Republic of Belarus: Selected Issues

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REPUBLIC OF BELARUS

Selected Issues

Prepared by Eliza Lis and Natalia Koliadina

Approved by Chris Jarvis

April 19, 2012

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RAISING PRODUCTIVITY GROWTH THROUGH ECONOMIC RESTRUCTURING AND ENTERPRISE REFORM

I. BACKGROUND

1. Belarus’ economic fundamentals could worsen in the absence of structural reforms. High rates of economic growth have been driven by investment, while total factor productivity (TFP) and labor contributed modestly. Since 2000 real wage growth on average exceeded productivity growth. The economy has been plagued by significant savings-investment imbalances. International competitiveness was eroded by a long spell of exchange rate overvaluation. The labor force has not been growing and is projected to decline in the future, with an aging population.

2. Government support to the economy has boosted domestic demand but failed to generate productivity growth. Belarus’ growth model, according to the World Bank’s Country Economic Memorandum (CEM, forthcoming), has been relying primarily on a combination of external borrowing and cheap energy inputs, while productivity growth has been slowing. The labor market has been dominated by state-owned enterprises (SOEs) and labor mobility has been low. Capital returns have been flat, and capital has been flowing primarily to sectors with low and declining returns.

3. The authorities’ economic liberalization plan could facilitate private sector development, although it is not comprehensive. The action plan for the implementation of the President’s Directive #4 “On the Development of Entrepreneurial Initiative and Business Activity in the Republic of Belarus” would facilitate private sector development. The plan focuses on critical issues, including strengthening competition; improving the business climate; removing red tape; strengthening the tax system; and moving to international accounting standards. Addressing issues selectively, however, could exacerbate, rather than alleviate economic distortions.

4. Structural reforms have been progressing slowly, experiencing reversals. Concerns about the social costs of reforms—the loss of job opportunities and the erosion of real incomes—slowed them down. Support for structural reforms is not broad-based—privatization and the enterprise reform are being opposed by SOE managers and workers. Price liberalization has been partially reversed.

5. Drawing on analysis of Belarus-specific conditions and cross-country research, the note proposes a roadmap for real sector reforms. Section II of the note “Business Environment in Belarus” highlights distortions resulting from government’s interference in the economy. It is followed by section III “The Impact of Product Market and Labor Market

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1 Prepared by Natalia Koliadina and Eliza Lis (EUR)
Reforms on Growth” which is an overview of economic benefits of deregulation, labor market liberalization and the enterprise reform. Section IV “Reforms that Could Support Sustainable Economic Growth in Belarus” provides estimates of potential gains for Belarus from conducting structural reforms. Section V, “A Roadmap for Real Sector Reforms and Enterprise Restructuring” offers a blueprint for restructuring, while minimizing the risks of resource dislocation. Section VI concludes.

II. THE BUSINESS ENVIRONMENT IN BELARUS

6. Belarus has made less progress in market reforms than most Eastern European and Central Asian economies (Figure 1). It has performed poorly on large- and small-scale privatization and enterprise reform. Little has been done to harden SOEs’ budget constraints; promote competition or strengthen corporate governance. Banking sector reform, trade liberalization and competition policies have been slowly improving. Price liberalization was partially reversed in 2011, with some 25–30 percent of the consumer price basket subject to administrative regulation at end-2011, compared with 20 percent a year ago.

7. Administrative controls hampered reforms and propagated inefficiency. GDP growth targets kept the economy at or above potential in 2005–08 and in 2010, with the corporate sector striving to meet output, investment and employment targets. Mandatory output targets—economy-wide GDP growth broken into the sectoral, regional and company-specific targets—shifted companies’ focus from maximizing profits to maximizing output, regardless of the cost. Cross subsidization, the inflexible labor market and government-controlled investment distorted factor and resource allocation, while producers, operating under a soft budget constraint, were not driven to improve efficiency. The banking sector, dominated by state-owned banks, provided easy access to finance. Administrative price regulation muted market signals.
Figure 1. Belarus: EBRD Transition Indicator, 2010 1/

Sources: EBRD, Transition Indicators.
1/ Higher indicators corresponds to greater transition.
8. **Government interference in the allocation of resources exacerbated distortions.** SOEs’ incentives to maximize profits have been weakened by the transfer of profits to innovation and development funds; ad hoc dividend payments; the surrender requirement of export proceeds; cross-subsidization and by occasional mergers of poorly performing companies with well-performing companies (Box 1). Resources channeled to government sectoral or company-specific programs absorb significant resources—5.5 percent of GDP in net lending in 2011—but their selection is not transparent or market-based.

### Box 1. Belarus: Government support to the economy

The magnitudes, instruments and objectives of government support to the economy are opaque. According to the World Bank, budget support to the economy exceeded 8 percent of GDP in 2010 (CEM, forthcoming). This support is usually extended in the form of tax benefits; budget subsidies; interest rate subsidies; debt guarantees and bank recapitalization. Support can also take the form of exemptions from tax liabilities and the surrender requirement of export proceeds. While eligibility criteria for government support are not well defined, only companies meeting quantitative economic targets can qualify.

Widespread quasi-fiscal activities finance government-sponsored investment programs and provide financial support to selected sectors and companies. The surrender requirement of 30 percent of export proceeds; profit transfers to ministerial innovation and development funds and cross subsidization penalize strong companies, while supporting weaker companies.

9. **The misallocation of labor is manifested by excess employment in SOEs.** The official unemployment rate in Belarus remained low at 0.6 percent of the economically active population at end 2011. With full employment being an integral part of the Belarusian economic model, SOEs have been effectively the employer of the last resort. The World Bank found that labor has not been moving toward sectors with high and rising productivity and estimated labor hoarding in SOEs to be 10 percent higher than in the private sector (CEM, forthcoming). The wage structure remains compressed, notwithstanding the liberalization of wage-setting in July 2011, when the single pay grading system became recommended, but not mandatory.

10. **Belarus’ economic integration with Kazakhstan and Russia calls for economic liberalization.** Belarus’ accession to the
customs union lowered import tariff barriers, but nontariff barriers remain significant. Belarus maintains import restrictions and quotas, licensing requirements, and non-transparent regulation. Investment flows are restricted by extensive state control. Free movement of capital and labor within the Common Economic Area with Kazakhstan and Russia, launched on January, 1 2012, requires an investor-friendly environment and flexible product and labor markets to avoid capital flight and labor emigration. Belarus would gain from product market, trade and financial market liberalization, as explained in Section IV.

III. THE IMPACT OF PRODUCT MARKET AND LABOR MARKET REFORMS ON GROWTH

11. **Empirical evidence suggests that product and labor market reforms foster competition and, along with enterprise reform, improve resource allocation.** Product market deregulation—dismantling barriers to entrepreneurship, trade and investment and lowering state control—strengthens competition and improves resource allocation, facilitating TFP growth and innovation (Wölfl, A. et al, 2010). Labor market liberalization complements enterprise restructuring, generating employment growth, if competition is strong. State control in Belarus—restrictive regulatory environment and government’s interference in SOEs’ operations—hinders private sector development, while impediments to free market entry and exit and remaining trade and investment barriers weaken competition.

**Benefits from Product Market Reform**

12. **Product market deregulation facilitates per capita GDP growth.** Countries with less stringent product market regulation (PMR) have grown faster in GDP per capita terms, while stringent PMR has led to resource misallocation in European countries, hampering productivity growth (Wölfl, A. et al, 2010; Arnold et al. 2008). The OECD analysis for Ukraine, Russia and China implies that transition economies—countries comparable to Belarus—would benefit from deregulation. In the case of Russia competition is positively correlated with TFP growth, but competition remains weak, owing to highly concentrated industry and government’s interference in the economy (Aghion and Bessonova, 2006; Conway et al., 2009). Gianella and Tompson, 2007 found that market concentration in Ukraine slows labor productivity growth, as opposed to import competition boosting it. China has been moving away from very restrictive regulation of 30 years ago (Crafts, 2006). SOEs in China have been operating more like private-sector firms, following the governance reform, which expanded managerial independence and decoupled the SOE ownership function from other aspects of government policy making. More needs to be done, however, to keep relations between the state and the market at arm’s length (Conway et al., 2010). The lesson for Belarus is that deregulation and reduced government interference in the economy could contribute to per capita GDP growth.

13. **Market competition facilitates entrepreneurial initiative and productivity growth.** Several studies suggest a positive link between competition-enhancing reforms and growth (Nicoletti and Scarpetta, 2003; Morsy, 2011). Competition forces enterprises to
reduce costs, to invest more and to become more profitable and innovative (Crafts, 2006). Strong competition could speed up international technological diffusion, i.e. countries lagging behind the world technological frontier can increase productivity growth by upgrading their capital stock and adopting new technologies (Acemoglu et al, 2005). Competition also fosters the efficient use of resources by stimulating managers to work harder (Arnold et al., 2008). However, positive effects of pro-competitive policies could be undermined by soft budget constraints and pervasive state control (Carlin et al., 2001; Aghion et al., 2002). To boost entrepreneurial initiative and enhance productivity growth in Belarus, strengthening market competition should be accompanied by restraining state control and hardening the budget constraint facing the corporate sector, particularly SOEs.

14. **Removing the barriers to market entry and exit could improve resource allocation and facilitate enterprise restructuring.** Aghion and Bessonova (2006) point out that reducing barriers to entry, particularly to foreign products, motivates domestic incumbents —which are relatively close to the technological frontier —to engage in innovation in order to catch up. Enterprises with low productivity, however, are forced to exit the market and free resources for more productive new entrants. The removal of barriers to entry and exit induce organizational change at the firm level, e.g. more efficient management and more R&D activities, as exit becomes less costly and competition strengthens. Competitive pressures boost innovation, particularly among new entrants, but only if they have access to finance (Aghion et al., 2002). Business registration in Belarus is easy, but informal barriers—non-transparent regulations, the lack of adequate protection of property rights and economic uncertainty—remain significant, limiting foreign competition. Market exit is costly, as bankruptcy procedures are not well developed (World Bank, 2012).

15. **Barriers to trade and investment impede FDI inflows.** Sustainable long-term economic development depends on innovating. A vast literature points out the positive effects from international openness for productivity growth, as it promotes the efficient allocation of resources through comparative advantage and allows the dissemination of knowledge and technological progress (e.g. Edwards, 1998). India and China significantly liberalized their trade. Notably, import tariffs on manufactured goods are fairly low in China, compared with some other large emerging economies, and China has made significant efforts to reduce regulatory barriers to foreign firms. India halved import tariffs on most tradable goods and eliminated quantitative controls in 1990–97. Belarus could attract FDI, if it reduces nontariff barriers and steps up multilateral trade liberalization.

16. **Pervasive state control over economic activity leads to economic inefficiency.** State enterprises are less efficient and productive than private enterprises: as SOEs usually face soft budget constraints, they are less eager to upgrade their capital stock, adopt new technologies and downsize employment. Private companies in Belarus are more productive than SOEs (CEM, forthcoming). Fostering competition, liberalizing prices and eliminating quantitative targets is essential for efficient resource allocation and private sector
development. Deregulation would positively affect the Belarusian economy, as this will free up resources for efficient use, strengthen competition, and enforce market discipline.

17. **Strengthening corporate governance would level the playing field for all market participants, fostering economic development.** Corporate governance reform positively affects growth and economic development through various channels (Claessens, 2006). Enterprises governed in line with best international practices enjoy access to external financing, including direct investment. Corporate governance reform leads to better operational performance and strengthens competitiveness. It can also improve fiscal discipline and overall public governance (Conway et al., 2009). Corporate governance is a key element of an enterprise reform. In countries like Belarus where governments exercise considerable control over SOEs strengthening corporate governance is essential for their ability to operate in a competitive environment. The OECD (2005) has developed corporate governance guidelines for SOEs focusing on the need to strengthen their boards; to improve the transparency of SOEs’ performance and the accountability of their managers; to reinforce the ownership function of the government by setting commercial incentive structures for managers; and to protect minority shareholders. In Belarus most SOEs were commercialized, but political interference in SOEs’ decision-making is still substantial.

**Benefits from Labor Market Reform**

18. **Labor market reform can increase output and employment growth.** Research by the IMF and OECD indicates that pro-competitive labor market reforms can generate substantial output and employment gains (Nicoletti and Scarpetta, 2005; Berger and Danninger, 2007, Blanchard, 2004). Economic theory suggests that wage growth should be aligned with labor productivity growth. Countries with wage growth in excess of labor productivity growth are usually characterized by low labor mobility, high labor bargaining power, and wrong wage incentive structures, making wages less sensitive to demand or technology shocks, slowing adjustment to new economic conditions (Morsy, 2011).

19. **Strong state control over wage-setting and labor mobility undermines employment performance.** In Belarus wage increases have outperformed increases in labor productivity due to excessive wage increases in the public sector aiming to achieve a certain wage target. Considerable state support to financially weak SOEs and the survival of these due to social goals does not allow labor to move to more productive enterprises.

20. **Reducing the labor tax wedge raises potential output and lowers unemployment.** Cross-country analysis finds that lower labor taxes facilitate employment and long-term growth (Bassanini and Duval, 2011; Barnes et al., 2011; Morsy, 2011). High labor taxes increase the wedge between the labor costs and the net pay of workers. A high tax wedge reduces labor demand and intensifies exit from the labor market reducing labor supply (Morsy, 2011). Among the members of the custom union, including Kazakhstan, Russia and Belarus, the latter has the highest labor taxes.
Complementarities Between Product and Labor Market Reforms

21. **Product and labor market reforms are complementary.** Berger and Danninger (2007) show that simultaneous deregulation of labor and product markets can have sizeable positive effect on employment growth. Labor market reforms generate higher employment growth when the product markets are more competitive, and vice versa. Deregulation of labor and product markets should be coordinated.

22. **Privatization should go hand in hand with enterprise reform to benefit fully from product and labor market liberalization.** Privatized enterprises are more innovative, more productive and adopt new technology and new management techniques faster than SOEs (Conway et al., 2009). Product and labor market reforms, by opening new business and job opportunities, could facilitate the privatization process, which is still nascent in Belarus.

23. **Structural reforms—including product market deregulation and trade liberalization—promote economic growth.** Structural reforms implemented over a 5-year period can generate at least an additional one half of a percentage point increase of GDP annually (IMF, 2010; Hóbza and Mourre, 2010; Swiston and Barrot, 2011). These simulations are based on closing the gap, compared with the best performers in a region (EU countries, OECD countries, Central American countries). Section IV elaborates on the potential GDP growth gain from product market deregulation and trade liberalization in Belarus.
IV. REFORMS THAT COULD SUPPORT SUSTAINABLE ECONOMIC GROWTH IN BELARUS

24. Belarus has little scope to boost growth via increasing investment in physical capital. Belarus’s investment to GDP ratio is one of the highest compared to peer countries. In recent years investment has been mainly directed towards residential housing construction, with only modest impact on productivity growth, rather than by investment in machinery. Future growth will have to rely more on productivity-enhancing structural reforms and less on investment.

25. The effects of structural reforms on GDP growth in Belarus were evaluated by using a new IMF-developed dataset. The dataset, which includes Belarus, was constructed by the IMF (Prati et al., 2010) and applied by Swiston and Barrot (S&B; 2011) for Central American countries. It includes indexes of financial market liberalization, external transaction liberalization and product market liberalization. S&B augment a typical growth regression for 79 countries by including these indexes to determine the impact of structural reforms on economic growth. They find that structural reforms in all three areas are statistically significant in explaining growth.

26. We used S&B’s growth regression results to estimate the impact of product market liberalization (PML), trade market liberalization (TL) and domestic financial market liberalization (DFL) on potential growth in Belarus. We assumed that the best performers in Central and Eastern Europe—Lithuania, Poland, the Slovak Republic, Slovenia and Romania (CEE-5)—are on the production frontier and Belarus’ potential output growth could be enhanced by catching up with them by liberalizing its product and financial markets and international trade. Similar to S&B, we calculated the gap between the CEE-5 and Belarus for the PML, TL and DFL indexes. We then multiplied it by the PML/TL/DFL coefficient obtained from S&B’s growth regression results. Hence, the impulse growth (G) from variable (x) can be expressed as: \( G_x = \beta * (x_{CEE-5} - x_{Belarus}) \).

27. Belarus has substantial scope to improve growth through structural reforms compared to peers. Apart from trade liberalization where Belarus has performed as peers have, Belarus has ample room to reform its product and financial markets. The

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2 PML refers to liberalization in the agricultural sector and telecommunications and electricity markets, while TL measures the openness of international trade. For more details see Prati et al., 2010.

3 We average the five indexes for the five countries into a single index for the CEE-5 for both PML and TL, respectively.
comparators—the customs union members Russia and Kazakhstan—have outperformed Belarus in product and financial market liberalization. Embarking on reforms in these areas will be essential for Belarus to stay competitive in the customs union.

28. **The effect of structural reforms for Belarus’ potential output growth could be significant.** After deregulating its product markets to the level of the CEE-5 Belarus’ annual potential output growth would increase by 3½ percentage points. Bringing import tariffs down to the CEE-5’s level would increase growth by only 0.05 percentage points. Product market liberalization is important to foster financial market liberalization. If Belarus deregulates its financial market to the level of CEE-5 its potential output growth would increase by another 2.3 percent. Belarus’ potential output growth would exceed that of comparators until it converges with their level of per capita income. While the results of this simple exercise should be treated with caution, they illustrate the significance of product and financial market liberalization for Belarus’ growth. The potential gain for GDP growth could be higher if product and financial market liberalization is complemented by other structural reforms, e.g. labor and privatization.
V. ROADMAP FOR REAL SECTOR REFORMS AND ENTERPRISE RESTRUCTURING

29. **Belarus needs a multifaceted structural reform.** Removing price distortions, developing market incentives and competition are the priorities for restoring efficient factor proportions, improving resource allocation and changing the sectoral composition of the economy in line with its comparative advantage. This also requires phasing out administrative economic targets and subjecting SOEs to market competition. The government should step up (i) product market deregulation; (ii) privatization; (iii) financial sector reform; and (iv) small- and medium- enterprise development (SME). Privatization, financial sector reform and SME development are not discussed in this note, as international financial institutions (IFIs) have been already working these areas. The ongoing financial sector reform should make quasi-fiscal activities transparent by shifting LGP to the Development Bank; state owned banks should be privatized; and all financial institutions, regardless of their ownership, should face a level playing field, as recommended by the 2008 FSAP Update. The World Bank Group has been assisting the authorities with privatization, price liberalization, SME development and the SOE reform.

30. **Economic restructuring has to be balanced to avoid dislocation of the factors of production.** Several factors are important for balanced restructuring—achieving efficient resource allocation without going through a period of underutilization of the factors of production.4 First, reforms are likely to be more successful, if they are implemented in a holistic way—they should be broad-based; avoiding market segmentation and discrimination.5 Reforms should begin with strengthening product market competition. Second, strong and well-functioning institutions and well-identified and enforced property rights help avoid underutilization of resources. Third, enterprise restructuring is likely to be more successful in the absence of high unemployment.6 Macroeconomic stability and disciplined macroeconomic policies, along with the exchange rate, consistent with economic fundamentals, facilitate balanced economic restructuring.

**Building Blocks of Economic Restructuring**

31. **Impose market discipline and strengthen competition through price liberalization and the removal of non-tariff trade barriers at the outset of reforms.** Prices of goods and services should be liberalized immediately to remove price distortions and to facilitate domestic and international trade. Removing non-tariff barriers in regional and

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international trade would strengthen competition. Efforts should be made to restore Belarus’ eligibility to the EU’s Generalized System of Preferences and toward changing Belarus’ status to that of a market economy to facilitate WTO accession. Price liberalization implemented along with trade liberalization would preclude excessive price increases by companies facing market competition but would also reveal “winners” and “losers”. Targeted social assistance should be used to mitigate the effects of price liberalization on the poor.

32. **Reduce government’s interference in SOEs’ operations and level the playing field.** The “winners” should be “supported” by allowing them to operate in market conditions—they should forgo all government support, while the government should discontinue *ad hoc* profit withdrawals and abolish the surrender requirement of export proceeds. Eliminating surrender requirement would boost exports and, eventually, capital repatriation. “Losers” have to be supported by the government to avoid disorderly dislocation of resources. This support, however, should be in the form of direct producer subsidies with a sunset provision. A timetable for phasing out these subsidies and well-defined eligibility requirements for government support would help leveling the playing field.

33. **Revisit the government’s role in the economy focusing it on institution-building and ensuring the rule of law.** To facilitate resource allocation and to alleviate rent-seeking opportunities, quantitative economic targeting needs to be discontinued and replaced with indicative market-based benchmarks. Enacting a bankruptcy law, in cooperation with the World Bank Group, would allow companies to exit from the market in an orderly manner. Developing the legal and institutional framework to control anti-competitive behavior, in collaboration with the International Financial Corporation (IFC), would facilitate contract enforcement and fair market competition. The confiscation of assets in the absence of a court ruling should be discontinued.

34. **Foster market reallocation of resources.** Ensure equal access to resources for all market participants by developing transparent and competitive markets, including for resources freed during economic restructuring. Quick disposal of assets by companies in distress and the acquisition of these assets by new owners would improve the allocation of resources, while raising cash for companies under restructuring. A liquid market for resources freed during restructuring would facilitate the divestiture of non-core assets by SOEs. Over time the state procurement system would be phased out, with the government making its purchases on the market.

35. **Facilitate labor mobility by improving wage and employment flexibility.** Labor market policies should focus on alleviating labor hoarding at SOEs, and employment opportunities in the private sector would help achieving this objective. The government should consider implementing labor market reforms, spelled out by the World Bank in its Country Economic Memorandum and calling for the decentralization of employment and remuneration decisions, delegating them to SOEs, while reducing the tax wedge. The decisions related to the downsizing of SOEs would be more acceptable for SOE managers
and workers if new job opportunities in the private sector become available and if those who become unemployed are eligible for an adequate unemployment benefit. The existing unemployment insurance scheme can provide adequate support to unemployed, if the recommendations of the November 2011 IMF technical assistance mission on strengthening the social safety net in the context of SOE restructuring are implemented.

The Basics of the Enterprise Reform

36. **Strengthen the accountability of the SOEs by improving corporate governance.** The government’s rights as an owner should be clearly delineated and the government and SOEs should have an arms-length relationship. The government should not delay the implementation of its plan to move to international accounting standards and should develop a time-bound program for SOEs’ transitioning to IFRS. Developing a program for listing large SOEs on international stock exchanges and clear, transparent and competitive privatization procedures would help attract investors and reduce opportunities for asset stripping. All companies, including SOEs, should be required to publish their annual audited accounts. Large companies should publish quarterly financial statements and clearly communicate their financial results to general public.

37. **Enhance SOE performance by expanding managers’ operational autonomy.** Managers should be fully in charge of the day-to-day operations of SOEs, including output and resource allocation. To strengthen managers’ incentives to improve efficiency and maximize profits, market-based indicative targets should be incorporated into managers’ performance-based contracts. At the same time, managers should be held responsible for poor performance of their companies. Consistent failure to meet market-based performance targets should lead to a change of a SOE management and/or privatization. Financially non-viable companies should exit the market through privatization and restructuring, or through liquidation.

VI. Conclusion

38. **Real sector reforms are overdue in Belarus.** The delay of economic restructuring, including enterprise reform, would further weaken the economy’s fundamentals. With external imbalances declining and fiscal and monetary policies being disciplined, the current macroeconomic situation is conducive to real sector reforms. The authorities’ economic liberalization plan could facilitate economic restructuring and private sector development, if it is transformed into a comprehensive reform strategy. International financial institutions have been working with the authorities on developing a strategy for balanced economic restructuring and enterprise reform and could support the government in implementing these reforms.
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