits is usually granted to agriculture in spring (for sowing) and in August (for harvesting). Correspondingly the money supply was increasing during this period of time. At the end of the year the National Bank provided operations to withdraw free money from circulation and money supply was contracting.

The volumes and rates on preferential credits were set up by presidential decrees or resolutions of Council of Ministers. The main provider of state macroeconomic policy the National Bank of Belarus (NBB) was obligated to fulfill the instructions. The credits were granted by NBB to preferential sectors according to the following scheme (Rusakevich, I., 2002):

1. Through high interest rates NBB attracted bank deposits, and then through group of separate banks directed it to the agricultural sector (or other sectors). To this schema

there was also added Ministry of Finances. Then the credit channel was the following: National bank – Ministry of Finances – commercial banks – ‘household construction and agricultural sectors’.

2. NBB gave emission credits to banks (mainly to Belarusbanks and Agroprombank) to finance agriculture and other preferential sectors. Then through high refinancing rates NBB attracted bank deposits to withdraw free money from circulation.

The result of such credit policy was the quasi-fiscal financing of preferential sectors. Because all credit operations were provided through NBB, state budget accountancy declared a very low state deficit. Taking into account credits granted by NBB to the government it is be clear that the actual deficit was much larger than it was introduced in state accountancy.

The other characteristics of NBB credit policy was the existence of a multiple refinancing rate, similar to the existence of a multiple exchange rate (for more see below). Although the multiplicity of the exchange rate was canceled at the end of 1999, the multiplicity of refinancing rate is still present. The “declared” refinancing interest rate differed from interest rates on credits granted to commercial banks to finance state programs tenfold. The real refinancing interest rate represented a combination of all interest rates existing at the NBB (Rusakevich, I., 2002):

1. Preferential NBB refinancing interest rates were granted for housing construction programs. The rate didn’t exceed one tenth of the “declared” refinancing rate. While the prices increased by 2.8 times during 1998, the interest rate of housing construction credits was only 4 % over 40 years.
2. Preferential credits rates granted to the agricultural sector. The rate of such credits was half of “official” refinancing rate, during 1997-1999.
3. The “officially declared” refinancing rate. During 1998-1999 the government received credits from NBB to the cover budget deficit on the official refinancing interest rate.
4. The market refinancing interest rates, used for short-term financing (Lombard, reserve credits). Those interest rates always exceeded the “declared” rate by twice as much. These refinancing rates were used to compensate for the existence of preferential refinancing rates.

During the whole period of 1995-2000 the real refinancing rate of NBB was negative. Even the “declared” refinancing rate in some periods of time was lower than real price increases.

Soft monetary policy provided by government was destabilizing in its nature and led to the acceleration of inflation and devaluation of the national currency. The financial crisis in Russia was not the main reason for economic instability in Belarus. It was only a catalyst, which disclosed the drastic effects of government soft monetary policy. Therefore at the end of 1999 the Belarusian government was forced to undertake stabilizing measures. The result of tighter monetary policy was a slowdown of inflation increase, stabilization of the national currency and unification of the foreign exchange market. Unfortunately however, preferential crediting of social programs and the agricultural sector remained. The consequence of the preferential crediting of agriculture was the deterioration of both banking system and the agricultural sector. For banks it was much easier to get cheap credit from the National Bank than to attract more

expensive resources of private individuals on deposits. The government reached its “social goals” to support preferential sectors, but at the expense of inflation that spread over the whole economy.

2. Administrative Regulation of Prices

Although most prices were liberalized in the early 1990s, price regulation of some commodities remained. The intensification of administrative control resulted in stronger price regulations since 1996. Prices of “socially important” goods – food and utilities were controlled first and foremost. In 1998-2000 about 70 % of consumer prices were regulated. The law “On pricing”, adopted on 10 May 1999, directed price regulation and allowed the government to use such measures as: fixing prices, setting price ceilings, setting compulsory trade mark-ups, setting maximum rates of return, determining price-calculation procedures, and declaring prices¹²⁷. The list of “socially important products” declined with the start of stabilization policy at the end of 1999 and reached a minimum at the end of 2003. But in 2004 the list was expanded again and became even longer than it had been before (Table 2.10).

The other legislative act, “On counteracting monopolizing activities and promoting competition”, allowed the government to interfere in pricing of enterprises which are believed to be monopolies on the national or on local markets. Government officials are persuaded that market competitiveness can be also reached through administrative regulation. Nevertheless, in fact state monopolies are highly protected by government from domestic and foreign competition.

The other method of limiting prices was setting up maximum rates for price increases. The Council of Ministers defined maximum price increase rates based on the planned inflation rate. No firm is allowed to increase their prices above this level (for instance, 2 % a month). Today the government only sets so called ‘forecasted’ inflation rates, but firms are inclined not to surpass this rate anyway¹²⁸.

Price regulation has a vast variety of negative effects. First of all, the regulation of consumer prices neglects the descriptive abilities of the CPI index which measures inflation. Secondly, the regulation of food prices put home producers into a position where it is very difficult for them to reach profitability.

A Price control is intended to suppress inflation increases, but the achievements of that goal are highly questionable.

Table 2.10: Price Regulation in Belarus, 2000-2004

¹²⁷ “Is Price Regulation the Proper Way to Achieve Food Security in Belarus?”, IPM&GET, 2004

¹²⁸ “Is Price Regulation the Proper Way to Achieve Food Security in Belarus?”, IPM& GET, 2004

	2000	2001	2002	2003	2004
Number of positions (goods and services) for which prices are regulated (either fixed or ceiling prices are used)	66	66	62	59	61
Share of goods/services with regulated prices in CPI basket, %	27	25	24	21	24
Number of positions (goods and services) for which margins are regulated (either profitability or trade margin is restricted)	8	7	7	8	8
Number of enterprises which are on the list of monopolists/ and which require government clearance for their price increases	312	300	265	205	197
Number of export commodities for which minimum export prices are used	12	12	12	10	11

Source (WB(2005): Ministry of Economics

3. The Exchange Rate Policy

There are two possible ways which a country can chose to reach macroeconomic stability – to focus on external stability (i.e the exchange rate) or internal stability (i.e prices). Belarusian and foreign experts agree in opinion that, because Belarus is a small open economy, it is much better for it to focus on external stability¹²⁹. The Belarusian government for many years also tried to reach external stability through regulation of the exchange rate regime. Nevertheless, its policy was often ambiguous and had a rather un-stabilizing effect on the economy.

Through the 1990s the exchange policy could be divided into several periods: 1) 1991-1993, the phase of multiple exchange rate policy, 2) 1994 - November 1995 – period of unitary exchange rate (market and official rates were identical), 3) November 1995 - November 1999 - the second phase of **multiple exchange rate policy**, 4) 2000-2008 – relative stability and unity of the exchange rate.

During the first period monetary policy in Belarus was totally dependent on Russian Central bank policy. After Belarus exited the ruble zone and imposed its national currency it started its own stabilizing monetary policy. The stabilizing program was based first on floating, and then on a fixed exchange rate.

To the end of 1995 soft credit policy exerted pressure on devaluation of the national currency. But instead to devaluate the ruble, the government began to set up the exchange rate administratively. The “declared” exchange rate was on average 60 % lower than the market exchange rate. In 1998 the gap between official and market exchange rates reached its maximum - 200 %. Through the period of 1996-2000 six exchange rates could be observed: the official NBB rate for tax and accounting purposes; for the obligatory surrender of 30-40 % of exporters’ earnings (corresponding to the stock market exchange rate (main session)); the stock market exchange rate (additional session) for the obligatory surrender of an additional 10 % of exporters’ earnings; the non-stock market exchange rate or commercial rate for inter-bank settlements; the non-resident market exchange rate (quotations of the Central Bank of Russia),

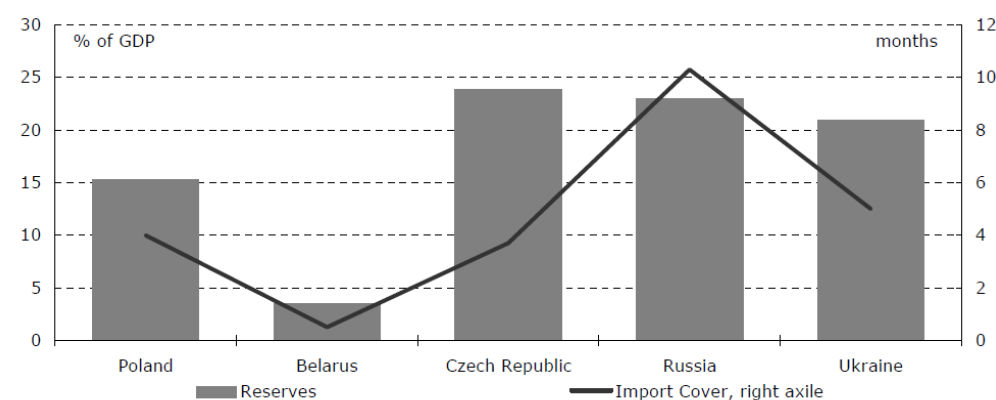
¹²⁹ “Monetary and Exchange Rate Policy in Belarus: Analysis and Recommendations”, IPM&GET, 2004

the exchange rate ‘set’ by commercial Belarusian banks for cash currency sale to individuals; the black market rate¹³⁰.

Such policy led to expansion of the shadow market foreign currency and further dollarization. The official statistics declared a decrease in the dollarization rate in 1998. But it occurred only because the “declared” exchange rate was used, which differed from the market rate tenfold. Authorities began to provide stabilizing policies aimed at making a uniform exchange rate at the end of 1999. The official exchange rate was devaluated to the market level in 2000.

Since 2000 the government has been using currency anchor to reach external stability. Actually the Belarusian ruble was regulated within crawling peg. To achieve external stability government has to intervene on the foreign exchange market. The scope of such interventions is determined by the amount of foreign currency reserves or the rate of foreign trade. The amount of foreign currency reserved in Belarus, compared with other transition countries is very low (see Figure 2.11). Till 2008 Belarusian ruble was anchored to US dollar. The gas crisis occurred at the end of 2006 had seriously threatened the stability of the Belarusian currency and the foreign exchange market in general. The trade balance deficit began to increase steadily. Belarusian export contracted and was not able to level the trade balance deficit. The only salvation was to increase foreign borrowing or attract FDI inflow. Belarus’ international image was seriously damaged by government interventionist policies and the unfavorable business environment, thus there was no chance to rely on FDI inflow in the near future. The Belarusian government could only rely on foreign borrowing through Belarusian banks and interstate channels.

Figure 2.11: Foreign Exchange Reserves for Selected Countries, 2006



Source¹³¹: EBRD

¹³⁰ “Exporters by surrendering their 30-40 % of earning at the official exchange rate were paying an additional 15 % tax. For preferable importers there was used the other exchange rate. 15 % = .40*.60/1.60 (Nuti, 1999, p.8).”- “The Belarusian Case of Transition: Whither Financial Repression? Korosteleva J. and Lawson C., University of Bath, 2005

¹³¹ “Energy Shocks and Macroeconomic Management: Policy Options for Belarus”, IPM&GET, 2007

The Outcomes of the Realized Monetary Policy

The outcomes of state monetary policy are destabilization of banking system and the economy as a whole. Preferable crediting of chosen economic sectors led to a lack of liquidity in banks – most credits granted to agriculture (and industry as well) have never been repaid. The preservation of soft monetary policy led to erosion of the whole economic system. Further prolongation of market reforms would lead to irreversible consequences in the future. The apparent stability of the Belarusian economic model was reached by methods that were anti-stabilizing in nature. Belarus appears to be unsecure under external shocks such as the global crisis, which reveals the real condition of the Belarusian untransformed economy.

9.2 Fiscal Policy

Similar to other post-socialistic countries, Belarus inherited a large state government. But while other countries provided decentralization of power and contraction of the state budget, a totally different process occurred in Belarus. Strengthening of administrative control over the economy led to centralization of budget revenues and expenditures.

Preservation of soft budget constraints on enterprises, quasi-fiscal financing of preferential sectors and complicity of tax legislation lower the transparency of state fiscal policy. During the initial stage of transition a strong capacity for revenue collection helped to smooth the initial output decline and ensure high social expenditures. But instead of lessening government revenues and expenditures, they only expanded (see Table 2.11). About half of the GDP (49.57 %) was redistributed by the state budget in 2007. The high level of state spending has always played a central role in the Belarusian economic model. The high capacity of the state to redistribute budget resources became one of the factors which boosted domestic demand since 2000, when wages increased substantially. Increasing domestic demand was one of the significant composition parts of GDP growth in the last ten years.

State Budget

The state budget incorporates the national and local budgets. There are also a number of social and extra budgetary funds: the Social Protection Fund, the Employment Fund, the Road Maintenance Fund, the State Foreign Exchange Fund, the Price Regulation Fund, the Fund for Support of the Agriculture Producers, the Chernobyl Fund and the most important Presidential Fund. It is difficult to follow the expenditures and costs of extra budgetary funds, especially of the Presidential Fund. Thus, the reliability of budget statistics is highly questionable.

Most transforming countries suffered large budget deficits caused by economic recession, low tax payment discipline and high budget expenditures. To reduce budget deficit governments in transition countries privatized of state-owned enterprises and tried to attract FDI into the economy. In contrast to other transition countries, Belarus declared a low state budget deficit for many years. But the result was reached only due to the exclusion of quasi-fiscal operations from

budget accountancy. While the budget deficit was declared low, the government annually received credits from National Bank to cover the deficit.

Continuous economic decline and deepening of the structural crisis induced by expansionist monetary policy and vast quasi-budget operations, forced government to undertake stabilizing measures and revise budget policy starting at the end of 1999. A number of steps towards consolidation of budget accountancy and its adjustment in accordance with international standards were implemented. In 2004 the National Bank ceased the direct financing of the state deficit. Two off-budget funds were incorporated into the state budget – the Social Protection Fund in 2004 and the Innovation Fund in 2005. The direct financing of preferential sectors was reduced and cost recovery in the energy sector improved.

During 2000-2004 the share of state support via tax benefits was also reduced. It was partially due to the pressure from Russia in the course of negotiations on equalizing conditions for business in the two countries. This resulted in a gradual reduction in the amount of individual tax exemptions and benefits (from 2.1 % of the GDP in 2000 to 0.5 % of the GDP in 2004) and the replacement of the exemptions and benefits with the restructuring of tax credits and tax arrears (WB (2005)).

But all those adjustments of fiscal policy only had an interim effect. Soft budget constraints on enterprises were preserved and preferential financing of agriculture was still implemented through budget or banks. Despite proclamations from government officials that the size of the state budget would be reduced, it has only expanded lately.

Table 2.11: Revenues and Expenditures of State Budget, in % of GDP (1996-2007)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Revenues	26,33	30,76	34,13	34,86	34,82	33,47	32,90	33,24	44,121	48,4	48,42	50,01
Expenditures	28,31	32,75	35,54	37,67	35,43	35,07	33,44	34,58	44,08	49,1	46,2	49,57
Deficit	-1,99	-1,99	-1,41	-2,81	-0,61	-1,61	-0,54	-1,34	0,04	-0,69	2,2	0,44

Notes: since 2004-including Social Protection Fund, since 2005- including innovation funds

Source: IPM data collection

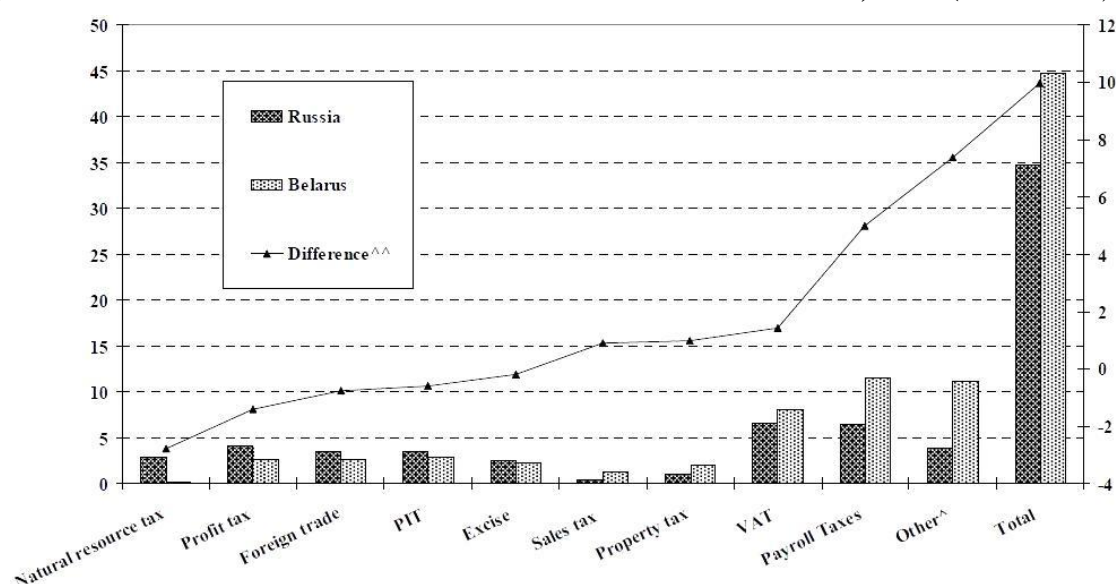
Revenues

The main source of budget revenues are tax revenues from state-owned and private companies and payments to the Social Protection Fund. The Belarusian tax system is one of the most complicated in the post-Soviet region. The extremely high tax burden restrains development of the private sector and harms the business environment in the country in general. The main characteristics of government tax policy are *complexity of the tax system* and *high concentration of tax base*.

• Complexity of the Tax System

In Belarus about 36 different taxes¹³² and other obligatory payments exist, which make up the main source of revenue of state consolidated budget. About 60 % of budget revenues is created by indirect taxes. The fifth of non-tax payments is created by penalties and payments from sanctions (1.9 % of the whole volume of budget revenues)¹³³. The higher tax burden, compared to neighboring countries, undermines competitiveness of Belarusian enterprises both on domestic and foreign markets. For example, the total explicit tax burden in Belarus amounted to 44.7 % of the GDP compared to 34.7 % in Russia (in 2003) (see Figure 2.12) (WB (2005)). The main difference is created by two groups of taxes: payroll (income) taxes and “the other taxes” (indirect taxes). Indirect taxes include turnover taxes and taxes to extra budgetary funds. Thus, the highest share of tax revenues in Belarus comes from indirect taxes, which are known for their distortive effect on incentives in the real sector. Turnover taxes were largely eliminated in most transition countries.

Figure 2.12: Tax Burden in Belarus and in the Russian Federation, 2003 (% of GDP)



Notes: ^ Includes turnover taxes and EBRs. ^^Between Belarus and Russia

Source (WB (2005)): WB Staff calculations based on data from the MoFs (Republic of Belarus and Russian Federation)

In Belarus a tough tax policy with high taxation and penalties for the slightest violation exists together with tax allowances and subsidized operations. Each body of state management has a wide range of powers to change the tax burden for any group of companies. The tax burden is dispersed unevenly among economic players. It makes fiscal policy extremely inefficient and non-transparent.

¹³² Data for 2002

¹³³ “Belarus: a Choice of Direction/ Беларусь: выбор пути”, p. 159, IPM, Minsk, 2003,

Tax policy has to be reformed in the first place to liquidate disproportions of the economic system and ensure development of the private sector. In turn, it would lead to increased competitiveness on the domestic market and create a better business environment for FDI inflow.

Several attempts to liberalize the economy and reduce the extensive tax burden have been made by the government since 2007. For example, a number of obligatory payment were reduced and the income tax was lowered to 12 % for all economic players¹³⁴. But all those reforms were introduced under the pressure of external factors and were not a part of the complex program of economic reform. Thus, reforms had little impact on the overall business environment.

- **The Tax Base is Concentrated and Dependent on Export**

The Belarusian state budget is dependent on tax payments of a limited number of large companies. This makes the tax base too concentrated. A fourth of all tax revenue comes from 30 enterprises (see Appendix 2- the Top 20 of major tax payers). Among the largest tax payers are oil refinery companies, electric power plants and distillery production companies. 30 large companies proceeded 35.95 % of total budget revenues in 2006 and 42 % in 2007¹³⁵. In previous years concentration of tax base was much lower. For example, the one hundred largest taxpayers contributed only 27 % of total tax proceeds in 2003 (See Table 2.12). The range and list of top companies, which contribute to the budget most, change over time.

Table 2.12: Tax Concentration in Belarus: Shares of 10, 50 and 100 Taxpayers in Total Proceeds of Consolidates Budget, 1999-2003 (%)

	19 99	20 00	20 01	20 02	20 03
10	13. 6	13. 3	14. 1	13. 4	12. 5
50	24. 6	25. 2	24. 9	24. 5	22. 6
100	29. 4	30. 1	29. 6	29. 2	27

Source (WB(2005)): Ministry for Taxes and Contribution

¹³⁴ During 2008, which was characterized by advance in reforms, a number of payments were reduces and the income tax was lowered to 12 % for all economic players,
http://naviny.by/rubrics/finance/2008/12/31/ic_news_114_303958/

¹³⁵ “Economics of Belarus: Research, Forecast, Monitoring / Экономика Беларуси. Исследования, прогнозы, мониторинг”, IPM report 2007

Both budget revenues and foreign exchange proceeds depend heavily on the operations of a limited number of exporters. In turn, the exporters are highly dependent on business conditions at the single or limited number of external markets.

Expenditures

Belarusian fiscal policy is characterized by strong government capacity for revenue collection. But high centralization of budget resources conditions lowers the efficiency of state expenditures. The largest part of budget resources is used to support households and producers.

The state supports **households** through subsidization of transportation, utilities and social services (education, healthcare and pension system). Subsidies to households amounted to an additional 1.9 % of the GDP in 2004. It declined from 2.9 % of the GDP in 1999, owing to the increase in cost recovery in these sectors after the process of stabilization started. The housing credits on average amounted to about 1 % of the GDP in 2000-2004 (WB (2005)).

The real sector or **producers** are supported through state budgetary programs, extra budgetary funds and the banking system. The main forms of state support of state-owned and privileged private companies are the assignment of individual subsidies, tax privileges, payment delays, preferences in custom duties and VAT. The government also guarantees commercial credits granted to state-owned or commercial enterprises and collective farms. Agriculture remains one of the most subsidized sectors in the Belarusian economy. The share of budget expenditures on agriculture during 1998-2002 reached 3.3 % of GDP on average.

State support in the amount of BYR 1.9 trillion was provided to 2651 enterprises in the real sector in 2004. Also 74 different presidential and governmental decisions on granting state support were issued (a reduction from 133 decisions in 2003). In 2001-04, the estimated annual net subsidy amounted on average to 6 % of the GDP (WB (2005)). The state programs usually favor large state-owned enterprises, which undermines fair competitiveness and limits entry possibilities for new firms.

Budget resources were also used for annual bank recapitalization. Direct lending to preferential sectors threatens the liquidity of commercial and state banks because a large number of direct credits are never repaid (especially in agriculture), thus recapitalization helps banks deal with the financial consequences of such lending.

Budget Deficit and Its Financing

The declared rate of the state budget deficit remained low for many years. If we take into account quasi-fiscal operations, the rate of the state budget deficit would increase substantially. (Table 2.13)

Table 2.13: The deficit of State Budget Including Quasi-Fiscal Operations

	1996	1997	1998	1999	2000
Official data	-1.9	-2.2	-1.4	-2.9	-0.6
Corrected data(with quasi-fiscal operations)	-3.4	-5.8	-5.0	-4.2	-0.9
Difference	1.5	3.6	3.6	1.3	0.3

Source¹³⁶: Chubrik "Statistical review" Kalechic(2001), Ministry of Statistics and Analysis of Belarus, the others estimates on the basis of Ministry of Finance of Belarusian Republic.

Since international organizations have almost completely withdrawn from activities in Belarus, all financing of the budget deficit comes from the domestic banking system, where credits from the National Bank are the main source of financing. Thus, until 2004 the budget deficit was financed by central bank credit (about 2.5 % of the GDP) at an interest rate below market level. Combined with other substantial off-budget (quasi-fiscal) spending directed through the banking sector, the implied monetary expansion has fuelled persistently high inflation in Belarus. This inflation has also served to reduce the real value of government debt¹³⁷.

The main sources of budget deficit financing in recent years have been the sale of government securities, government deposits and external resources. The major provider of intergovernmental credits for Belarus is Russia. Belarusian external debt had increased significantly in recent years, after Russia imposed higher prices on gas and a custom duty on oil delivery to Belarus. At the beginning of 2008 the external debt of Belarus reached 2 336.7 mil. USD, while at the beginning of 2006 it was only 783.8 mil. USD¹³⁸.

The Outcomes of Realized Fiscal Policy

The position of the state budget is highly unstable. Local budgets are dependent on state donations up to 90 %. The complexity of tax laws and a too high tax burden restrain the development of the private sector and thus limit the possibilities for higher tax revenues. The present tax system only creates incentives for skimming.

Dependence of the state budget on a number of large tax payers, mainly exporters make it especially vulnerable to external shocks. The too high share of resource redistribution lowers the efficiency and transparency of budget management.

The most problematic sectors, which require immediate reform are – the pension security system, health care and education. Negative demographic trends represent the main threat to budget policy in the next ten years. Existing demographic forecasts show a significant increase in

¹³⁶ The data estimating accrual budget deficit or hidden deficit differ in various sources.

¹³⁷ "Strengthening Budget Management", WB (2003)

¹³⁸ <http://www.neg.by/news/4084.html> , <http://www.minfin.gov.by/icooperation/debt/>

the %age of the elderly population from 21 % to 28 % between 1995 and 2025 and a deterioration of the ratio of the working age population to the elderly from 2.7:1 in 1995 to 2:1 in 2020 and to around 1.5:1 in 2040 (WB (2005)). Thus, the tension in this sector is continuously increasing.

The low competitiveness of the domestic market stimulates high emigration of young specialists abroad (brain drain). Recent education reforms have not improved the quality of education, but instead led only to deterioration of the existing educational base.

10. Inevitability of Market Transformation in Belarus

The issue of market transformation in Belarus has exclusively become a task of the government's political will. Economic policy, realized by government, hadn't been based on consistent long-term strategy that stipulated increase of competitiveness of Belarusian economy. The economy had been placed under the control of the administrative apparatus, whose only interest was to preserve the stability of the semi-authoritarian political system. It was possible to defer market reforms as long as "special relations" with Russia supplied Belarus with a range of benefits - mainly cheap energy resources and free access to the Russian market. Favorable external conditions, Russian economic and political support, and inherited industrial potential were the main factors ensuring the relative stability of Belarusian economic system. However, economic competitiveness is presently determined by investments in innovations and new technologies, rather than the ability to redistribute resources by administrative methods.

The Belarusian government has managed to persevere under a former soviet industrial and technological base, but wasn't able to ensure investments in new technologies to exploit its inherited potential. Thus, the transformation of the Belarusian economy became exclusively dependent on political will and good relations with Russia. The influence of internal factors, such as social protests or lobbying of political groups, was almost eliminated and couldn't stimulate market reforms in Belarus.

As relations with Russia began to change, it became evident that Belarus can't survive without complex reform throughout the economic system. A sharp rise in oil and gas prices reveals the most pressing problems of unreformed economy. However, Belarusian government was aware that complex market reformation would inevitably undermine present political system as would reduce administrative control over the economy. Thus, reluctant to lose power, the state authority initiated only partial reforms, which had little effect on improving the economic situation and competitiveness.

10.1 The Impact of Price Hike of Energy Resources on Belarusian Economy

In contrast to other post-socialistic countries after the dissolution of the Soviet Union, Belarus managed to keep prices for energy resources low for quite a long time. Gas price for Belarus was only 46.68 USD (per 1000 cubic meters) in 2006, while Baltic States paid 120-125 USD (for 1000 cubic meters). The average price for the EU was 250 USD in 2006¹³⁹.

Using these prices as reference points, the increase in preferential prices in Belarus in 2006 alone is estimated between 6% and 11% of the GDP. In general, CIS countries received Russian energy resources for lower prices than the rest of the world. Taking into account specifics of Russian foreign policy, lower prices on energy resources could be considered an exchange for political loyalty in the post-soviet region. Table 2.14 illustrates the diversification of gas prices for three CIS countries and their further increase.

Table 2.14¹⁴⁰: Gas Prices Paid by Ukraine, Moldova and Belarus in 2006-2007, in USD

	2005	2006	2007
Ukraine	50	95	130
Moldova	80	110-160	170
Belarus	47	47	100

Russian energy policy has changed with the accession to power of the new president. The attitude towards former Soviet Union states became more pragmatic and prices for energy resources began to increase gradually for all CIS countries.

Belarus, which managed to exchange integration rhetoric for cheap Russian energy recourses for quite a long time, has also met with the unpleasant reality of price increase. The beginning of 2007 was the next stage in the change towards market prices for CIS countries, and its most characteristic event was the Belarusian- Russian gas and oil crisis. According to Gazprom's initial declarations, gas prices for Belarus had to increase to 200 USD. But after lengthy negotiations and the Russians' threat to withhold gas supplies, a new contract was signed on December 31, 2006, under which the price rose to 100 USD. A new schedule of further price increases was established lasting until 2011, when the price is to be equal to the "European price"¹⁴¹. Two countries had also negotiated that Belarus will sell Russia 50% of its shares in Beltransgaz for 2,500 mil USD over 4 years.

¹³⁹ In 2008 the average price for gas in Europe reached 470 USD per 1000 cubic meters.

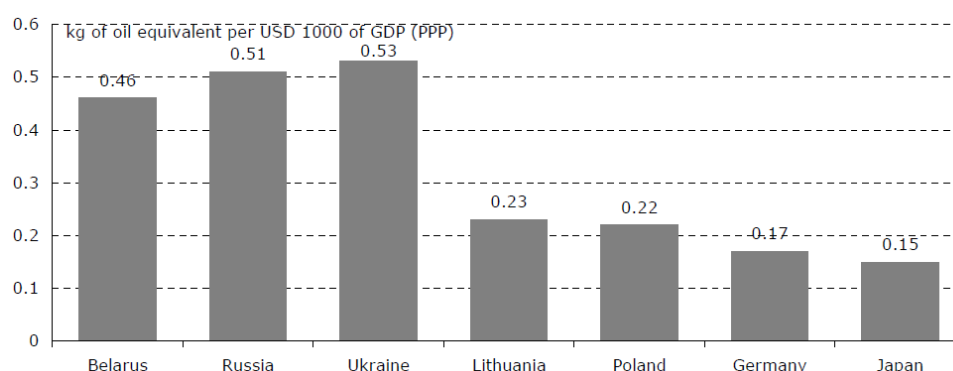
¹⁴⁰ The Table is from "Energy Game: Ukraine, Moldova and Belarus between the EU and Russia", Stefan Batory foundation research paper, 2007

¹⁴¹ "Energy Game: Ukraine, Moldova and Belarus between the EU and Russia", Stefan Batory Foundation, 2007

Belarus is a transit country, thus to compensate the price hike of gas the government had also increased price for transit of Russian gas. The overall gas transit through the country amounted to 41 bcm in 2006, from which 14 bmc was transited through Beltransgaz and the remaining 27 bcm went through Russian Yamal-Europe pipeline. While transit price through the Beltransgaz in 2006 amounted to USD 0.75 per tcm of gas per 100km, in 2007 it increased to USD 1.45. The price of transit through Yamal-Europe was USD 0.38 per tcm per 100 km in 2006, and became USD 0.43 in 2007¹⁴².

Figure 2.13 represents the energy intensity of selected countries. It is evident that post-soviet countries (Russia, Belarus and Ukraine) have extremely high energy intensity caused by inherited industrial structure, which hadn't been substantially reformed (in contrast to Baltic States). Gas comprises 84.9 % of Belarusian energy balance¹⁴³.

Figure 2.13: Energy Intensity for Selected Countries, 2005



Source¹⁴⁴: IEA, Energy Statistics

The increase of gas prices was not the only challenge. A more painful consequence arose from imposition of custom duty on crude oil imported from Russia (at the rate of 52.7 USD per ton) and custom duty collected on oil products exported by Belarus to external markets (at the rate of 108 USD). Until the end of 2006, Belarus bought crude oil at an inner Russian price and then re-exported oil products to the western and CIS countries. Taken together, preferential prices for gas and the absence of export duties on oil products have allowed Belarus to save at least about 6 million USD, or about 13.5% of the GDP per annum¹⁴⁵.

After the imposition of custom duty, Belarusian oil refineries experienced a decrease in profits, which automatically led to lower revenues to the state budget. Trying to raise the efficiency of Belarusian refineries, the government first reduced excise on oil products. But the effect was opposite - import of oil products from Russia had increased and the government was

¹⁴² "Bleeding Belarus: Economic Outlook after the Energy Conflict with Russia", BISS, 2007

¹⁴³ http://naviny.by/rubrics/economic/2008/10/15/ic_news_113_299891/

¹⁴⁴ "Energy Shocks and Macroeconomic Management: Policy Options for Belarus", IMP&GET, 2007

¹⁴⁵ "Can the Stronghold Withstand an Economic Attack? The Challenges and Prospects of the Belarusian Economy in the Near Future", Minkov Y., 2007

forced to raise the excises rate back. The Belarusian government undertook measures to subsidize crude oil suppliers, which hadn't improved the situation particularly.

The total losses of the budget will be USD 77.7 mil or 0.4% of revenues of the general government. The Minister of Finance officially declared the necessity to reduce the budget expenditure by 5%¹⁴⁶. New conditions of energy resources supply had seriously deteriorated the balance of payments. At the end of 2007 the current account deficit was - 4418 mil USD and at the end of 2008 it reached – 5422.4 mil. USD¹⁴⁷.

The negative effect of “energy shock” hasn't become apparent immediately after prices increased. Belarusian government was able to smooth the economic effect of the shock by increasing prices for transit, by sale of the first part of agreed stake of Beltransgas company and negotiation to delay the payment for gas. But in subsequent years when the price of gas would reach the European level, Belarus could deal with far more complicated situations. Thus, reformation of energy sector and the economy in general is the main challenge for Belarus for the next few years.

10.2 Attempts to Reform Energy Sector

Price hike of energy resources forced the Belarusian government to consider the task of energy security more seriously than before. Only “energy shock” was discussed regarding reduction of energy intensity of the economy and diversification of energy resources. In 2007 a new program was prepared for state energy security for the period till 2020, which considered the gradual increase of prices for energy resources for Belarus¹⁴⁸. It was stipulated to diversify used sources of energy; in particular there were announced plans to build three coal stations with power output of 800-850 MW. The document had also stipulated to reduce the share of gas in energy balance from 80% to 60% until 2020. The share of local energy resources used to produce electricity and hitting energy has to reach 30%. The energy output, in terms of GDP, has to be reduced by 31% till 2010 (compared with the 2005) and by 60% till 2010.

The concept of new energy security program also includes the possibility of supplying energy resources from other countries of the world (to diversify suppliers of energy resources). In particular, studies have shown energy resources from Caspian region, Iran and Venezuela. The concept of Black – Baltic Sea union (see Chapter 5- Initial conditions), suggested by the Belarusian Popular Front party in early 1990ies, was taken into consideration by the Belarusian government only after “energy shock” in 2007.

To diversify energy dependence the Belarusian government introduced a decision to build a nuclear power plant. Unfortunately, the decision was made without public discussions. Without

¹⁴⁶ “Bleeding Belarus: Economic Outlook after the Energy Conflict with Russia”, BISS, 2007

¹⁴⁷ <http://www.belstat.gov.by/> Ministry of statistics and analysis of Belarus

¹⁴⁸ <http://news.tut.by/politics/94127.html>

any tender it was soon announced that the nuclear power plant was likely to be built by a Russian company.

Because Belarus lacks the capital resources to realize such huge investment, it is supposed that most likely the government would apply for Russian interstate credit. Thus, instead of reduction of energy dependence on Russia, Belarus would only intensify it. The construction of a nuclear power plant is a political decision which can hardly be justified by economic rationality – agree most independent experts.

10.3 Possibilities for Authoritarian Transformation in Belarus

New conditions of energy resources supply to Belarus disclosed the most pressing problems of Belarusian economic system. The result of low competitiveness in the home market and decreased of export was a sharp increase in import inflow and trade deficit. In conditions of energy shock, demand for foreign currency has sharply increased, with intensified dollarization of Belarusian economy. The only way out was to increase foreign borrowing or FDI inflow. Foreign direct investment is extremely important for enterprise restructuring. It also brings new technologies and management practices to the enterprise. But to attract foreign investments, the Belarusian government must first initiate market reforms to improve the business climate and country's image.

Despite the fact that market transformation has almost been suspended by the Belarusian government, some reforms to increase economic efficiency have been provided. Unfortunately, the economic effect of such reforms was always short term and had little influence on the improvement of the whole system. The government tried to reduce the symptoms, but not to treat the illness of the whole Belarusian economy.

New conditions of supply of Russian energy resources force the government to undertake more decisive steps towards economic reformation, which has led some experts to speak about authoritarian modernization in Belarus¹⁴⁹. The most important reforms were the following:

1. In 2007 Belarus finally received sovereign credit rating from international rating agency Standard & Poor's, which enabled Belarusian banks to receive loans from foreign banks. Thus, Belarus started active foreign borrowing.
2. In the same year the government abolished social benefits for all groups of population and switched to social support of highly vulnerable groups of population.
3. Government announced the intention to reduce state subsidization of industrial and agricultural state-owned enterprises.

¹⁴⁹ "Authoritarian Modernization in Eastern Europe: Belarusian Political System/ Авторитарная модернизация в Восточной Европе: Политическая система Беларуси" Jury Shevcov - <http://www.regnum.ru/news/1030455.html>, Valeriy Karbalevich "Is the Authoritarian Transformation Possible in Belarus" <http://www.buntby.com/by/analytics/2007/sep/17/transfarmacyja/>

4. Since 2007 several state-owned enterprises (“Motovelo” plant, state share of mobile operator “Velcom” and state share of several banks (“Stavneftebank”) have been sold to foreign companies.

A new atmosphere of reforms, with maintenance of tight state control, caused discussions about the possibility of Chinese (or Asian) way of economic transformation in Belarus. Unfortunately, Belarus exists in different internal and external conditions to repeat the Chinese way of economic transformation. Belarus doesn't have such competitive advantage as abundant of cheap labor force. Also, the Belarusian home market is too small and uncompetitive to absorb at least half of produced goods. Moreover, a large number of Belarusian enterprises work exclusively for external markets.

Too an unreasonably high dependence on Russia together with political and economic isolation from European Union forced Belarusian authority to seek for economic partners among countries with similar political regimes (China, Iran, United Arab Emirates, and Venezuela). After Russia increased prices for energy resources, the Belarusian government initiated an ambitious project in Venezuela – by building an oil-extracting plant “PetroVenBel”(joint-stock company). It was anticipated that extracted oil would be sold on local markets, and that Belarus would spend the revenues on oil from closer regions.

The success of such authoritarian transformation in Belarus is rather questionable. The Belarusian economy has entered a phase of systemic crisis and needs complex reformation. A lack of necessary resources needed to maintain stability of a semi-soviet market economy would inevitably lead to reforms in Belarus. A reduction in the overregulation of the business sphere and privatization of state-owned enterprises – are the main reforms, which can seriously improve the state of Belarusian economy.

11. SWOT Analysis of Belarusian Economy

To summarize the previous analysis and draw the complex picture of Belarusian economy, the SWOT analysis is introduced in this part of study.

Strengths <ul style="list-style-type: none"> • large industrial base • unexplored market for foreign firms • high share of educated and skilled labor force • geographical position 	Weaknesses <ul style="list-style-type: none"> • inefficient state management • poor business law • deterioration of the educational system • negative demographic trends • absence of domestic raw materials
Opportunities <ul style="list-style-type: none"> • close cooperation with European union within the Eastern partnership program • Caspian-Baltic- Black sea Union 	Threats <ul style="list-style-type: none"> • high dependence on Russia • world crisis • brain drain

Strengths

- **large industrial base**

Belarus has inherited large industrial base. In case of privatization, Belarusian state-owned enterprises have a great deal of potential for successful development. Maintenance of close economic relations with CIS countries make Belarus especially interesting for those foreign investors who would like to expand on former Soviet Union market.

- **geographical position**

Belarus exists on at the crossroads of important transit ways. Through Belarusian territory lie two important pipelines (“Druzhba” and Jamal-Europe) from Russia to Europe. Belarus also connects Baltic States and countries of Black sea region. The potential for trade and energy resources delivery (from Caspian region) in this direction hasn’t been realized yet.

- **unexplored market for foreign firms**

Belarus represents an unexplored market for large number of foreign firms. Improvement of business environment can stimulate inflow of foreign investments and further economic

expansion. Establishing companies working in communication technologies, internet and computer science would confer additional benefits.

- **high share of educated and skilled labor force**

Compared with other developing countries, Belarus has rather high share of highly educated specialists. Nevertheless, few changes have taken place in Belarusian educational system since soviet times. Thus, Belarusian education has begun to deteriorate with time.

Weaknesses

- **inefficient state management**

The main reason of the structural crisis which Belarus faces today is inefficiency of state management. Preservation of soft budget constraints and state-ownership has only deteriorated competitiveness of Belarusian enterprises in home and external markets. The only way to improve the situation is to decentralize economic power through privatization of state-owned enterprises and development of competitive local business.

- **poor business law**

Government interventionist policy and expansion of administrative control over the economy made business law one of the most complicated and unfavorable among transition economic. Poor protection of property rights is one of the main factors which low the interest of foreign investors in possibility to invest in Belarus. Despite the fact that the “rule of law” was abolished in March 2008, investors still meet with excessively high requirements from state institutions.

- **deterioration of education**

Belarusian education base has changed little from soviet times. Weak international contacts limited the possibilities of Belarusian universities’ ability to participate in world scientific processes. Limited work opportunities force young specialists to immigrate (to Russia, European countries or United States). The quality of business education is too low to prepare specialists in corporate management. Most Belarusian enterprises today suffer from a lack of good specialists management positions. One possible solution with respect to enterprise restructuring and privatization would be to encourage immigration of foreign experts.

- **negative demographic trend**

The Belarusian government has made few attempts to reform the inherited soviet system of social security. A high proportion of people employed in a shadow economy exclude them from solidarity pension system. Thus, the government had to finance many pensions from the state budget. A negative demographic trend is the other factor which seriously undermines the stability of the social security pension system in Belarus.

- **absence of domestic raw materials**

Belarus' insufficient store of raw materials and energy resources makes it extremely dependent on imports from neighborhood countries.

Opportunities

- **close cooperation with European union within the Eastern Partnership program**

Closer cooperation with European Union could accelerate economic and political transformation in Belarus. A recently created Eastern Partnership includes six post-soviet countries (Armenia, Georgia, Azerbaijan, Ukraine, Moldova and Belarus) and is intended to foster cooperation of these countries with European Union. Belarus has been included to the Eastern Partnership, despite numerous complaints addressing the slow process of democratization in the country. This illustrates the European Union's effort to draw Belarus out from a Russian sphere of influence.

- **joining of Caspian-Baltic-Black sea union**

In 2005, the Ukrainian and Georgian presidents initiated the process of creating a Caspian-Baltic-Black sea union. Presidents of Poland and Lithuania had also expressed interest in joining the union and working on the solidification of the project, for example, completing construction of the Odessa-Brody pipeline. But the fully-fledged existence of Caspian-Baltic-Black Sea Union requires political loyalty of such countries as Azerbaijan, Kazakhstan and Uzbekistan, which are not very inclined to join the Union. Nevertheless, in the case of realization of Caspian-Baltic-Black Sea Union and Belarus' participation in it, the latter would get a chance to diversify channels of energy resource supply and thus, reduce dependence on Russia.

Threats

- **High dependence on Russia**

Extremely high dependence on Russia represents the main threat to further development and economic transformation in Belarus. The dependence on Russia has extremely intensified in recent years, after price hike on energy resources. To cover trade deficit and fulfill foreign exchange reserves, the Belarusian government has applied for Russian intergovernmental credit for several times. Also, Russia represents the main export market for Belarusian producers. One of the ways for Belarus to reduce high economic dependence on Russia is to reorient its trade in the direction of the EU and other western democratic countries.

- **World crisis**

In present conditions of world crisis foreign investors have no interest in large investments. This may result in the supposed absence of FDI inflow to Belarus in the recent future.

- **Brain drain**

Emigration of specialists has extremely negative impact on the competitiveness of Belarusian economy. The deficit of qualified workers can already be noticed in Belarusian labor markets. Specialist and skilled workers are leaving the country for better opportunities and better living standards. It can be expected that the niches in labor markets would be filled with emigrants from Asian countries. It turn, it can lead to social extension in society¹⁵⁰.

¹⁵⁰ “Winds of Changes In Belarusian Economy”, Volha Dudko, 2007, Association for International Affairs

12. Conclusions

After the collapse of the Soviet Union, Belarus, together with other post-soviet countries, started the process of economic transformation. Issues of independent state building and nation creation were as urgent for Belarus as they were for many other former Soviet Union states. A rather spontaneous market transformation was accompanied with destruction of the former Soviet institutional system and the necessity to create a new socio-economic model of society. Belarus had been one of the most sovietized countries, where the population can be characterized by a rather weak national consciousness. Therefore, after the Soviet Union collapse Belarusians were unprepared for political and economic independence from Moscow.

All these factors conditioned the fail of national and democratic forces to seize power and the 1st Belarusian president became a pro-Russian and pro-Soviet populist, Alexander Lukashenka. Since then all market reforms, initiated during the first years of independence, have been suspended. The former command-administrated methods of governance have been returned to the economy. The introduced political and economic systems were based on old institutional and economic practices with the simultaneous existence of a shallow private sector. This “new” economic model was called “the socially oriented market economy”.

Despite the fact that market reforms had been suspended, Belarus indicated positive and even high rates of economic growth starting from 1996. The analysis of the nature of economic growth in Belarus, however, shows that it is a growth “for any cost” which has not been backed by the same increase in productivity and economic competitiveness. The state macroeconomic policy was intended mainly to stimulate economic growth and support preferential sectors of economy, but not to ensure stability of the financial system. Consequently, the economy became extremely vulnerable to external shocks.

One of the main factors which conditioned the relative stability of the political and economic systems in Belarus was Russian support. Therefore, when Russia decided to reduce the subsidization of Belarus and imposed higher prices for energy resources (at the end of 2006), the Belarusian economy met with serious difficulties. The subsequent world financial crisis disclosed all the former problems of the unreformed Belarusian economy. The only way out of the crisis which Belarus faces today – is to implement complex market reforms. Nevertheless, the market transformation in Belarus is dependent on the political will of the government authority. Since the reduction of state control over the economy can undermine the present political system, it could be expected that complex market transformation in Belarus will be deferred for as long as possible.

There is one important factor behind the process of market transformation – the transformation of the society itself. Market reforms can be successful only in the case, when market values are accepted by the majority of the population. Belarus has been lost in transition also because it had been lost in the process of nation building. The widely accepted model of socio-economic development, based on historic transitions and national values, has not been introduced yet. Unfortunately, soviet mentality still dominates in Belarus. Thus, the transformation of the Belarusian economy and society remains an open question.

13. Appendix 1: The Largest Tax Payers in Belarus

First quarter of 2004, 2006, 2007

№ In 2007	Enterprise	The unit weight of tax payments in the total number of tax revenues in consolidated budget, %			The overall number of paid taxies, \$ml. in 2007
		2004	2006	2007	
1.	Mozyr oil refinery plant (МНПЗ)	3,81	6,64	5,63	1000
2.	Joint-stock company «Naftan»	3,54	4,98	4,88	880
3.	Joint-stock company «Beltransgaz»	1,05	2,43	4,27	770
4.	Republican JSC «Belarusalii», producer of potash fertilize	1,79	0,78	2,11	380
5.	Foreign JSC, «Lukoil- Belarussia»	-	1,41	1,68	300
6.	Foreign JSC, «Junivest-M»	-	2,88	1,13	205
7.	Republican JSC «Minsk crystal», producer of artificial crystals	1,35	1,08	1,05	190
8.	JSC «Belshina», producer of pneumatics	31 th place, 0,28	0,29	1,01	180
9.	Republican JSC «Belarusian metallurgy plant»	1,47	1,02	1,00	180
10.	Republican JSC «Minskenergo»	1,29	1,86	0,95	170
11.	Republican JSC «Gomelenergo»	0,84	1,13	0,73	130
12.	Republican JSC «Vitebskenenergo»	1,05	1,26	0,69	125
13.	Joint venture «Mobile digital connection»	0,39	0,76	0,66	120
14.	Republican industrial company «Belarusneft», chemical production from oil	1,62	1,71	0,65	115
15.	Joint venture «Mobile		45 th place,	0,56	100

	telesystems», mobile operator		0,15		
16.	Republican JSC «Grodno tobacco factory «Neman»	32 th place, 0,26	33 th place, 0,23	0,52	95
17.	Republican JSC «Klimovichy distillery plant»	0,33	0,4	0,51	90
18.	Republican JSC «Breist distillery plant «Belalco»	0,76	0,53	0,46	85
19.	Republican JSC «Minsk tractor plant»	0,58	0,54	0,39	70
20.	JSC «Traipl»	outside top-100, less 0,073	34 th place, 0,22	0,38	70
21.	Republican JSC «Beltelecom»	0,70	0,43	0,37	65
22.	JSC «Tobacco-invest»	34 th place, 0,26	0,37	0,35	65
23.	JSC «Interservice», transport company	outside top-100, less 0,073	35 th place, 0,21	0,35	65
24.	Republican JSC «Vitebsk distillery plant»	40 th place, 0,22	0,31	0,33	60
25.	Republican JSC «Grodnoenergo»	0,36	0,66	0,32	60
26.	Republican JSC «Mogilevenergo»	0,37	0,65	0,31	55
27.	Republican JSC «Gomeltransneft «Druzhba», oil transportation	0,38	37 th place, 0,20	0,31	55
28.	JSC «Vitebskoblgas», energy company	outside top-100, less 0,073	32 th place, 0,24	0,31	55
29.	Republican JSC «Gomel distillery plant»	38 th place, 0,22	0,33	0,31	55
30.	Republican JSC «Minsk automobile plant»	0,87	36 th place, 0,2	0,29	50
	Total	around 24,09%	33,9 %	32,51%	5840mil.

		26,85	35,95	42	
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Source: Scientific Research Mises Center in Minsk, <http://liberty-belarus.info/content/view/1661/37/>

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