Reform 3.0: Making Belarusian transition happen

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If history moves in cycles, Belarus has to decide again which spiral staircase to choose: fixing an 'old model' or embarking on a new development path. Population seems to be supportive of the latter option: recent opinion polls revealed that more than 80% of Belarusians agree that the country needs reforms[1]. Weak external environment pushes towards more decisive economic policy actions: domestic policies remain the major instrument to deal with external and internal challenges and constraints. The National Bank of Belarus has tightened monetary policy, switched to managed exchange rate float, and is striving for de-dollarization of the economy. Markets and households seem to be reassured, at least for a while. However, a substantial part of the economy, including large share of the banking system, is still state owned, and the pace of this sector restructuring is rather slow.

The authorities launched a conversation with the IFIs on selected elements of a structural reform roadmap. Given the complexity of the economic situation and the related challenges, this roadmap has to embed a comprehensive approach. The reform agenda is filled with far-reaching and complex policy solutions, similar to reforms made in other post-socialist economies much earlier. There have been two waves: 1991–1997 (Estonia, Hungary, Poland, Latvia, Lithuania, Croatia, Slovenia, and Slovakia), and 1999–2005 (Bulgaria, Georgia, Romania, Armenia, Kyrgyzstan, Macedonia, and Albania). Russia displayed a mixed record of reforms, but transition indicators rank its progress quite high[2]. The most recent wave of reform brings Kazakhstan and Ukraine. Belarus might join this camp of reformers by launching the 'Reforms 3.0' package.

Legacy: A history of bug fixes and stability improvements

In the 1990s, Belarus had promising initial conditions: sophisticated industrial and R&D structure made the Belarusian Soviet Socialist Republic the second largest exporter outside CMEA countries (after energy-exporting Russia). A number of former scientists and engineers have been capable to capitalize on this legacy and created high-tech private companies, often export-oriented, which are unique for Belarus's landscape[3] (Daneyko and Golenchenko, 2013). Like in other countries in the region, a number of steps were made in the early 1990s to move towards installing institutions of market economy. Private sector has been born: some firms survived and matured into successful entities. However, Belarusian policy-makers had decided to cope with transition recession by renovating and not dismantling existing economic structures. Instead of cutting subsidies and privatizing banks, a system of soft budget constraints had been reinstalled to meet the needs of state-owned enterprises (SOEs). The level playing field has been generally tilted towards SOEs, suppressing the development of a private sector. As a result, Belarus has become a 'dual economy', where "an obsolete sector of state-controlled – often loss-making – enterprises coexists along with a viable sector of relatively efficient, competitive firms" (Bonatti and Haiduk, 2010).

Apart from better access to subsidies, domestic producers were protected from competition through provisions of the customs union with Russia (created in 1995). As a result, they had little incentives to become more efficient and started to lose market shares even at their traditional markets in Russia (World Bank, 2012; Chubrik, 2013). In 2007, Russia increased prices for crude oil and natural gas supplied to Belarus, and this has downscaled the price subsidy package for Belarusian enterprises. Cost pressures required changes in the operational environment for all companies across the economy, and the authorities had relaxed business regulations[4], but simultaneously expanded the volume of preferential loans under the government programs (Kruk and Haiduk, 2013). Liberalization of business environment helped private sector to grow, while increased access for cheap credit led to increase in imports, and contributed to widening of the current account deficit. As a result, between 2009 and 2014 Belarus came through three currency crises.

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[1] According to the national opinion poll conducted in March–April 2015 within the project "Reforum" of the Belarusian Institute for Strategic Studies, see http://belinstitute.eu/ru/node/2513.

[2] Based on the average score of the EBRD transition indicators: reforms are considered as advanced enough if this score surpassed 3.33 (scale varies from 1 – planned economy to 4.33 – standards of an advanced industrial economy). However, the EBRD dataset ends in 2012 and it is hard to say whether this movement had been sustainable or not.

[3] Speaking at Kastryčnicky Economic Forum conference in 2014 (KEF-2014), Young Chul Kim, World Bank country manager for Belarus, mentioned strong engineering and manufacturing capacity of Belarus as an important background for further structural reforms, see http://eng.kef.research.by/webroot/delivery/files/KEF-2014_conference20141105e_Kim.pdf.

[4] The World Bank's *Doing Business* Distance to frontier indicator showed that between 2006 and 2014 Belarus was the top-3 reformer globally (World Bank, 2013); later reform pace became slower but the easing is continuing.

The costs of 'doing business as usual' have been rising, particularly in the discouraging external environment, including recession in Russia[5]. Monetary and fiscal interventions have become costly and even more harmful for the macroeconomic situation. Domestic structural constrains are more apparent, including misguided allocation decisions of the past, and the authorities decided to start cutting state subsidies to the SOEs and set an upper limit of wage increase equal to the labor productivity growth rate. All in all, the maintenance of the old system has become too costly.

The new "initial conditions"

After years of "bug fixes and stability improvements", the Belarusian economy has become rather different from those of reform pioneers of the early 1990s. The differences are profound. First, **privatization is more serious challenge than it was in the beginning of transition**. Most state owned enterprises (including oil processing flagships) that might have been attractive to potential investors as far as 5–10 years ago are now perceived more often as a burden rather than an asset. FDI inflow remains low, and investors preferred neighboring countries. Both domestic and external investors prefer greenfield to brownfield[6]. Second, **labor has become more flexible, as workers use opportunities offered by regional economic integration**. In the beginning of transition, all countries of the region were equally poor, while the transition recession had not brought drastic loss of workforce due to labor outmigration. Nowadays, any meaningful reduction of incomes could push the most productive workers out of the country (see Bobrova et al., 2012; Valetka, 2013).

However, as a reform laggard, Belarus has secured certain advantages. First, **there is a big room to improve allocation efficiency** and through this move to sustainable growth. Second, there is the evidence that **the economy has the capacity to generate efficient, innovative, and high-returns activities**. The Belarusian private sector had emerged despite an unfriendly environment and expanded later when the authorities turned to easing of doing business. Currently it generates up to 40% of the country's GDP[7] and continues expansion: 80% of small and medium sized private companies consider existing barriers as a push to search for more effective business models and prospective markets[8]. In addition, the World Bank (2015) argues that the sector of mostly private micro and small enterprises has the capacity to absorb employment releasing from SOEs throughout the country. With this in mind, the negative social changes usually associated with reforms (but in fact accumulated in the period of inappropriate policies) looks not so dramatic.

Reform agenda, package 3.0

Belarus cannot return to the growth path, unless new factors of productivity growth will be discovered and activated[9]. This implies that inefficient activities, often made by state-supported SOEs, have to be downsized, while more space for efficient market participants becomes available. Opinion polls show that the population welcome this transformation by expressing support for structural reforms[10]. Therefore, **the environment for reforms becomes more enabling due to a perfect storm of factors: external challenges coupled with domestic constraints, recognition of the necessity of reforms by the economic authorities[11], and generally positive attitude of the population**.

The Implementation of a standard package of polices that include improving markets flexibility, price liberalization, enterprise restructuring, institutional reform aimed at promoting an enabling environment for private entrepreneurship among other relevant measures could become an efficient instrument only if a number of context-specific issues are taken into account. First, **there is an issue of trust.** In the past, many promises were made to households and investors – to maintain currency stability, to protect investors' rights – but from time to time they were broken as often short-sighted considerations dominated over more strategic approach. Reform reversals have become "normal" for Belarus: that is why it is critical to invest into building trust around new structural reform agenda and enhance consensus around its implementation.

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[5] At the KEF-2014 conference, Lucio Vinhas de Souza, economic advisor at the European Political Strategy Center of the European Commission (former Managing Director/Sovereign Chief Economist at Moody's Investors Service), argued that 1% of GDP decline in Russia brings more than 0.6% of GDP decline in Belarus, mainly through exports contraction, see http://eng.kef.research.by/webroot/delivery/files/KEF-2014_conference20141105e_LVS.pdf.

[6] This point was presented by Pavel Daneyko, CEO of the IPM Business School, at the KEF-2014 conference: he assumed that poor privatization track of Belarus contributed to emergence of healthy new private sector, when the most talented entrepreneurs had not "frozen" their talent trying to restructure former SOEs but invested it into greenfield businesses.

[7] Akulava (2015) estimated the private sector share (100% owned by private owners, both Belarusian and foreign) in Belarusian output as 25%, in household incomes as 29%, and in employment as 31%. Official figure (companies with the state share less than 100% are considered as "non-state") is 48% of gross value added, so the actual share of the private sector might be around 40%.

[8] The results of the recent SME survey conducted in April 2015 within the IPM Research Center's study "Returning Belarus to inclusive growth path: Unleashing the private sector potential", see http://www.research.by/webroot/delivery/files/survey2015r3.pdf.

[9] According to the IPM Research Center's estimates, annual growth rate of real GDP long-term trend is steadily decreasing and as of April 2015, it was around 0.6%.

[10] See the results of the Independent Institute of Social, Economic and Political Studies national opinion poll organized in March 2015, http://iiseps.org/old/data15-3.html.

[11] Recently Kirill Rydy, aide to the President of Belarus, provided justification for the necessity of fast and comprehensive structural reforms in Belarus, referring to inability of the existing approaches to cope with exhausted growth potential, increased role of the private sector, and weak external environment (see Rudy, 2015).

Second, the comprehensiveness of a reform agenda implies that policies are interrelated. **Partial fixes do not work anymore**. Utilities tariff reform should come along with de-monopolization of the sector, measures aimed at higher efficiency at the supply side and cost transparency and supported by compensatory mechanisms of social protection; SOEs restructuring would at least require a financial sector reform, introduction of full-fledged system of social protection of unemployed, a set of smart active labor market policies, and revised approach towards privatization ensuring protection of private property rights, etc. On top of this, the new structure of the economy would require public administration reform – all these aspects should be packaged together in order to reduce risks of reform reversals and promote confidence in the continuity of the measures taken by the government.

Third, **any reforms have winners and losers**. In Belarus with its long traditions of "socially-oriented" policies negative social effects are the main threat for the irreversibility of reforms. Hence, the reform package have to be designed to compensate losers and to turn them later on into winners, involving them into economic activity via private sector development and active labor market policies. Reforms should propose clear messages for the vulnerable groups and be consistent with these messages.

That is why **an open communication about a reform agenda is a fundamental precondition**: economic agents should be prepared as to what to expect, while consistency should bridge their expectations and reality. Kastryčnicky Economic Forum conference in 2015[12] aims at bringing various stakeholders together to discuss the reform plans of the government, and contribute to building consensus and trust towards a structural reform agenda.

[12] KEF-2015 "Economy of Belarus: At a Tipping Point" is scheduled for November 3–4, 2015, and will take place in Minsk. For more information, please visit the KEF website.

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