European Department

Belarus: Still in Need of Transition

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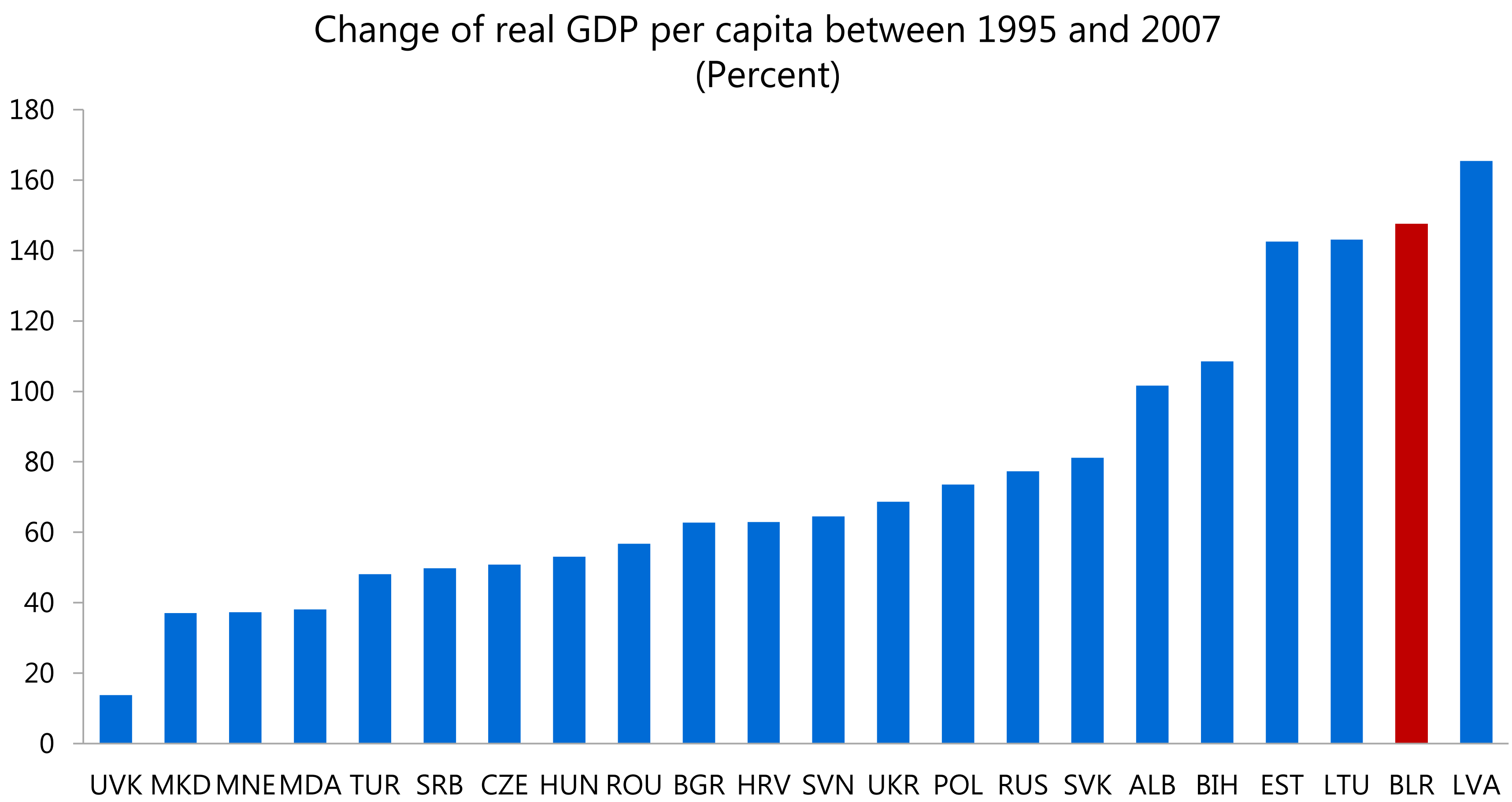
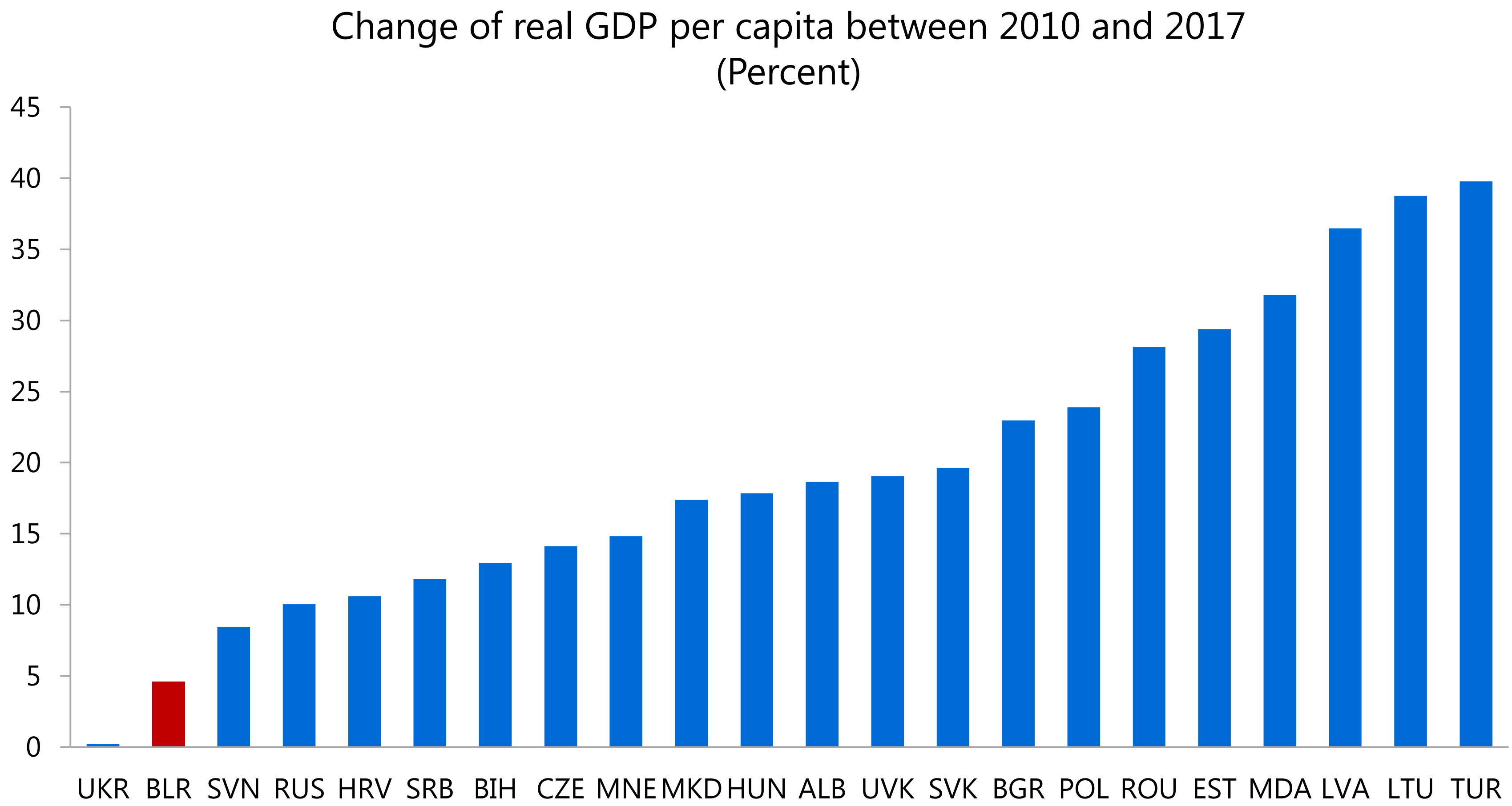
Between 1995 and 2007 Belarus had one of the fastest growing economies in CESEE

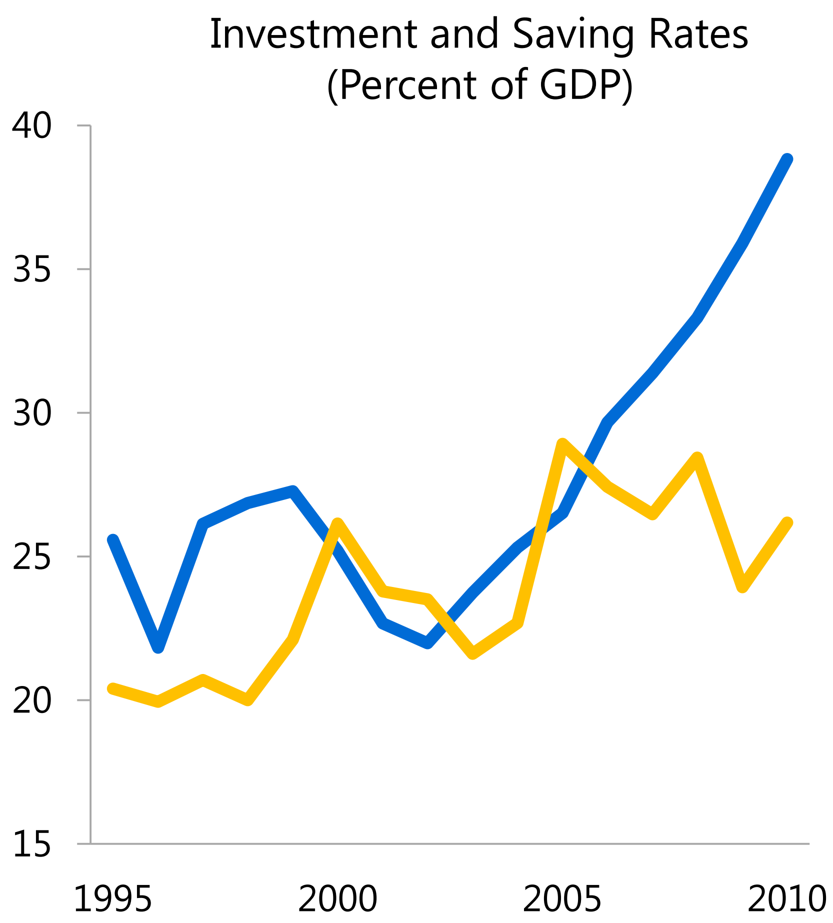


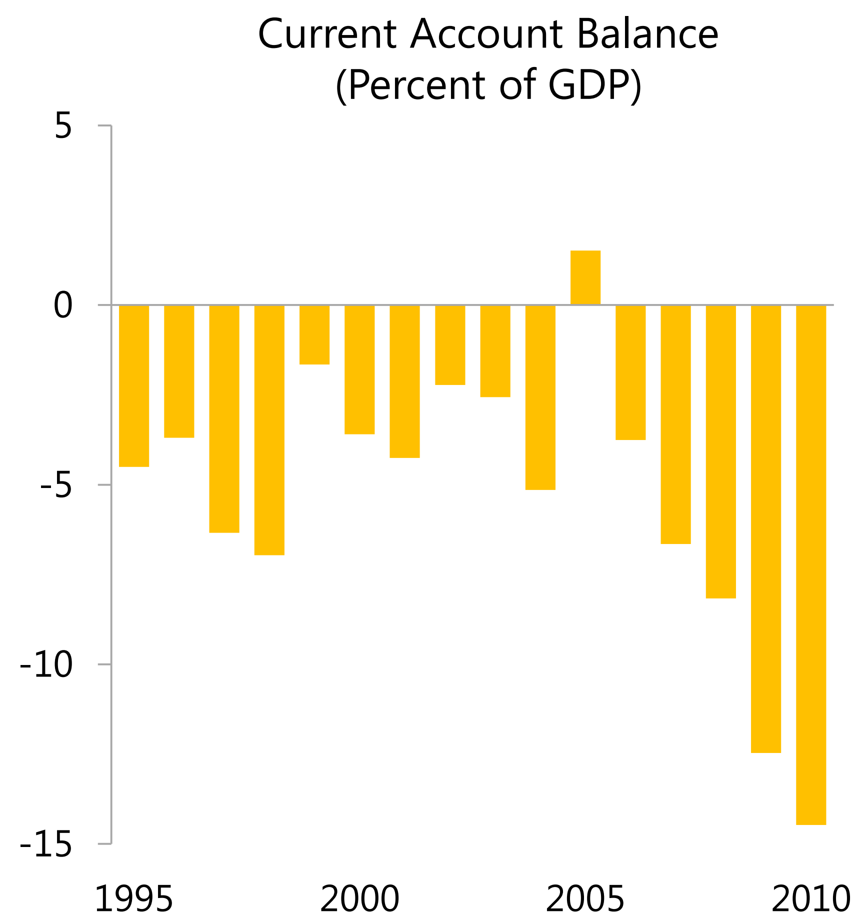
Note: starting year for BIH: 1996; for SRB: 1997; for UVK and MNE: 2000.

Since 2010, growth has slowed significantly



Why this change? One reason was that *macro*-situation during boom was not sustainable. Investment boom led to large CA deficit





And micro-incentives were distorted

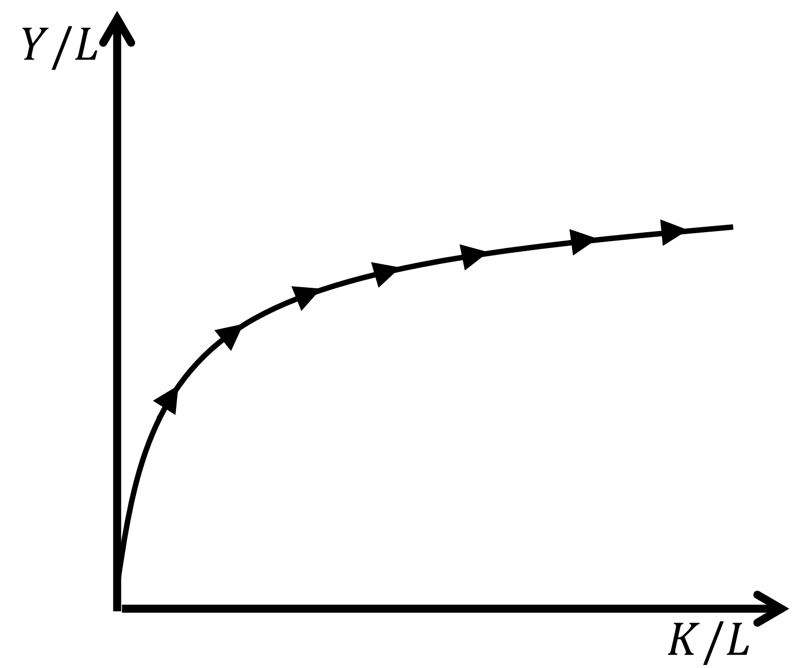
- Growth rates masked stagnating productivity
- To see why, let’s take a step back.
- What does economic theory tell us how to get sustainable growth?

Take standard production function

- GDP depends on capital, labor, and total factor productivity (A)
- Suppose A does not grow, what happens?
- As you add capital, GDP per worker increases – but at a declining rate
- Growth will inevitably slow

$$Y = AK^{a}L^{1-a}$$

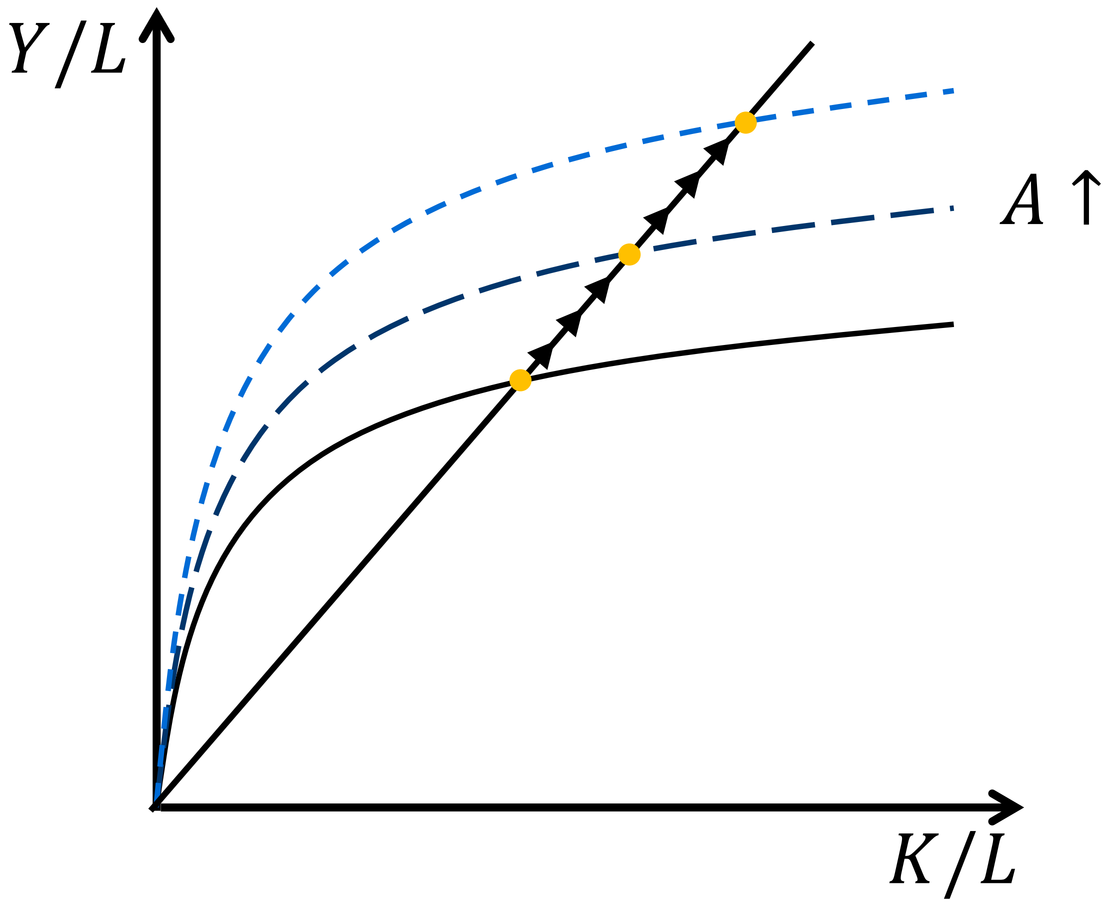
$$\frac{Y}{L} = A\left(\frac{K}{L}\right)^{(1-a)}$$



What happens if you have high investment in a world in which TFP does not grow?

- Initially, when capital-output level is low, you have high growth
- As capital-output ratio grows, same level of investment yields less-and-less growth
- You end up with a situation of high investment and low growth

To get sustainable growth, total factor productivity (A) needs to grow as well



TFP growth is necessary to offset declining marginal productivity of capital

- As you increase capital per worker, marginal productivity of capital declines
- Rising TFP can offset this
- As a result, over time output per worker can grow in line with capital per worker

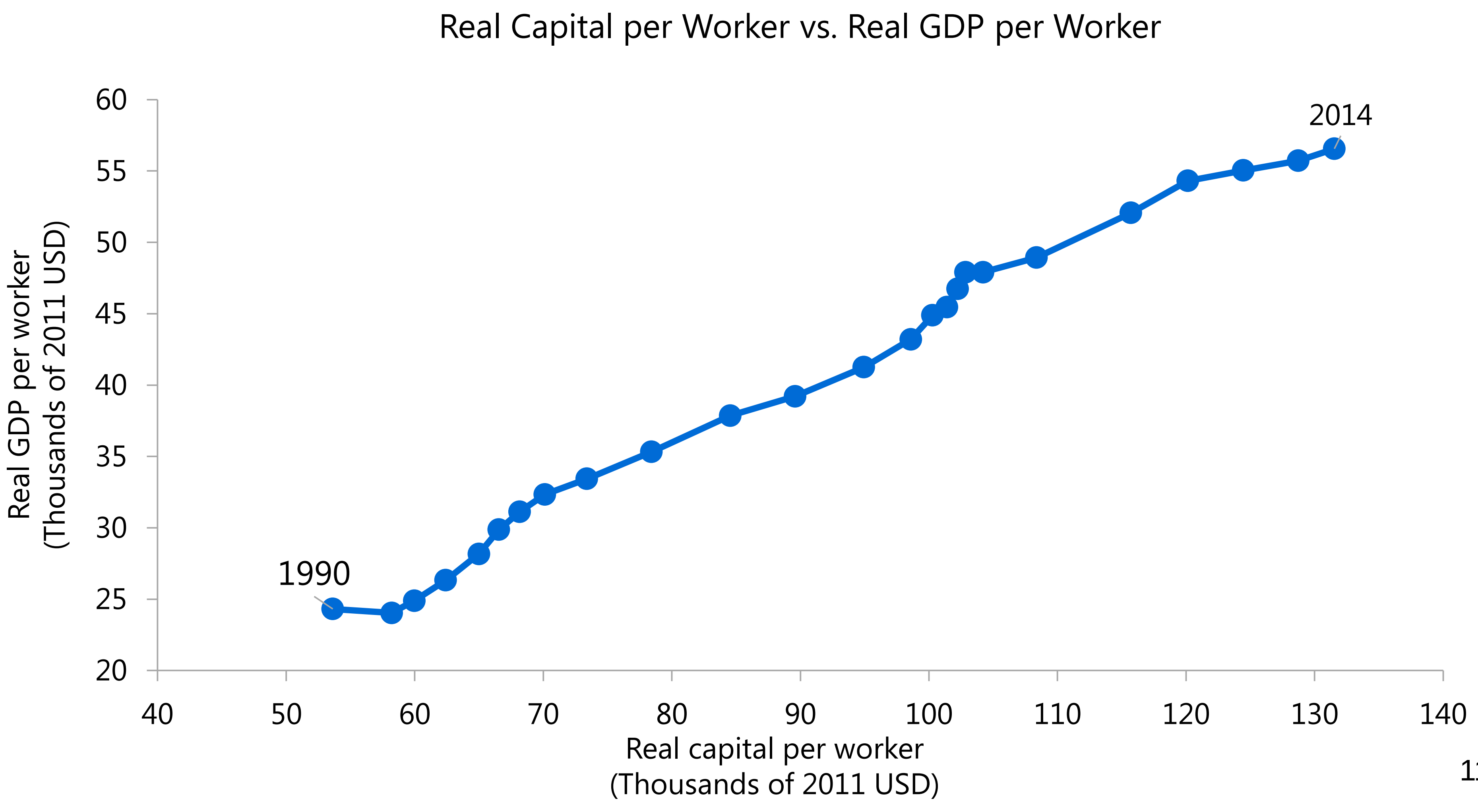
- So far, the theory, but what does this mean in practice?

Let’s compare Belarus and Poland

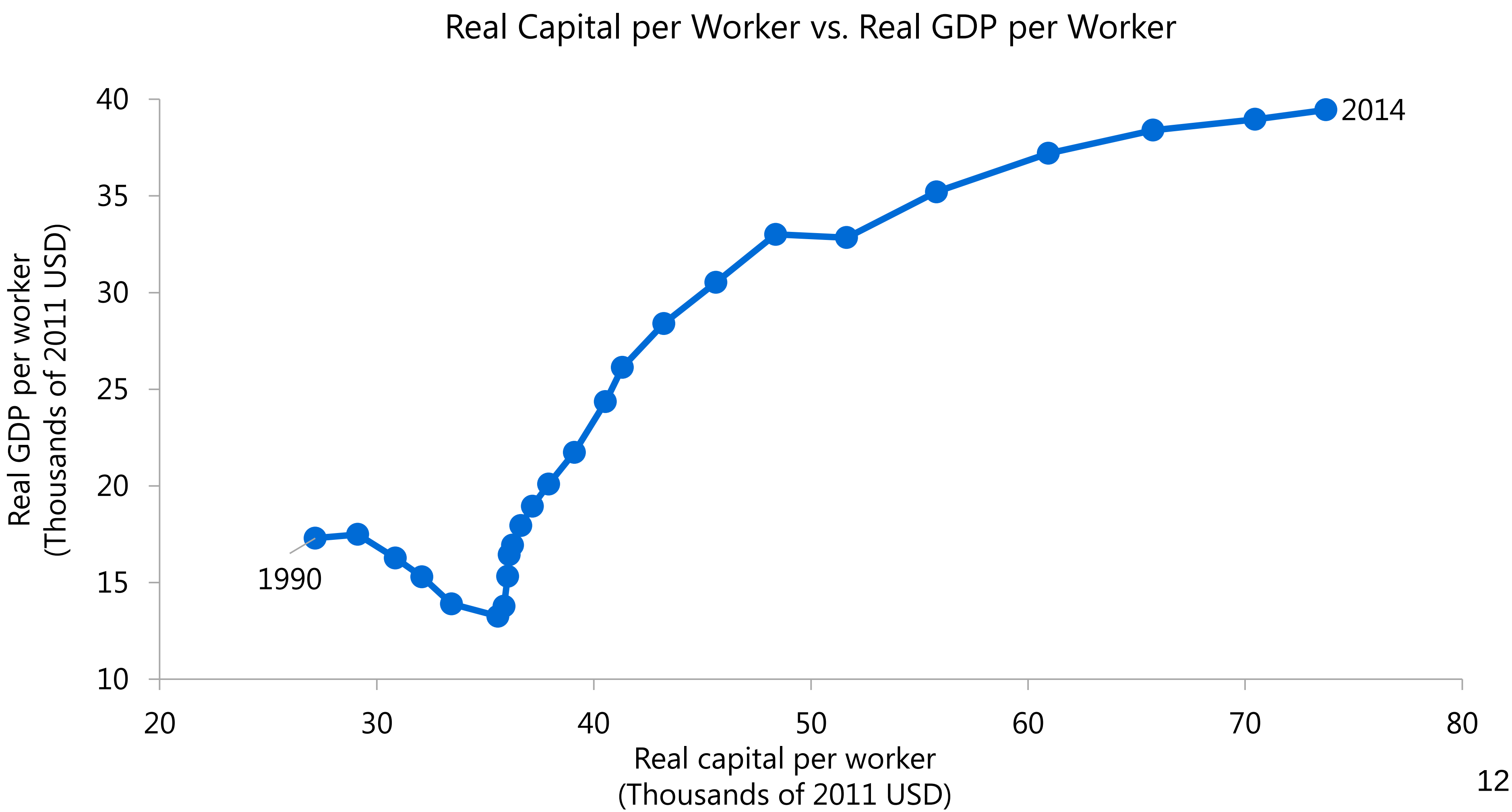
- In Poland, TFP growth has been key driver of economic growth
- Output per worker has increased in line with capital per worker

- In Belarus, high investment has been key driver of economic growth. TFP growth has slowed and is now negative
- As a result, increases in capital per worker have led to lower and lower increases in output

In Poland output per worker has grown in line with capital per worker



In Belarus, adding capital has run into diminishing returns

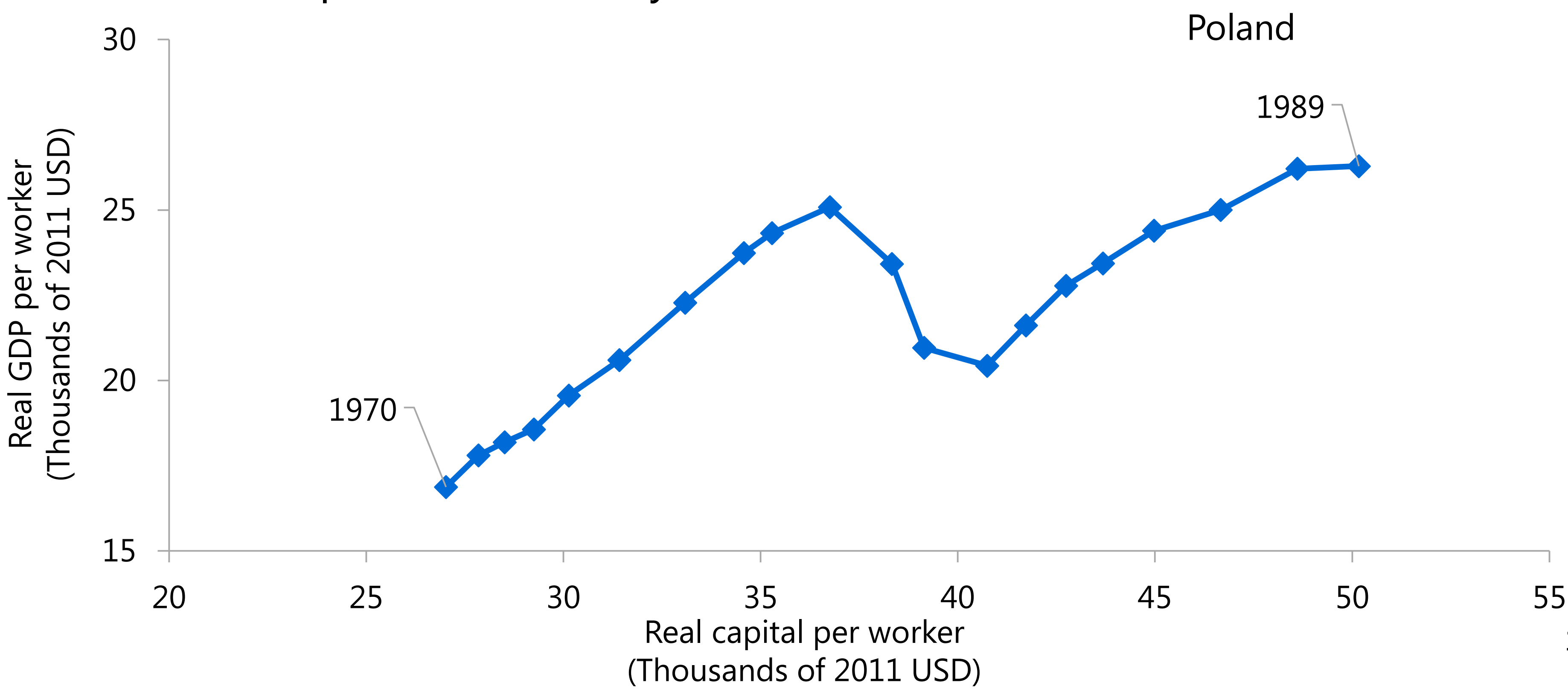


It was not just the amount of investment that led to declining returns

- Capital use was also *inefficient*
- In many instances it kept unviable SOEs alive, rather than productively supporting new companies

Lack of proper incentives, including in SOEs, hampers efficient use of resources

- Belarus is running into same constraints as Poland in 1980s
- Between late 1970s and late 1980s, capital per worker increased by almost half
- But GDP per worker barely increased

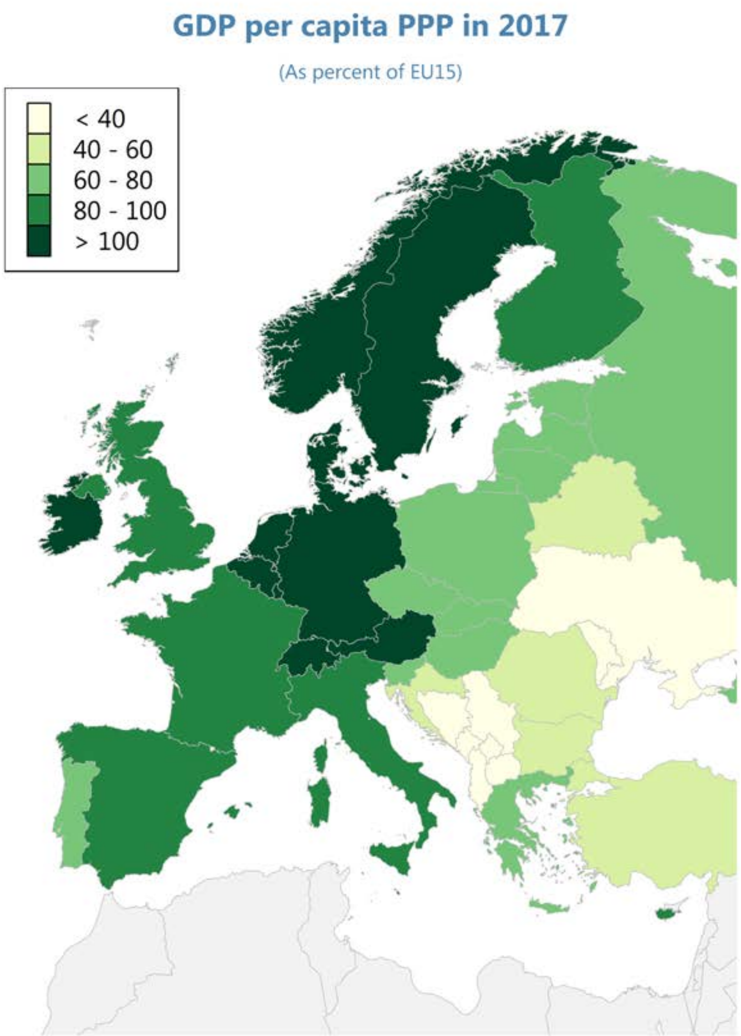


To get a more efficient use of resources, the restructuring of loss making SOEs is necessary, as well as a level playing field for the creation of dynamic new private sector companies

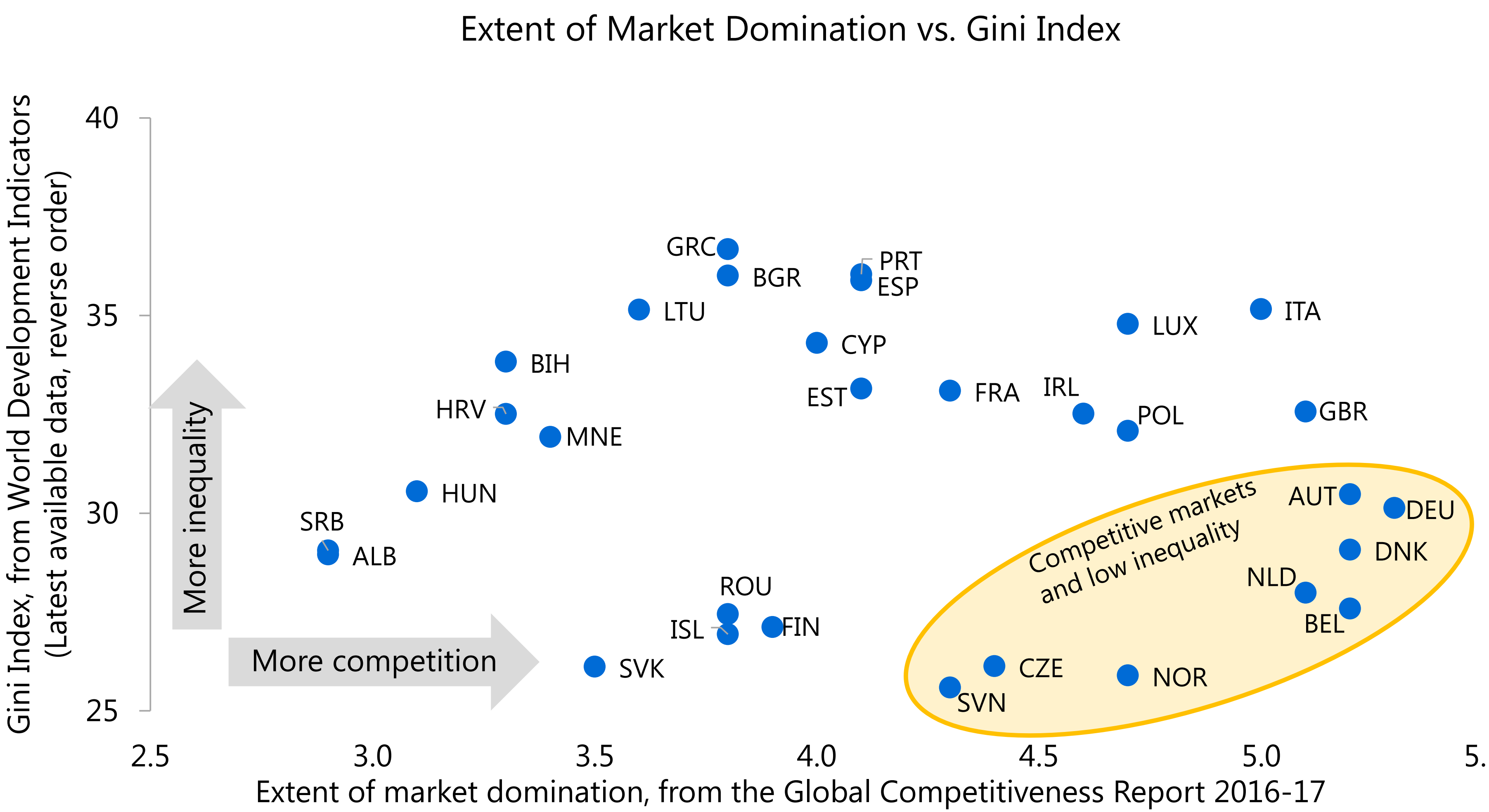
That does not mean that there needs to be a wholesale overhaul of Belarus' social model

- Some of the richest countries in Europe have large governments and low income inequality
- But what they have is:
  - Competitive markets, with oversight that ensures sufficient competition
  - Efficient governance

North-Western Europe is the richest region in Europe



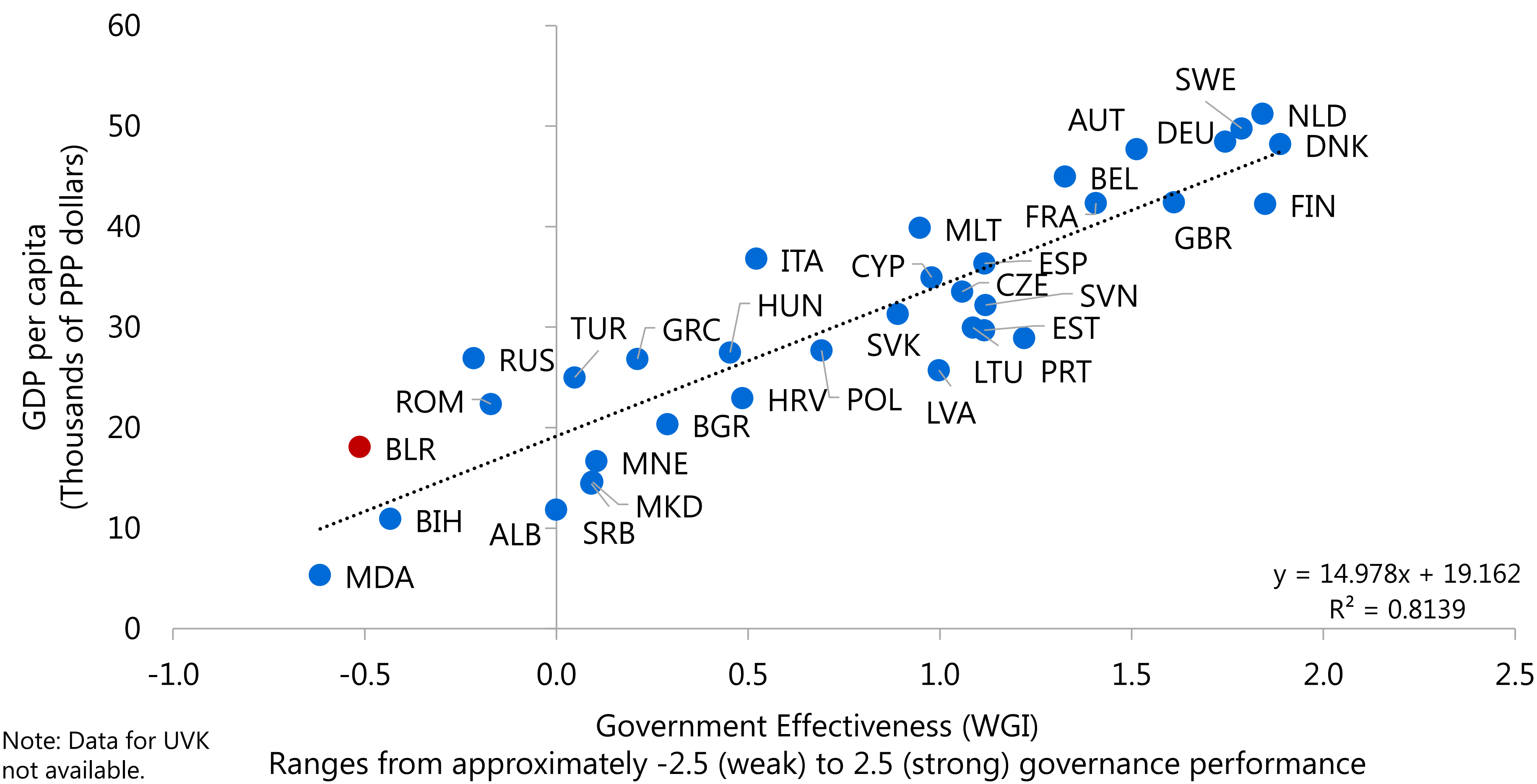
North-Western Europe combines competitive markets and low income inequality



Note: Data for BLR not available

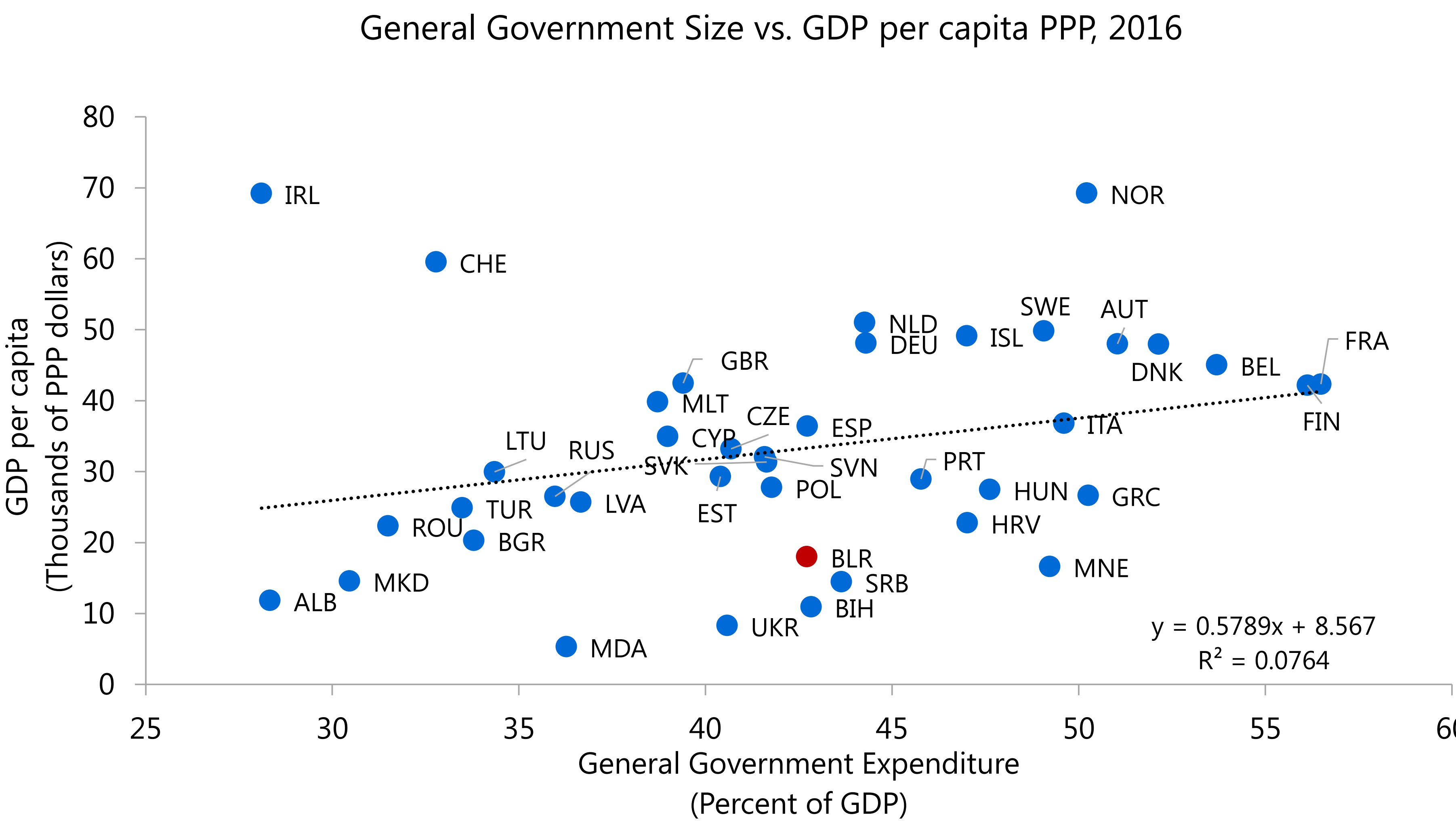
They have effective governments

Government Effectiveness vs. GDP per capita, 2016

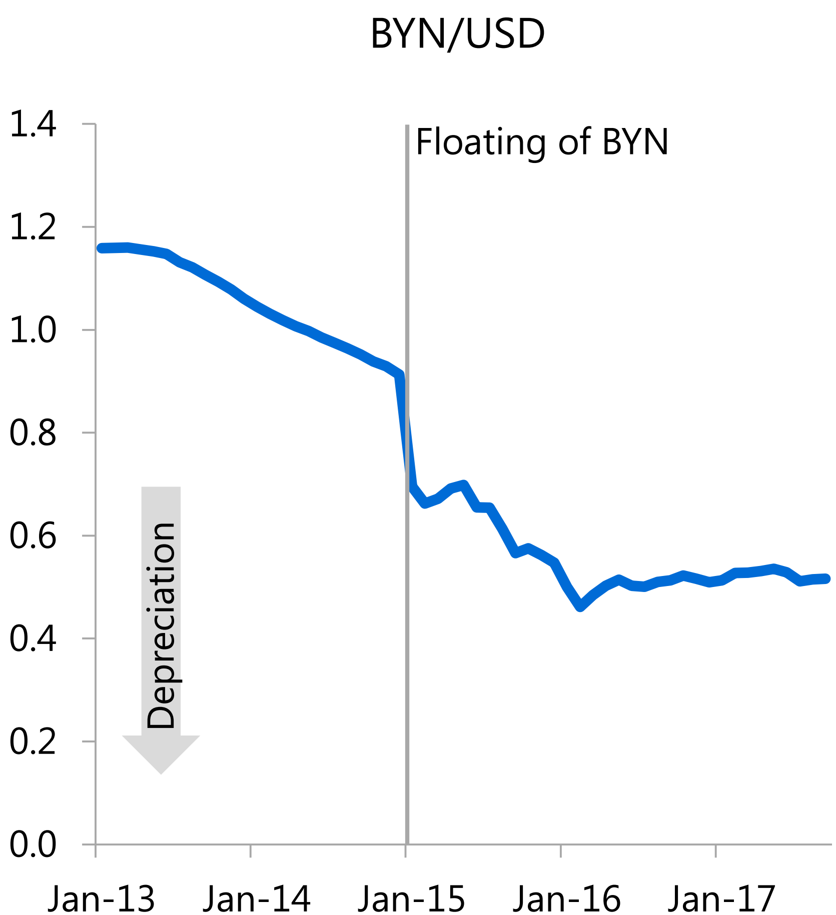


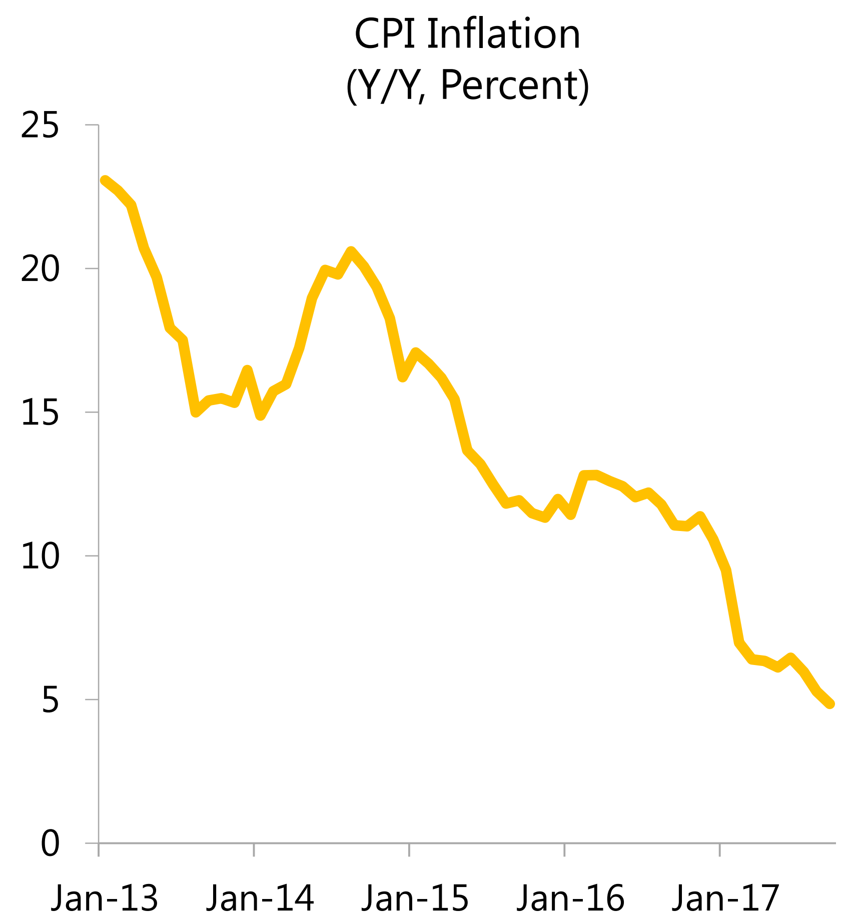
Note: Data for UVK not available.

Which are not necessarily small

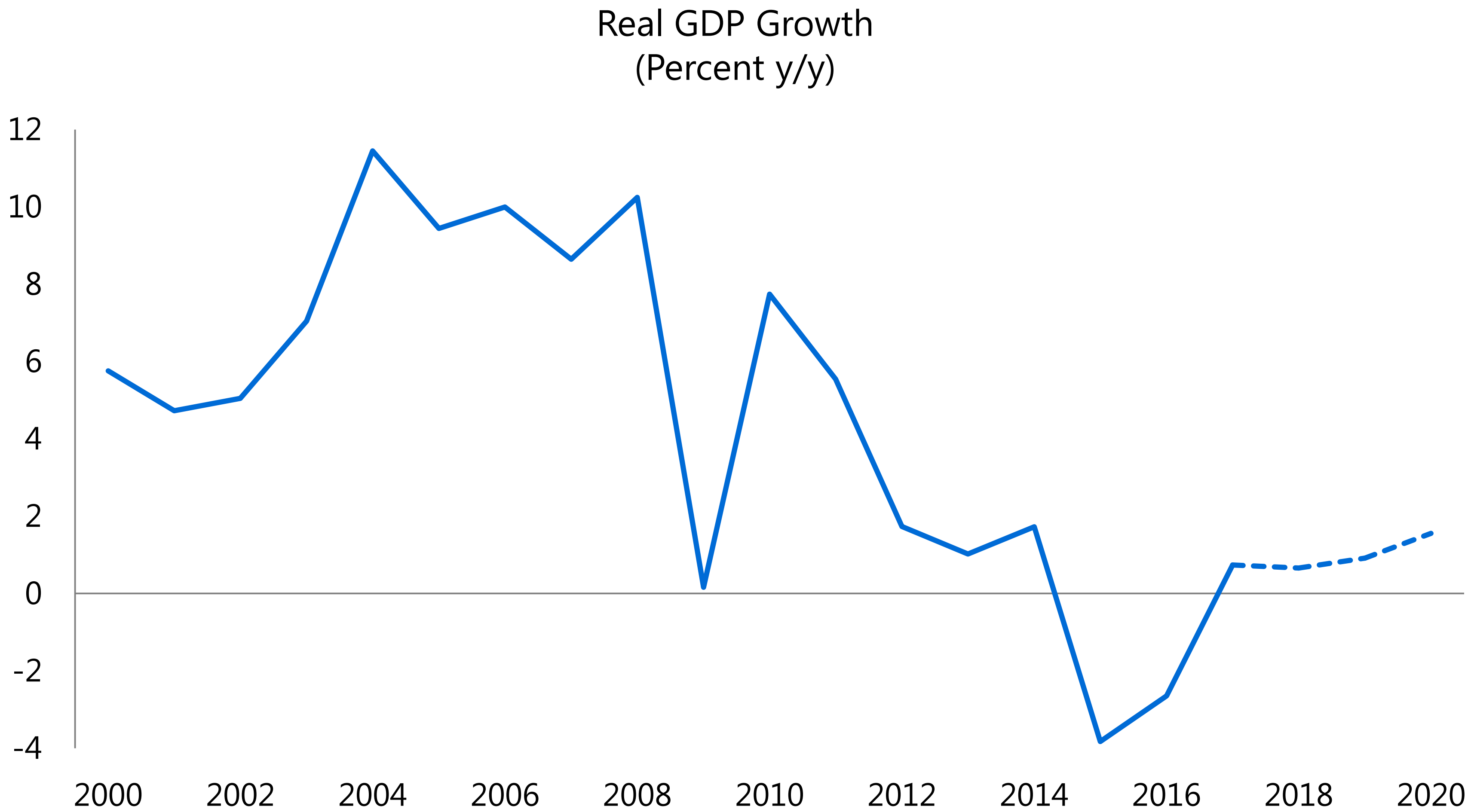


In short, macro stability has been restored





But it will be challenging to get back to fast growth



Conclusion

- It will be difficult for Belarus to go back to sustained rapid growth
- High public or SOE investment alone will not do the trick, as this runs into diminishing returns
- What is needed is a more efficient use of resources and a dynamic private sector
- Stronger competition and budget constraints for restructuring and renewal of firms needed

Thank you