



BELARUS:

A CHOICE OF DIRECTION

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Belarus: A Choice of Direction

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This book presents a range of materials about issues linked with economic transformation and creation of market institutions in the transition countries. A large part of publications deals with the results, problems and contradictions in Belarus' economic policy. The authors give their vision of possible market reforms in Belarus and discuss how the reforms could be supported by the international community.

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INTRODUCTION

1

The problem of ensuring effectiveness of technical aid is not a matter of its presence, volume or amount. The core of the problem is what it is aimed at, how it is provided and what tools are applied to use it. In brief the core issue is its modernization and creative approach to the aid's allocation.

Peter Morgan

Draft Background Paper on Technical Assistance, UNDP, 2001

The fall of the Berlin Wall in 1990 heralded the beginning of a new epoch for millions of citizens in former socialist countries. Mikhail Gorbachyov's words about the lack of a viable alternative to a market form of arranging the economy meant a principal change of the state's priorities in the sphere of politics and economy in most of those countries.

In spite of some differences in starting conditions in terms of the level of industrialization and collectivization, quality and size of labor, availability of raw materials, there were quite a few common prerequisites typical for all of them:

- Absence of motivation to make profit;
- Poorly developed competitive environment, shortages of most goods;
- Absence of natural structure of production;
- A large share of administratively regulated prices;
- Protection of the domestic market through the state monopoly on foreign trade;
- Absence of formal institutions that assist in developing market economy;
- Availability of distorted by the socialist system informal institutions and opinions that rule out the rule of law, spread anti-capitalist mentality, lack discipline, etc.

All the countries faced unprecedented tasks to increase effectiveness of their states starting from building stock markets to restructuring energy sector, utility sector and communications. There was no knowledge and experience. Domestic sources of investment were severely limited. Institutions of civil society in the form of multi-party system, independent media and NGOs did not exist.

Some countries chose to launch radical market reforms. Others decided to stick to gradual and mild market-oriented changes. Today, after 10–12 years, we have an opportunity to compare the results of the chosen model of development and effectiveness of methods, tools and technologies applied.

In spite of differences in their economic policies, a number of countries in Central and Eastern Europe, as well as the Baltic states, chose a concept of radical reforms, or the so-called shock therapy. They actively liberalized prices and opened borders, lowered tariffs and attracted investment, created conditions for small- and medium-size business development. They began to restructure and privatize the so-called natural monopolies. As a result of the lack of active industrial policy, the population of those countries witnessed quick growth of welfare, blooming industry, reorientation of trade flows from east to west, inflow of foreign direct investment (FDI) and new knowledge. Today, these countries are leaders as far as economic growth rate and attraction of foreign investment are concerned. The latter is the main source of new knowledge and technologies in those countries.

Thus, during the last decade, the countries of Central and Eastern Europe and the Baltic states have advanced fast ahead on the way of economic and democratic reforms. Economic reforms led to dynamic economic growth. As a result, today these countries have the highest GDP and standards of living among transitional economies.

Analyzing successes, failures and challenges of reforms, experts of the World Bank point out three important aspects that explain intensity and effectiveness of the policy of reforms¹. *Firstly*, experts underline the key role of setting up new small- and medium-size companies and bringing them to the market to ensure economic growth and job creation. The growth of new firms depends on the policy directed at the creation of favorable climate to let companies freely enter the market. But a successful policy of stimulating the creation of new businesses should be accompanied by a policy of tight budget constraints, primarily with respect to large enterprises set up before the beginning of the reforms. A policy of soft budget constraints lets these enterprises not to pay taxes, not to pay off debts and does not create equal legal and economic conditions for all economic entities. Moreover, it is the main reason of crises in fiscal and banking systems.

Secondly, international experts emphasize the need for developing and strengthening legal and regulatory institutions in order to monitor activities of enterprises and to manage them. It refers both to the state and newly emerging private sectors. The key to prevent conflicts in the sphere of privatization is direct sale of assets to strategic investors. It is the best method of privatization, provided there are rules to protect minority stockholders and norms against insider deals and conflict of interests. There also should be adequate accounting and auditing standards and rules to provide information, as well as legal norms to regulate mergers and acquisitions of companies. The

¹ Transition: The First Ten Years. Analysis and Lessons for Europe and the Former Soviet Union. The World Bank, Washington, D.C., 2002.

companies will abide by law in an environment where adequate mechanisms of law enforcement exist.

Finally, analyzing the political economy of the reforms, experts acknowledge that the groups that benefited from the reforms on the initial stage (including processes of liberalization and privatization) can become opponents of further reforms as they would reduce primarily acquired benefits that may be temporary in the mid-term. These winners will tend to oppose reforms, such as further liberalization of trade, development of competitive environment and coming of new competitors, including foreign ones, in the domestic market, adopting regulations that will protect rights of minority shareholders and creditors. The scale of activities of the winners will depend on the amount of potentially unearned profit.

As it was noted earlier, countries of Central and Eastern Europe and the Baltic states have achieved bigger success in building market economy and raising the living standards for their citizens than CIS countries. However, the success of these countries in building market economy and civil society would be much smaller, if it were not for the assistance of governmental and non-profit organizations. The process of changes in former socialist countries gives developed countries a unique opportunity to work out programs of effective assistance. This process also enables the countries to establish new and modern partnerships, work out new approaches to development financing.

Social assistance of donor countries, influential international organizations (World Bank, United Nations, USAID, European Bank for Reconstruction and Development), TACIS and TRANSFORM programs and also non-government donors, such as Soros Foundation, that is offered in the form of consultations, loans, grants and training courses helped these countries develop their internal potential for building market economies and democratic governments. In the near future many of these countries are ready to turn from recipients into donors. Among the main spheres of official assistance and assistance to non-government organizations, the following should be pointed out¹:

- *Grants on bilateral basis* (money transfers that should not be paid off);
- *Bilateral loans* (loans that are given by governments and official institutions. The grant component in them is at least 25%. They should be paid off in hard currency or in its substitutes);
- *Fees to multilateral institutions*, which are in the form of financing on preferential terms. The Committee for Development Assistance of the Organization for Economic Cooperation and Development (OECD) gives these grants and donations to multilateral institutions;

¹ World Development Indicators, 2001, World Bank, Washington DC.

- *Other official monetary flows* – transactions in the official sector aimed at developing market institutions. The grant component is at least 25%;
- *Private monetary flows*, i. e. monetary flows attracted on market terms and financed by private sector resources. Change of ownership of long-term assets that belong to residents of a certain country is a part of this factor;
- *Foreign direct investment* – investment of states that form the Committee for Development Assistance, directed at ensuring sustainable participation in administration (at least 10% of voting shares) of an enterprise that is located in the recipient country;
- *Portfolio investment on bilateral basis*. It includes the following banking insurance and purchase of bonds, shares and real estate in recipient countries by residents of the country that is a member of the Committee for Development Assistance;
- *Portfolio investment on multilateral basis*. It includes transactions of private banking and non-banking institutions from the countries that are members of the Committee for Development Assistance to securities that are issued by multilateral institutions;
- *Private loans to support export* – loans given to recipient countries by private sector organizations from countries that are members of the Committee for Development Assistance. They are directed at development of trade and are guaranteed by the state;
- *Net grants from non-government organizations*. These are private grants that are given by non-government organizations and net donations of the state sector.

Among the basic principles of providing financial and technical assistance, the following should be pointed out:

- *partnership* – i. e. participation of a recipient country in a donor program in order to increase its responsibility and provide assistance based on goals and needs of the recipient country. Following this principle means pursuing policy directed at full-fledged partnership with local authorities, civil and private sectors;
- *effectiveness* – i. e. monitoring, evaluation and regular changes in projects and programs in order to increase their effectiveness;
- *augmentability* – i. e. policy of assistance should be auxiliary to economic and social spheres;
- *transparency* – maximal openness of information about the project, its goals and tasks, participation of the third sector and academic institutions in public discussion.

According to the Committee for Development Assistance of the OECD, only net official aid to countries of Central and Eastern Europe and Baltic state amounted to about \$3 billion. If unofficial assistance of non-government organization is added to it (private grants), this amount will be even larger (see Table 1).

Table 1

**Net official assistance to countries of Central
and Eastern Europe and the Baltic states (in USD million)**

Country	1998	1999	2000
Hungary	240	249	252
Latvia	98	100	91
Lithuania	134	134	99
Poland	876	1186	1396
Slovakia	155	319	113
Slovenia	42	31	61
Czech Republic	449	325	438
Estonia	91	84	64

Source: State administration in transitional economies, spring 2002.

Today, other countries that demonstrate less success in market transformation – primarily, CIS countries – have a unique opportunity to take the best from the experience of the countries of Central and Eastern Europe and to copy effective programs of assistance, which are based on the experience of reforms, accumulated knowledge and experience of receiving assistance for more than a decade.

According to all indices that evaluate the progress in market transformation, Belarus is at the bottom of all rankings (indices of EBRD, IMF, Freedom House). Belarus holds 148th position in the index of economic freedom by Heritage Foundation. Belarus does not have its country credit rating, which is given by many influential international organizations that reflect investment attractiveness of the country.

Market transformations in Belarus have been inductive and primarily caused by the breakup of the Soviet Union and market transformations in Russia. Starting from 1995, the state pursued a policy of strengthening administrative tools of managing Belarusian economy. Although during the last 2–3 years some positive changes in monetary policy did take place, the administratively run and regulated economy still persists. However, it is getting increasingly difficult to justify such cause. In spite of economic growth that is reported by the official statistics, the dollar equivalent of the wage remained practically on the level of 1995. At the same time, the share of loss-making enterprises is about 50%. The society is beginning to realize that it is necessary to change the existing economic policy substantially.

Keeping public discussion on ways of Belarusian economic development, a group of economists and experts from the Institute of Privatization and Management has tried to offer their own vision of a new economic policy for Belarus. While working out our proposals, we have been of the opinion and still believe that Belarus can quickly form an effective market economy.

Firstly, the overwhelming majority of elite groups and the substantial majority of the population (this assumption is proved by results of opinion polls) support market economy. It means that there is consensus in the society on the necessity of market reforms.

Secondly, in spite of the lack of reform and full-fledged market institutions, there is a private business sector in Belarus and managers of state enterprises have much experience in working in a market or quasi-market environment. The population, too, has experience in using market institutions in everyday life. It means that if reforms are started and new market institutions are established, the overwhelming majority of economic players will be able to both realize new emerging opportunities and quickly use them.

Thirdly, Belarus has a small domestic and foreign debt. It is an important prerequisite for carrying out reforms.

Fourthly, we can count on the accumulated experience of reforms by countries of Central and Eastern Europe. Apart from this experience, Belarus can count on adequate financial support of its reforms.

Due to the lack of progress in building market economy in Belarus, a great number of programs supported by international donor organizations do not work in Belarus. Starting in 2001, EBRD and IMF stopped short their programs. What they do now is just economic monitoring. They do not provide any assistance on stand-by arrangement. But their programs helped other countries much. The World Bank has just one long-term project designed to fight AIDS and tuberculosis. Many foreign organizations are not even represented in Belarus.

Thus, the role of international organizations in lowering economic and social costs in Belarus is as follows:

- assistance to public discussion on issues of economic development and poverty prevention;
- demonstration of successful experience of other countries in lowering social risks;
- assistance to growth of national potential in such spheres as strategic planning, monitoring and evaluation of effects of strategy implementation and programs of reforms;
- improving access to investment and credit resources, which may help overcome negative consequences of economic reforms.

As it was noted earlier, since there has been no market reform in Belarus, the volume of assistance from international organizations is small at present. Evidently, the role and importance of this assistance is undervalued. Moreover, it is being spread among the general public in Belarus that Western assistance is very expensive to service and ineffective. Russia is set as an example of huge debts and payment arrears, which emerged as a result of the misuse of credit resources. State mass media underline that in case of initiating radical market reforms, Belarus will be left alone with its difficult problems of social

security programs and necessity to pay for social expenditures. This and other myths concerning the damage that the western financial and technical assistance by donor organizations can cause are deeply mistaken and ideologically harmful.

This book is a result of a series of seminars and conferences that were held by the Institute for Privatization and Management in 2002–2003 on ways of and possibilities for the development of the Belarusian economy and the role of international donor organizations in the process of market transformation.

We would like to express our gratitude to the Embassy of the United States of America in Belarus and special thanks to Christine Sheckler, Country Program Coordinator, U.S. Agency for International Development (USAID). We express our appreciation to the United Nations Development Program, representative offices of the World Bank, European Bank for Reconstruction and Development, International Finance Corporation, International Monetary Fund, TACIS in Belarus, TRANSFORM Program (Germany), and special thanks to Dr. Kirk Mildner, Head of the Bureau for Coordination of Economic and Consulting Activities, for their active participation in discussions on the ways of the development of the Belarusian economy and their help in making this book.

Apart from discussing technical and financial possibilities of international donor organizations within the programs of fighting poverty, support of development of SMEs, macroeconomic stability and institutional changes, there were many other topics that were discussed at the seminars and conferences. The experience of other countries in carrying out market reforms, main challenges and problems of reforms, successes and failures, advantages of this or that type of development in the framework of long-term economic growth pattern were also discussed at the conferences and seminars. In addition, different suggestions and proposals on changing the economic policy worked out by leading economists and IPM experts were considered.

In the second part of the book we present the most interesting speeches of the participants in the conference “Possibilities of Economic Development Support in Belarus”¹, which was held in Minsk on December 13–14, 2002. The third part of the book is devoted to presentations of goals and programs of donor organizations represented in Belarus. The fourth and fifth parts describe the discussion that took place on May 13 and 20 at the seminars focusing on the current economic development of Belarus and its mid-term perspectives². A

¹ All materials of this conference can be found at the web site of the Research center of IPM <http://ipm.by/index.pl?topicid=bd75b343>

² Materials of these seminars can be found at <http://www.ipm.by/index.pl?topicid=e65b3b37&briefid=f03a414ff9671411> and <http://www.ipm.by/index.pl?topicid=e65b3b37&briefid=ca78b4ba38c72e3a>

INTRODUCTION

few articles that describe the current situation in the Belarusian economy are presented in the fourth part of the book. The last part reflects the main guidelines for reforms and the vision of the new economic policy. The areas of possible assistance by donor support in case of radical market reforms in Belarus are also described in the last part of the book. These guidelines were prepared by economists and experts of the Institute for Privatization and Management.

Editors
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Igor Pelipas
Yelena Rakova

**PROBLEMS OF MARKET
TRANSFORMATION IN CEE
COUNTRIES, BALTIC
COUNTRIES AND CIS**

2

2.1. THE POLITICAL ECONOMY OF DISCIPLINE AND ENCOURAGEMENT: EXPERIENCE OF WORLD BANK

Many transition economies outside Central Europe and the Baltic states are stuck in a no man's land between plan and market. If the advantages of economic reforms are so obvious, why doesn't every country adopt them? Can economic policy choices be systematically related to particular institutional characteristics of political systems in transition?

The political economy of reform within the framework of discipline and encouragement can be expressed graphically by tracing the paths of winners and losers from the transition. Figure 1 depicts the gains and losses in income accruing to three different constituencies at different doses of reform in a typical transition economy.

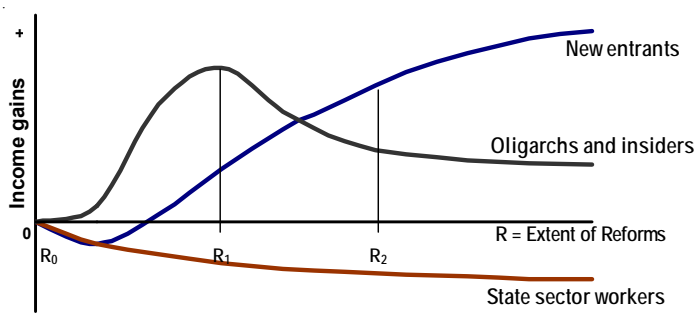


Figure 1. Winners and Losers from Reform

Note: R_0 = no reforms;

R_1 = point at which income gains of oligarchs and insiders are maximized;

R_2 = level of reforms that allows the winners of reforms beyond R_1 (new entrants) to compensate for or exercise enough political pressure to neutralize the resistance of oligarchs, insiders, and state sector workers.

Source: Transition: the First Ten Years. World Bank, 2002.

State sector workers, employed in state enterprises and lacking the skills to become new entrants in the competitive market, face a sharp drop in income as discipline calls for downsizing the sector, with little hope of any substantial recovery with the intensification of reform.

Potential new entrants, workers in state enterprises and new entrepreneurs with skills to become new entrants in the competitive

market, have a classic J-curve pattern of income. They face significant adjustment costs at low levels of reform as they exit the state sector. In addition, they realize gains only when enough progress has been made with policy and institutional reforms to promote and support new entry into the competitive market.

Oligarchs and insiders begin the transition with substantial de facto control rights over state assets and close ties with the political elite inherited from the previous command system. However, because of limited skills to compete in the market economy, they face an inverted U-curve of income gains. They are the immediate beneficiaries of liberalization and privatization, as de facto control rights over state assets can be converted into de jure control and cash flow rights. They reap concentrated gains in the early stages of reform from the opportunities for arbitrage, rent seeking, and tunneling that arise if liberalization and privatization are not combined with discipline and encouragement. But these gains dissipate as further reforms lead to increasing competition and market entry.

Given these patterns of gains and losses, each constituency prefers a different combination of reforms. State sector workers prefer the status quo R_0 and reject all reforms. Oligarchs and insiders prefer a partial reform and sustain the reform process through R_1 , the point where their gains are maximized and beyond which further implementation of policies of discipline and encouragement threaten to undermine gains from rent seeking and tunneling. For potential new entrants, the reform process offers sacrifices at the beginning for the promise of gains when the reforms are further advanced.

Where the risk of oligarchs and insiders blocking anything more than partial reform is high, potential new entrants and state workers will either reject reform or support only partial reform, because the latter, by limiting the downsizing of the state sector and maintaining the flow of subsidies, imposes lower adjustment cost. Yet it is precisely such partial reforms – liberalization without discipline and with selective encouragement – that make capture of state by oligarchs and insiders a self-fulfilling prophecy. This has led to so-called partial reform paradox in many transition economies in which governments lack credibility and are highly susceptible to state capture. This leads potential new entrants at the outset of transition to discount substantially the potential gains from any proposed radical reforms that offer lower costs early in the reform process, even though they are more likely to lead to barriers to entry. Public support for radical reforms therefore depends on perceptions of government credibility in its commitment to follow through with such reforms.

The risk of “getting stuck” at a low level of reform (R_1) characterized by liberalization without discipline and limited encouragement of new entry is high. As both insiders and state workers face declining incomes after R_1 , these groups have a strong incentive to join forces to oppose

further economic reforms. It is only when reforms reach a critical threshold (R_2) that the added gains to new entrants are enough to allow these winners to either compensate for the losses of the other groups or to generate enough political pressure to neutralize opposition to continued reforms.

By recognizing that different combinations of reforms produce different configurations of winners and losers, the framework of discipline and encouragement suggests two political challengers in promoting economic reform:

- Securing the support of potential new entrants for comprehensive reforms until wider efficiency gains from discipline and encouragement are realized;
- Preventing the early winners from liberalization and privatization from undermining further reforms that would impose discipline and encourage new entry and competition and thus reduce their rents.

To meet these challenges, governments must appear credible to potential new entrants in its commitments to follow through with the long and difficult process of economic reform. Government must also be able to constrain oligarchs and insiders from using their initial advantages in the reform process to derail further reforms that would create a more competitive market economy.

Credibility and constraint are rooted in political institutions shaped by the cultural and historical legacies that guided the exit from communism. In many countries in the CIS and Southeastern Europe, where the state has been captured by narrow private interests, the collapse of communism was rooted in a contest among competing elites rather than in any broad social movement. The new political arrangements, these “concentrated political regimes” were designed by incumbent leaders, often as a way to consolidate their power. They lacked the credibility to build and sustain broad popular support for a comprehensive reform program.

As a result, these countries embarked on transition without a broad social consensus on the goals of reform and without a way of organizing the public behind these goals. Instead, incumbent politicians sought alliances with powerful incumbent enterprises. In addition, the politicians continued partial liberalization and privatization in the context of soft budgets and barriers to entry that created tremendous opportunities for rent seeking by old and new enterprises, especially in economies rich in natural resources. Countervailing pressures from competing groups were weak and the disaffection and apathy of the “losers” minimized the direct costs to politicians of poor policy choices. As a result, countries with concentrated political regimes have tended to languish in an equilibrium trap of partial economic reforms. Political and economic power has been used to preserve market distortions that benefit narrow vested interests at considerable social cost.

This partial reform equilibrium can be contrasted with the situation in the “competitive democracies” prevailing in Central Europe and Baltic states. In the aftermath of popular revolutions against communist rule, political institutions in most of these countries emerged from roundtable negotiations among broadly representative popular fronts and a wide range of other organized interests. This, together with the close ties of these countries to Western and Northern Europe and the pull of potential European Union accession, contributed to a wider social consensus on main directions of reform and broad public support for comprehensive reform programs in the early stages of transition.

New governments in competitive democracies tended to focus first on promoting new constituencies of “winners” by removing entry barriers, quickly tackling severe macroeconomic instability (with its high costs to the public) and using social protection to support the “losers” from the dislocations of reform. A legacy of strong public administration allowed for greater security of property and contract rights and better public infrastructure, important preconditions for promoting new entry. As reform progressed to promote entry and improve the enabling environment, constituencies with a stake in advancing reform grew stronger, and the emergence of powerful insiders and oligarchs diminished. This combination allowed these countries to implement and sustain comprehensive reforms.

Political development and economic reforms are closely interrelated. Political systems affect the incentives of politicians to make certain economic policy choices; reform choices shape the configuration of social group and the distribution of power, which affects the structure and functioning of the political system. For example, economic reforms that facilitate new entry also strengthen the constituency of SMEs, which build support for increasing political competition.

Nevertheless, given the sharp break with communism and the disintegration of the Soviet Union, choices about the structure of political systems in the transition economies were generally made before decisions about the nature and pace of economic reform. Moreover, in all but a couple of countries – Croatia and the Slovak Republic – the nature of the political regime has not changed much since the start of transition. This suggests that while the pace and direction of economic reforms may have reinforced initial choices about the structure of the political system, they do not appear to have decisively shifted the course of political transition. As a result, a stronger case can be made for identifying the direction of causation from political choices to economic choices, thus providing part of the explanation for why some countries have been unable to move beyond partial reform.

2.2. KEYS TO ECONOMIC AND POLITICAL SUCCESS FOR BELARUS*

I am delighted to be here with you, and to represent USAID, and the United States Government, and I trust, to some degree at least, the International Donor Community. And it's particularly nice to be here with international colleagues and partners from the World Bank, the EBRD, the United Nations Development Program, TACIS, the IFC and the IMF. All of these organizations have played very important roles around the world and helped countries in transition. U.S. policy and our firm belief is that we work best when we work together. And I also want to say that I am excited to be here with the Belarus officials from the government as well as people from the private sector, all of whom are interested in thinking about the question of economic transformation in Belarus.

I should tell you that for three decades I have been involved in studying the Soviet Union, and the post-Soviet Union. I lived in Moscow for seven months in 1978, and again seven months in 1992, and I deeply respect Slavic culture. My task this morning is to address the topic of economic transformation in the former Soviet Union from the perspective of the international donor community. But I am not a trained economist, and I am going to speak very broadly about the context in which reform needs to occur, but perhaps this will be of some help.

I want to begin with some discussion of the context for the Soviet Union and the post-communist period. And also, I want to suggest to you that it is a great mistake to talk about economic transformation and not put it in the context of political and cultural factors as well.

So let's turn first to this question of what the historical context has been for the transformation that has occurred in many parts of the former Soviet Union. Why in the world would you want transformation anyway? What's the purpose of it? I want to remind you of what the KGB in the mid-1980s reported to President Gorbachev. In highly secret documents a report was given to Mr. Gorbachev in the mid-1980s which asserted that all the intelligence data, all the economic data indicated, that in fact it was a hopeless task for the Soviet Union, as it was then structured economically, to compete with the rest of the world economically, at least with those parts of the world that had free economies. Now this is despite the fact that by

* **Kent R. Hill** is Assistant Administrator Bureau for Europe and Eurasia USAID. It is an edited version of a speech given on December 13, 2003 at an economics conference «Possibilities of Economic Development Support in Belarus».

sheer force of power and will, and despite the sacrifices of people throughout the Soviet Union resulting in loss of considerable life and the burden of low standard of living, despite all those efforts, there was no way to compete with free economies. That was the message of the KGB: they were losing the battle at every point competitively with the West. In fact, you could try to steal the economic secrets of the West, but something was deeply wrong with the Soviet economy itself.

So what did Gorbachev do? Gorbachev said: We have no alternative but to try *perestroika* thru *glasnost*, etc, to try to reform communism, make it more sensitive to markets, introduce some capitalist elements. This was the experiment that Mr. Gorbachev launched. He did not know at that time that by pushing towards a freer society with *glasnost*, and trying to introduce the economic reforms, that he would launch something that would go much further than he had expected it to go. Gorbachev now says that he was mistaken to think that he could simply reform communism. The changes needed to be far more radical than that.

So what is the bottom-line here? The bottom-line is not a question of ideology, the West vs the East, capitalism vs communism, but rather the empirical economic fact based on several hundred years of study of the economic history of the world, and particularly the West, that Marx's economic principles and ideas simply do not work and it is important at the outset today to discuss why they don't work because you can't have a transformation, unless you understand what went wrong, and what you are going to need to do to fix it.

The first thing Marx did not understand was how capitalism would evolve. He and Engels predicted that capitalism would evolve to an ever more exploitive economic system that would lead to revolution. That is not at all what happened in the West. The reverse happened. In fact, the earlier *laissez faire*, more exploitive periods of capitalism evolved into a system which depended on laws of fair play that capitalists and business people, and political figures, had to play by, if they were going to exist and work within that society. A system of laws developed that was essential for the emergence of the capitalist system. Secondly, and this started particularly in Germany, a social net was created that helped those parts of the population that for one reason or another did not benefit from the capitalist economic progress. A system was developed to help take care of the needs of the less well off. And third, and Marx completely missed this possibility; it was not just the oligarchs, or the very very wealthy, that became wealthy because of capitalism. It was not very long until the wealth became to spread throughout the great majority of the population. And what happened was that for the first time in human history, the great majority of democracies that were based on economic principles of free markets were able to take care of, not just take care of but meet the needs of, the average people – not the elite, not even just the

middle class, but the lower middle class, and the lower class. And this occurred to a degree unheard of human history. This is an empirical fact, not an ideological assertion.

Gorbachev, to his credit, was coming to understand what a number of Russian economists were coming to understand who were quietly reading Western economic texts. Namely, that major changes were desperately needed. That is why at the end of the 1980s, when Gorbachev inaugurated his greater openness, there was a climate that was receptive and open to an explosion of activity, that was ready to try something radically different.

I would go on and say that it was not just the failure of Marxist economics that was at issue. I think that it should be understood that Marx also had misunderstood human nature. This is a critical point to me. First of all he did not understand that if you would allow people freely in a free market system not controlled by the government, not controlled by a central bureaucracy, to make their own decisions about what they would produce, sell, and buy, that it would be much better for everybody. He did not understand that you needed to allow self-interest to play a critical role in how the economy is organized.

And so what I would argue is simply this: what has been recognized in most of Eastern Europe and most of the former Soviet Union, with the exception of the states in the Central Asia, and to quite an extent in Belarus as well, is that an economic transformation is needed, because the old ways of thinking about the economy simply can not meet the needs of the people of the countries in question. But I would agree that we have learned that there must be political as well as economic new ways of thinking. We have learned, and economists and political scientists have learned it as well, is that the way a society is structured politically is intimately related to how it is structured economically. In fact, if you start with economic liberalization, it will almost certainly move towards political liberalization, because people who acquire material resources and become a part of an ever larger middle class, want to become more involved in charting the course of the country. And it also makes sense that if you are going to allow freedom for people economically, then there is no good reason not to allow them freedom politically as well. Now this is a threat for any way of thinking that believes a party, any party, any ideology, any individual, any group should control the destiny of the people. But this brings us to the most fundamental point: why does government exist in the first place. There are two possible answers to the question.

Either the government exists solely to promote the special and specific interests of a party, an ideology, an individual, or it exists to serve the great majority of the people in the country. So, that's the fundamental question that organizers of any society must answer. If it is decided that government is for the people, then there will be a move towards free markets. In addition, there is no other alternative

available if there is a desire to escape the economic isolation from the world of free economies, to escape the inevitable reality that a non-free economy will follow further and further behind the rest of the world, and the certainty that the people will become more and more impoverished. If the decision is based on what is best for the people, there will be a move towards economic liberalization. If also it is decided to allow the freedom of the people to express itself in other ways as well, the move towards democracy will occur as well. And since I rarely get to Minsk and I don't have the opportunity often to be with you, I want to be as frank with you as I know how to be, because I care about Belarus and I care about your future. I am very concerned about the growing economic and political isolation of Belarus in Europe. What would be most ideal for you and for Europe would be for you to be fully integrated into Europe, but you have become more and more isolated economically, because of the fear that to move away from a more centrally-planned economy might somehow be problematic, and to the extent you have given in to that fear, it has put you more and more outside of European community. Neighbors all around you, and I visit these countries every day, former communist countries, are making rapid progress in ways that are leaving and will leave Belarus behind, and it is hurting you and your people.

But you are also being isolated now politically. It used to be that the most negative state in Europe relative to religion was Albania, where the Constitution actually forbade during the communist period believing in God. But because of the new religion law here, which went into effect in mid-November, you now have the most repressive system of laws on the books anywhere in Europe relative to the freedom of conscience. And I am sorry about this, because this is in conflict with your own Constitution. It is in conflict with the Belarus commitment in 1948 at the United Nations to support the Universal Declaration of Human Rights, and the rest of the world is well aware of this, and it's ostracizing you. It is putting you outside the orbit of the European countries. I am hopeful that you can take a different course, honor your international commitments and your own Constitution, because I think your own economic transformation will in part depend on your ability to reverse that present course of actions.

The Executive Minister Andrey Tur this morning made some very interesting points about another part of the problem that we need to face. Transformations can sometimes be very awkward; they can have bad aspects to them. If they happen too quickly and without proper care, problems can develop. And the Minister was correct to note that those sorts of things can happen. And here Belarus finds itself in a very interesting situation. Since you have yet to initiate to a major extent many of the most fundamental economic reforms, you are in a position to learn some lessons from those who have gone before in terms of economic transformation. Hopefully, Belarus government

leadership can initiate needed changes because it is in Belarus' best interests to do so, and not just because there is political pressure from below to make the changes. You have the opportunity to move along this course more rapidly than some of your neighbors, if you can learn from the mistakes of some of your neighbors as well. Let me tell you what I have in mind here. This is some of my observations on watching your neighbors basically move in the right direction, but not always think it through as well as they should have. Just this week I gave a speech in Moscow in which I argued that there were four myths that had developed during this period of economic and political transformation, which I believe need to be addressed. Let me tell you what they are.

The first myth is that capitalism can be defined as unlimited greed, and I think the Minister was right to say that sometimes privatization schemes can be just ways to transfer the wealth of the Party to the wealth of a few individuals. Whenever that happens that is not true capitalism. Sometimes we live in a situation where the new economic powers seek to make it impossible for other competing economic players to even function. This is not capitalism. This is a kind of early stage of Western capitalism. But it's not mature capitalism. If that were capitalism, I would be opposed to capitalism. So what could you do differently that some of your neighbors did not quite get right first time around? You can ensure as best you can that there are laws in place that make corruption less likely to occur. You can ensure that there are rules of the game for competing in the market place that are applied to all and not just to the politically or economically powerful, and I think that's extremely important. So, the first myth is that capitalism is unlimited greed. Capitalism, in fact, is an economic system of free markets based on a common respect for law, and if that respect is not present, then there will be all sorts of problems.

Secondly, there is a myth about what democracy means. There is a myth that democracy means majority rule alone, and free elections, even fair and free elections. We all believe in fair and free elections and we are upset when we think elections are not fair and free. But I want to argue today, and I want to put forward the proposition to you, that if that is all that democracy is, that is exceptionally dangerous. What would we do if the majority, even in a fair election, votes to commit genocide against the minority? Is that right just because the majority voted for that? Of course, not. No, the definition of democracy we must use in this new world, in this world with economic liberalization and political democracy, is a definition which is much fuller and much broader. It includes majority rule and fair elections, but it also includes minority rights. There are certain things majorities can never do under any circumstances. This fuller definition includes limited government. Democracy is built on the proposition that government needs to be limited no matter what party is in charge. In the twentieth century,

Reinhold Niebuhr, an important theologian, once argued that “people are sufficiently good to make democracy possible, and sufficiently evil to make it necessary.” Democracy is built on a sober view of human nature, on the reality that governmental power must be limited. A democracy is built on a vibrant civil society with lots of NGOs and absolute freedom of conscience and freedom of religion. Democracy is based on a basically free economy. As you embark, if you are willing to embark, on the full road to democracy use that broader definition of democracy. Don’t be tempted to use a definition of democracy that might be a cover for fascism, which is what a narrow definition of “democracy” can lead to.

A third myth that has grown up in transition countries has been that if you can just technically organize the economy right, if you can just pass the right laws, if you can just have the right constitution, if you just have a fair judicial system, if you can just have fair elections, then you will be home-free. Then you will make it, then everything will be fine. The third myth says that a free economy and a democratic system are simply based on structurally how you organize the society. In fact, if you study the experience of hundreds of years in the West, that’s not quite true, that’s not enough. There have to be some values present that make democracy possible, some values present in society that make the free economic system work. There must be some kind of social or religious conscience that moderates and tempers the excesses of capitalism. The founders of the United States, all of them without exception, were convinced that the democratic experiment in the West and in Britain depended on their being a morale citizenry. Why is that important? Because if people are only capable of voting their selfish self-interests, they can never use their freedom responsibly to defend others and work for the common good, and such a society will eventually collapse. And when there is anarchy, it will invariably lead totalitarianism or authoritarianism on the left or the right. So, if democracy is going to work, it’s going to require an attention to values and if Belarus moving into the future, understands that clearly, and can take measures to unleash the forces in society that would support those values, it could create a cultural structure, a cultural set of support mechanisms that would help democracy and a free market that would really work. That’s one of the reasons I feel so strongly about religious freedom. One of the sources of morality in any society are different religions. And I am not saying that there can’t be secular sources of morality, but one source of morality is indeed religion. When you attack religion, you attack one of the major sources of cultural values that will help the democracy and the free economy to work.

The fourth and final myth is that human beings are simply material creatures. Here is an interesting irony. In much of the former Soviet Union which states openly and officially that Marxist economics failed, and that something else is needed, it is not noticed that though Marx’

economics have been rejected, his materialist view of human remains. If you can just feed people, if you can just provide them housing, if you can just provide for their security, then everything will be OK. But you see, it is much more complicated than that. If you are going to appeal to the best that is within us, you must appeal to our capacity to serve the common good, to look after each other. If Belarus as it looks towards the future can find ways to appeal to the best in human beings, in a way that reflects not just a rejection of failed Marx' economics, but also a rejection of Marx's inadequate view of human nature, you will unleash resources that can help Belarus not only catch up with her neighbors and become a full partner in the community of nations in Europe and the rest of the free world, but her people will live with a measure of freedom and economic prosperity that has thus far alluded it.

So I think there is much to learn both from the communist period, and the early years of transition towards a freer and more prosperous economy in the former Soviet Union and Eastern Europe, and I am hopeful that Belarus is poised and ready to consider some changes that would allow Belarus to participate in those positive changes. I wish you well in this and I am convinced that to the degree Belarus is willing to move in this direction, I know the representatives of international financial institutions and countries here in this room and elsewhere will be more than willing to step up and go hand-in-hand with you towards making some of those difficult decisions. But in the final analysis, all the important decisions must be made by you, and not by us. We look forward to working with you in the future. I wish you all the best.

2.3. PROMOTING ECONOMIC PROSPERITY IN THE BALTIC REGION: WHAT MORE NEEDS TO BE DONE?*

Introduction

I would like to begin by thanking the organizers of this conference – the Institute for Privatization and Management, supported by the United States Embassy in Minsk and the World Bank Office in Belarus – for the opportunity to speak about experiences of the IMF in transition economies. I will use this opportunity to speak about the experience in the Baltic region and what more needs to be done to promote economic prosperity there, as well as about challenges of economic transformation in Belarus.

The transformation that has taken place in Estonia, Latvia and Lithuania since the early 1990s has been remarkable, as the Baltic countries have transformed their societies into democratic states and market economies at a very fast pace. Now they stand on the threshold of reaching their strategic goals of joining the EU and NATO. The Baltic countries have quickly overcome the Russian crisis and have since then exhibited high rates of growth while the inflation has remained subdued. Significant fiscal consolidations have been undertaken, with budget deficits cut to low levels. Current account deficits have also been reduced, and the countries have good track records of attracting foreign investment. The trade regimes have been liberalized, the privatization processes are well advanced and the conditions for new businesses have improved, with the private sector accounting for 70–80 percent of GDP.

In summary, Estonia, Latvia and Lithuania have been well served by their strategy of EU and NATO accession, use of favorable geography, broad political consensus, effective cooperation with the IMF and other international financial organizations, and flexible and effective economic policies. These efforts leave the Baltic countries well placed to reap the benefits of the EU and NATO membership.

Still, the challenges ahead are significant. The countries need to continue to protect macroeconomic stability, in particular by maintaining prudent fiscal policies as the main **macroeconomic policy**

* **Mark A. Horton** and **Zuzana Brixiova** are the former and the current IMF Resident Representative for Lithuania and Belarus, respectively. We thank Patricia Alonso-Gamo, Thomas Richardson, Julia Lyskova and Elena Kovalenko for helpful comments.

instrument under the fixed exchange rate regimes and open economies. Yet, fiscal policies themselves faces numerous challenges, from weaknesses in revenue performance, combined with a desire to ease the tax burden to improve the business environment, to considerable expenditure needs for EU and NATO projects and capital investment. The three Baltic states also face numerous **structural challenges**: business environment suffering from excessive regulations, high and persistent unemployment, rural and urban poverty, weak fiscal situation of municipalities, a need to promote improved health and education, and aging populations demanding timely and effective pension reforms.

The main objective then must be to promote continued rapid economic growth to generate employment as well as fiscal revenues to finance capital and social expenditures. Accordingly, I will discuss the following three topics:

- First, effective fiscal management to enhance macroeconomic stability and to promote high quality growth;
- Second, improvement of the business environment to encourage competitiveness and job creation; and
- Third, addressing gaps to ensure that all groups of society share the benefits of EU and NATO membership.

Macroeconomic policy management

Let me begin with **macroeconomic policy management**. The main risk to the macroeconomic outlook in the Baltics is that, if realized, unsustainable levels of domestic demand under fixed exchange rate regimes could lead to sharp widening of the current account deficits, and erosion of competitiveness. Also, since the financing of the current account deficits in these countries depends heavily on FDI inflows, reduction in these inflows would result in higher gross external financing requirements and eventually in a slowdown in growth. In these circumstances, maintaining appropriately prudent fiscal policies and monitoring the credit expansion are crucial.

While the recent **fiscal adjustments** in the Baltics were necessary to maintain stability, they were achieved through heavy expenditure cuts, as revenues declined. In response, the three Baltic states have initiated tax reforms with a view to simplify the tax system and reverse the decline in revenues while easing the tax burden and improve the business environment. The revenue increases are even more important, given pressures on rising expenditures associated with spending needs for EU and NATO accessions. Transfers from the EU will help, but significant contributions from national budgets will be needed.

One might ask, “why not simply raise the deficit?” Despite the temporary increases in deficits in 2003 and 2004 due to costs of EU

and NATO accessions, the Baltic countries remain committed to pursuing a cyclically adjusted balanced budget strategy. A decline of privatization revenues gives further reason for caution. Maintaining fiscal discipline will be also crucial for the participation of these countries in ERM2. In addition, an appropriately prudent fiscal stance will help maintain low interest rates, key to further growth and avoid increased external imbalance.

In summary, with the imperative to move towards a balanced budget strategy, the immediate adjustment falls on rationalizing expenditures and enhancing their efficiency.

Where to target possible measures to enhance efficiency and rationalization? The areas include reduction in discretionary spending and continuation of public service reforms, but rather than give a long list, I'll focus on public administration reforms at the municipal level.

The main functions of municipalities in the region are to provide education and welfare benefits and to manage utilities and infrastructure. An agenda for municipal reforms, which have so far lagged behind reforms at the central government level, would include:

- increasing municipal autonomy over revenue and expenditures;
- improving the efficiency and quality of service delivery and the management of municipal utilities, which suffer from high operating and capital costs; and,
- improving the quality and transparency of financial information, as well as internal and external audit.
- generating co-financing to EU structural funds for capital investment, strengthening capacity to generate good projects, and improving project monitoring and evaluation.

Business Environment

Let's now turn to fostering of an environment conducive to businesses and competitiveness. The Swiss business school IMD has developed a simple, useful framework of competitiveness based on a set of "golden rules," which include:

- creating a stable and predictable legal framework;
- investing in traditional and technological infrastructure;
- promoting private savings and domestic investment;
- developing aggressiveness on the international markets and attractiveness for FDI;
- focusing on quality, speed and transparency in government and administration;
- maintaining a relationship between wage levels, productivity and taxation; and,
- investing heavily in education and in life-long training of the labor force.

These “golden rules” can be seen in the economic policymaking of Estonia, Latvia, and Lithuania over the past several years. The next steps will be centered on enhancing the quality of public administration and targeting investment in infrastructure and education, and further streamlining regulations, including licensing procedures. Specifically, efforts will continue to simplify procedures and reducing costs in the areas of:

- Taxation and customs
- Labor markets;
- SME development;
- Export promotion;
- Restructuring and bankruptcy;
- Management of state property; including energy sector restructuring; and
- Financial market development.

Let me talk briefly about labor markets. With fixed exchange rate regimes, labor market flexibility is essential to ensure adjustment to exogenous shocks on world markets. The past three years have shown that Baltic labor markets are indeed relatively flexible. There are few constraints on hiring and firing, minimum wages are fairly low and unemployment insurance is modest. Still, unemployment is high, and tends to be geographically concentrated, as labor mobility is limited. The share of long-term unemployed is growing, and there are mismatches between the skills of the unemployed and the needs of new enterprises. In segmented labor markets, there is simultaneously high unemployment and labor shortages. The Baltic governments are keenly aware of the “skills gap” and aim to better tailor education to labor market needs. Other measures to address the unemployment include regional and sectoral variation of minimum wages and reducing taxes on labor income.

Turning to financial sector reforms, all three Baltic countries have participated in the joint IMF-World Bank Financial Sector Assessment Program. The FSAP reports found that Baltic countries financial sectors are generally well regulated. Non-bank financial segments remain less developed, while there is a need to strengthen oversight and regulation in securities and insurance. As the recovery of the Baltic economies has accelerated, credit growth has reached high levels. So far, ratios of non-performing loans have remained modest, but the rapid credit expansions warrant monitoring.

“Gaps”

Turning to “Gaps” we can observe the need for efficient and targeted social spending, for effective public administration, and most of all, for high economic growth. Regional income disparities are significant, as incomes in the Baltic capitals are far above national averages, while

some regions have income levels of just 60 percent of the national average. These regional disparities will require constant attention so that discontent of those groups of population does not lead to slow growth, characterized by continued revenue weakness and further expenditure cuts; high fiscal deficits crowding out private sector; and increasing current account deficits.

Pension reform is another area requiring attention. Although the pay-as-you-go systems have been strengthened and elements of fully-funded system introduced, the lack of viability of the systems and unfavorable demographics call for accelerated implementation of reforms.

What are the economic prospects for the three Baltic countries? The answer is that given the policy track record of past few years and the recent invitation to join EU and NATO, they are very good. The prospect of EU and NATO accession have stimulated investment; macroeconomic stability and improved business environment have created a sound basis for continued transition and high long-run growth. Prospects are very good, but challenges remain. The risks outlined above are well known and well understood among the Baltic governments. With continued efforts, the "slow growth scenario" will not materialize and Estonia, Latvia and Lithuania will move to even greater prosperity and security.

Belarus

Let me now turn briefly to Belarus. The authorities in Minsk have undertaken some positive economic policy steps during the past two years: in September 2000 the system of multiple exchange rates was eliminated; from April through September 2001, the authorities entered into a staff monitored economic program with the IMF, which provided a framework for establishing a track record of successful policy implementation; and in November 2001, the final restrictions on full convertibility of the rubel for current transactions were removed.

With these steps, the authorities have moved from money emission and directed credits to exchange rate targeting and tighter monetary policy. Still, the staff monitored program with the IMF in 2001 was undermined by fiscal weaknesses and not all program targets were met.

Structural reforms lag far behind the other countries in the region, the last year's removal of some elements of the complicated system of price controls notwithstanding. The Belarusian economy lacks flexibility and investment, and the lack of protection of property rights and an unfavorable business environment have led to little SME growth and insignificant FDI, as evidenced by a small share of the private sector in GDP and employment.

Looking ahead, it is time for Belarus to launch fully-fledged market reforms, while taking advantage of the skilled labor force, a strategic

location for transit trade and light industry, and very low levels of external debt. The tasks include:

- ensuring a greater degree of macroeconomic stabilization;
- substantially improving the business environment by increasing certainty over property rights, reducing regulations and price controls, and liberalizing labor policies;
- increasing the coverage, transparency and efficiency of budget management;
- initiating financial sector reforms;
- easing of a restrictive external trade regime; and,
- establishing greater legislative stability. These reforms, together with harmonization of legislation and policies of Belarus with those of Russia that the authorities in Minsk are pursuing, may help in overcoming Belarus isolation and joining in growing regional prosperity.

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2.4. PROBLEMS OF MARKET INSTITUTIONS FORMATION IN TRANSITION ECONOMY*

This article is an extremely short summary of the vision of possible market reforms in Belarus. In 2001 a group of Belarusian economists managed to formulate its vision of possible reforms in Belarus. It was previously discussed at numerous conferences and seminars and during informal discussions. Unexpectedly for all participants they faced the situation when the vision of each element of reforms was different. As a result of long discussions, this vision of possible reforms was formed. Later it was expanded to "Program of Reforms for Belarus".

Monetary policy was the least debatable. All participants agreed to carry out tight monetary policy and carry out reforms with zero budget deficit.

While discussing other reforms we relied much on the existing experience of reforms. One of the lessons of the past decade of reforms was in understanding the importance of market institutions formation. The traditional approach to transitional economies was expressed in the formula "liberalization, financial stabilization, privatization" and paid little attention to the problem of effective market institutions formation. Even the authors who treated the process of privatization quite broadly as the process of private property formation and carrying out institutional reforms did not pay attention to how new market institutions are formed.

Understanding private property as the key element for the creation of market economy is commonplace for all concepts of market reforms. However, property is often understood in a very simplified way: as laws allowing or prohibiting actions with these or those economic resources. But laws are only a part of norms, which are used to realize these or that type of property. Property is like a bunch of rights as a set of different norms that regulate behavior of people and organizations and that is stated in various public institutions like law, morality, traditions etc. A part of these norms exist as formal norms that are stated in laws and supported by judicial system. The other part of norms exists as "informal" and norms of behavior are not stated in written form. Fulfilling these norms are supported by traditions and public opinion. Change of property system means change of both formal and informal norms of behavior.

Ways and speed of changing formal and informal part of norms differ much. Formal rules are formed quite quickly. Political will of the parliament and the government are needed to pass adequate changes

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in legislation and to ensure independence of the judiciary as the institution that supports observance of these new rules. Informal rules are formed as a method of accepting new “formal” rules of behavior by the people. This process takes much more time.

The situation concerning the development of property rights in transitional economies differs from the same process in traditional market economies. In the latter, formal rules are amended as incremental changes in informal rules. In transitional economies the process is reverse. First, formal rules are passed, and then their “acceptance” and formation of their basis in the system of informal rules takes place.

The emergence of any new economic institutions requires investments. It is necessary to spend resources on the creation of legislative base, training of professional participants, who would ensure functioning of this institution, creation of material and information infrastructure and training of users of the new institution. For example, in case stock market is created, it is necessary to adopt the appropriate legislation, which would promote successful development of this market. Then a commission on securities shall be created to exercise control over the functioning of this market with its specialists trained. Then a stock exchange shall be set up and appropriate specialists trained. Later an association of professional participants of the stock market shall be created. Enterprises shall become joint stock companies with staff trained to operate on stock market. Population and business should be informed about capacities of stock market and trained in making use of it. This all would require time and investments.

In transitional economies the state makes primary investment. Then private sector and population, i. e. users of the new institute, begin to invest. In developed market economies where formation of institutes is incremental, most part of investment on the initial stage are made by users of the new institute and only then the state begins to invest.

New economic institutions can be established in two ways. The first assumes minimization of state expenditures on the creation of new institutions. In this case private sector assumes the main burden of financing creation of new institutions. However, private sector is going to invest into the most profitable projects; on top of this, the level of accumulated resources limits it in each particular moment of time. This way of creating institutions can be called evolutionary: institutions are created slowly as private sector develops. Still the objective of reforms is to create private sector and try to shift responsibility for the development of institutions onto its shoulders, but this is an obstacle to the development of private sector and thus to the reforms in general.

The second way envisages state financing for the creation of new economic institutions to the extent and to the level of development

that the private sector finds it profitable to make use of it and invest in its development.

Let's consider, for example, the formation of the stock market in Poland and in the Czech Republic. The starting conditions for the reforms in those countries were quite similar. In both countries there was national consensus on the necessity of carrying out reforms. Reform-oriented governments were in place. They chose quite radical variants of reforms. Both countries chose the European vector of development. However, the formation of stock market in these countries was distinctly different. Poland took a concept of forming "hard" market institutions. It meant putting tight requirements with regard to security of investors. Accordingly, it means high standards for Commission for Securities and for professional participants of stock market. This model of stock market introduced measures to stimulate business and population to use this new market institute. The Czechs took a different approach. They thought that it was necessary to give business freedom and it will form effective market institutions itself. In case with stock market it was revealed itself in lower legal protection of investors' interests and weak incentives for both business and population to use this new institute. As a result, the Czech stock market hardly fulfilled its function of capital mobilization. In Poland, investment of the state in setting up stock market made this activity attractive for business. It got profit on the stock market and invested it in further development improving capital base, raising professional level of knowledge and improving operations of the stock market.

Since the creation of market requires investments, the pace of reforms will be limited by opportunities to invest in the development of these or those market institutions. Presumably, the volume of investment will depend on the choice of the right structure (sequence) of reforms and the level of readiness of society to the introduction of new market institutions. The less business and population are prepared to perceive values and norms of the new economic institution, the more expensive its creation would be to the state and society. The more efficient the institution created by the state in the process of reforms turns to be, the more private investments would be attracted for its development.

The primary level of values and norms of behavior that existed in the society is just one form of restriction to the speed of reform. There are limitations to the possibility of forming and recognizing new institutes in the conditions of limited time. Humans have limited capacities in perceiving and comprehending new things. Therefore, the pace of reforms cannot be higher than capacity of the majority to perceive and comprehend new values and norms of behavior.

Reforms will not be successful, if such limitation is not taken into account. Reforms are needed to improve the life of people. However, reforms must not be pursued with the use of the Bolshevik motto "we

will use an iron hand to push people into a happy future". Any reform requires a person, affected by it, to change behavior and the way of life; such changes cause irritation towards the initiator of the changes. The situation resembles a surgical operation: useful but at the same time painful.

Such position calls for certain requirements concerning decisions on the speed and sequence of reforms. The concrete form of solving this or that problem of economic transformation arises as a balance of possibilities and aspirations of various political and social groups existing in the society. Only an open and tense dialogue in which minority has a chance to present its position enables us to find publicly acceptable ways to reform the economy. The transformation experience of former socialist countries shows that the countries where political dialogue was the most intensive were successful in transformations. The only "favorable" example of Pinochet is not quite convincing. Under Pinochet dictatorship, the market economy was not formed after decades of state economy dominance. His task was to prevent planned economy from causing destruction and to restore market principles. Such reforms were carried out in the most developed market economies of Latin America. This country had the most developed traditions of democracy on the continent.

An open political dialogue on ways of reforms can be successful only if society forms active demand for market institutes and the dialogue is conducted on a high professional level. An important condition of developing such a dialogue is participating in international organizations which have much experience in developing private sector, which accounts for the largest share of demand for new institutes. International organizations are not just important carriers of expertise on reforms. They are also a source of finance for the process of forming new market institutes. At the same time, the integration of the national economy into the world one economy and attraction of foreign investors is equally important. The influence of international organizations on the formation of market institutes is primarily in supporting the formation of formal institutes and, to a lesser degree, the formation of informal ones. Attraction of foreign investment and open economy that involves new organizations and people in international economic activities contribute to the formation of demand for market institutes.

The role of foreign investment is not just in bringing modern technologies or financial resources. It is obvious that a person trained by reading books is unlikely to become a good doctor or watchmaker. Practical skills need to be acquired, which can only be done by on-the-job training with a trainer. Vaclav Klaus stated that the Czechs do not need foreign assistance in pursuing reforms and reorganizing industry, as they are clever and educated enough to cope with their problems – and that statement caused puzzled looks. Wisdom and theoretical

knowledge are not directly related to mastering of skills and norms of business. Skills are acquired in the process of joint activities.

Studies conducted in Ukraine show that at enterprises with foreign investments and foreign management values of employees change quicker. They acquire new skills faster and form perceptions that are adequate to rising market institutes.

On the initial stage of reforms, a foreign investor focuses primarily on internal market. To lower risks for a foreign investor in Belarusian domestic market, which is relatively small, it is necessary to make accessible markets of neighboring countries. To achieve this we should aim at signing free trade agreements with all neighbors. It is time to destroy the myth that Belarus has some peculiar economic possibilities as it is situated in the center of Europe. We are situated in the geographical center of Europe but in economic sense Belarus is in the outskirts of Europe. It is rather Switzerland that is situated in the economic center of Europe. Belarus should join WTO and get as much access to markets of other European countries as possible. Active involvement of Belarusian organizations in international business would stimulate the acquisition of new skills and knowledge and would contribute to the formation of informal institutions of market economy in the country. At the same time, the integration of Belarusian economy in the world one makes our country more attractive to foreign investors who will consider investing in Belarus not just as an opportunity to enter a new market but also as a means to increase their competitiveness in their strategy of global competition.

The attractiveness of the country for foreign business is determined by the existing legislation and social environment, which stimulates development of business and entrepreneurship through creation of expectations of economic growth. It is more important than benefits and subsidies which the foreign investor is getting there.

In post-socialist countries economic growth can be provided only by a new private sector. New private sector shall mean and refer to enterprises started on a "green field", i. e. from a scratch. It is difficult to imagine that the Minsk Tractor Works would again produce 120,000 tractors, or the same amount of MAZ trucks will be made. An objective for enterprises of "from the time socialism" is to keep production, on a considerably lower level, though. However, it must be the level that would provide for the efficient functioning of the company. Economic growth will be provided, first of all, by new enterprises, emerging in new sectors. In addition, the new private sector is a source of competition development in the economy. Internal competition is more efficient compared with competition with foreign companies. So, it is exactly the successes of the new private sector that would stimulate both former state-owned enterprises and new businesses to become more active.

The pace of creating the "new" private sector affects the pace of reforms. State sector restructuring is accompanied by redundancies

and reduction of workers. The growing new private sector is the main source of labor that is reduced at old enterprises. Thus, a high growth rate of the new private sector weakens one of the social limitations of reforms connected with unemployment growth during the restructuring of large enterprises.

While carrying out reforms, it is necessary to concentrate on the development of private sector. First of all, it is necessary to reduce the existing market entry – exit barriers for new businesses. An important element of reforms is to create an infrastructure to support the development of private sector. The policy of SME support should have a long-term perspective. It should include the creation of education infrastructure, possibility of small business access to funds through various systems of micro-crediting and insurance of SME's property. The effectiveness of this system is extremely important when the public does not understand social importance of entrepreneurship and does not value its significance for the society.

The cost of support to development of small and medium business would depend on the people's willingness to open their businesses, and bear responsibility for their company. The lower the values of entrepreneurship are in people's eyes, the more aggressive the external environment would react on the initiative and the more resources would be spent on the development of entrepreneurship in the country.

In the process of reforms, everything should contribute to the creation of the new private sector. Foreign investments and restructuring of industry are important sources of incentives for the growth of the new private sector.

New businesses emerge as a "bud" from a similar enterprise or transfer into related branch. Foreign investments are important in setting up new businesses. A foreign investor provides for the development of personnel, which then, having acquired experience and skills, often "buds" new businesses, working in segments not covered by the "mother" company, or gets its segment in a growing market.

Active restructuring of private enterprises is an important factor in the development of the new private sector. Restructuring of enterprises is related, first of all, with property restructuring as socialist enterprises are overloaded with assets. This means appearance on a market of a considerable amount of investment goods attractive from the price-quality point of view. It gives chances for setting-up new businesses, as soon as the barrier of capital to enter the market goes down.

The formation of a fast growing effective private sector is the most important guarantee of long-term development of reforms. It is private sector that forms the largest share of demand for new market institutes. It influences the process of their formation both through political process and passing new legislation and through its practical activities.

During its business activities new formal institutes are being adjusted too, i. e. The formation of informal institutes that are adequate to formal ones is taking place.

An important element of success of reforms is creating an effective training system. The fast transformation of economic environment and setting-up of new economic institutes require managers and technical specialists to possess new knowledge and skills. The system of training and retraining should enable managers and technical specialists to acquire new knowledge and skills. It is also necessary to reform the existing system of higher education. It applies not only to public and economic subjects but primarily to engineering education. The system of engineering education should correspond with modern demands as professional level of specialists determines possibilities of economic development. Developing private business should have an opportunity to actively participate in the formation of training programs and setting qualification standards in both higher educational institutions and other educational organizations.

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2.5. CAN BELARUS SURVIVE AS ENCLAVE OF NON-MARKET ECONOMY IN THE CENTER OF EUROPE?*

Even though one may claim that the current economic system in Belarus does not represent any longer a classic Soviet-type command model, it can hardly be referred to as a market economy even from the CIS standards' point of view. The majority of enterprises continue to be controlled by the state or work collectives. In both cases they are subjected to tough administrative control. The traditional kolkhoz and sovkhoz system almost indisputably dominates in the agriculture. A considerable part of prices remains subject of administrative regulation. In spite of the official and market exchange rates coming closer recently and fulfilling the obligations coming from Article VIII of the IMF Articles of Agreement has been declared by the National Bank of Belarus and Government the Belarusian Ruble is far from being fully convertible. Therefore, quality and equilibrium of commodity markets remain far from Russia's and Ukraine's standards, not saying about Poland and Lithuania. Some segments of the commodity market are reminiscent of the times of the shortages economy. Credit decisions of commercial banks are significantly determined by the government guidelines and priorities. Thus, the quality of the credit portfolios cannot be considered satisfactory, and majority of Belarusian banks will need expensive restructuring, sooner or later. The share of foreign non-Russian capital in the Belarusian economy is close to zero; however, the scale of Russian investments (apart from oil and gas sector) is not impressive, too.

According to all ratings, evaluating progress of transformation (for example, those of EBRD, World Bank or Freedom House)¹ Belarus is amongst outsider countries, both in the sphere of establishing market relations and institutions, and in terms of democratization and civil liberties: in one group with Uzbekistan and Turkmenistan. The worst thing is that the relative position of Belarus in both spheres worsened considerably from mid-1990s. Even though Belarus has never been considered as leader of the transition process, the gap between it and its neighbors has never been so big as it is today.

Looking at the situation in the neighboring countries, three of the five direct neighbors of the Republic of Belarus (Latvia, Lithuania and Poland) will become members of the European Union within the next

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¹ See World Bank (2002).

eighteen months. In spite of the slow pace of reforms in the past and their inconsistency, Russia and Ukraine advanced in the process of creating the basis of the market economy over the recent years. Both countries carry out intensive negotiations about joining the World Trade Organization and have chances to complete the process within the nearest 2–3 years. In turn, a membership in the WTO will open them the doors to start negotiations on free trade agreements with the enlarged EU. In the current situation Belarus has no chances to join the WTO and come closer with the European Union. This means that conditions of external trade, investments and other forms of foreign economic cooperation will deteriorate. The continuation of the current relatively liberal trade regime with Russia and other CIS may occur impossible and Belarus will find itself in the growing economic isolation (in addition to the political isolation already in place).

The geographical location of Belarus is one of the best in Europe. The future border with the European Union, the second biggest economic power in the world, could have promoted economic and social development of the country. However, this needs harmonization of economic, institutional and legal systems, which is very unlikely for the time being. In spite of numerous declarations about economic and political union with Russia economic systems of these two countries are also more and more differentiated.

An attempt to forecast what is going to happen during the next five or ten years will give the following picture: in the west and north, Belarus will be surrounded by the well-integrated Single European Market, in the south, there will be Ukraine with market economy trying to enter the European Union, and in the east – market Russia, step by step implementing the project of creating the European Economic Area with its participation. Can Belarus survive as an enclave of non-market economy in this single European Economic Area, as a kind of reserve of the Soviet system, attracting researchers from the whole world to study a live history of this system or carry out comparative researches? Can the status quo be continued for a long time, at least in the economic sphere?

Naturally, the answer to these questions includes possibility of a mistake as soon as it touches the sphere of political futurology. However, such risk is part of any forecast. Even though the forecast does not always come true, it helps to understand the interaction of various factors, affecting the course of economic and political events.

So let us ask again: can the present state of things go on for a long time, at least in the economic sphere? It seems that in the short-term perspective (two-three years) the answer may be positive. The current regime is far from exhausting all of its economic and political resources; therefore during a certain period of time it may continue effective resistance to market reforms. However, from the point of view of a long-term perspective stability of the existing system raises serious

doubts. A number of factors would act against this system.

Inside Belarus the inefficiency of a non-market or semi-market economy will cause growing social discontent. In case economic growth in Russia and Ukraine will continue with market reforms going on (even though slowly), it will be difficult to persuade somebody in the benefits of the Belarusian economic and social experiment. Statistical tricks will not help. Comparison with the nearest neighboring countries will be a strong factor of psychological pressure both on population in general and on political elite.

The Belarusian enclave will probably hamper the process of political and economic integration between Russia and Europe. It is unlikely that Russia will be happy to continue financial support of the Belarusian economy with more credits and energy resources supplied on beneficial terms. On its part, Russia will go on pressing for harmonizing economic systems of the two countries and opening of the Belarusian market to the Russian investments.

Summing up, the country cannot be closed for a long time and, in spite of ideological preferences of the Belarusian leadership and all administrative limitations, capitalism will be penetrating Belarus, if not from the west and north, then from the east and south. In turn, this will push for gradual changes in the economic system.

Market transition can be made in different ways. The first hypothetical scenario is a gradual economic liberalization, carried out within the framework of the present political regime.¹ The possibility of this scenario is not very high but it cannot be excluded. In the future it should result in political liberalization, even though the time gap here may turn to be quite big.

The second opportunity is the change of regime and acceleration of the process of economic and political integration with Russia. This may lead to acceleration of market transformation and certain political liberalization, even though the Russian model of capitalism and democracy is far from being perfect.

Finally, the third scenario – radical change of the political regime and Belarus turning rapidly towards democratization, far-going economic reforms and integration with the West, the European Union included. No doubt that this would be the most promising scenario and the only one offering real opportunity to eliminate economic and civilization backwardness of the country.

All the three scenarios will need catching up the time lost earlier. The sooner Belarus embarks on the way of democratic and market reforms the more chances are there to limit the negative consequences of the last decade.

¹ Some progress was made in this sphere in 2000-2002. I.e. partial liberalization of the currency market and easing the burden of administrative price control.

2.6. MICROFINANCE IN UKRAINE: A MODEL FOR BELARUS?*

1. Introduction

Belarus displays one of the most hostile environments for the private sector in all European transition countries. According to official statistics, the private sector has only a share of 20% of GDP in the Belarusian economy. This share has remained stable since the mid-1990s. Even taking into account the high incentive to misreport economic activity due to the prohibitive Belarusian tax system, the private sector's share will not be substantially higher than 30% since the shadow economy is much less significant than in other FSU countries. In particular, micro, small and medium-sized enterprises suffer from state regulation and intervention. They are much more vulnerable in dealing with the unfriendly and unstable regulatory environment compared to large companies. Hence, the number of SMEs in Belarus per 1,000 residents is with only 2,7 much lower than in Russia with 5,7 or Western Europe with 45. Today, the SME sector contributes only 8% to total output¹.

The attitude of the Belarusian Government towards SMEs is difficult to understand as they provide additional employment and income opportunities. SMEs help to set off the huge employment losses in the largely inefficient state sector and foster structural change. Whereas in more advanced transition economies, like Hungary, already almost 60% of the workforce have found employment in the SME sector, the figure for Belarus is well below 20%. As in other transition countries, Belarusian SME's face an almost total lack of access to credit from the banking system:

- The banking system in Belarus is still state-dominated and largely misused by political interests. The private sector suffers from a serious crowding out as the state sector absorbs most of the available funds.
- Banks are undercapitalized, lack transparency and have little incentive for lending to the private sector.

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¹ For a comprehensive overview of the state of the SME sector in Belarus see www.ifc.by.

- Belarusian banks have failed to develop demand-oriented credit technologies, i. e. credit products and procedures that are in line with the specific credit demands of SME's.
- Belarusian banks lack mid- and long-term refinancing sources. They have almost no possibility to tap international capital markets.
- Unfavorable banking and foreign exchange legislation keeps transaction costs high and, thus, seriously hampers lending to the SME sector.

The international donor community, in particular KfW, EBRD, IFC and the EU have successfully addressed similar problems in many other transition countries by setting up revolving loan funds and microfinance banks. Only in the Balkans 7 microfinance banks were founded during the last years:

Tabl. 1

Microbanks in South East Europe

Microbanks	Share capital M EUR	International financial organizations' share in different banks, %					
		KfW	IMI ¹	IFC	Commerz-bank	EBRD	Others
Micro Enterprise Bank, Bosnia	7	8	19	25	10	25	13
Micro Enterprise Bank, Kosovo	7	16	16	16	16	16	16
Micro Finance Bank, Romania	10	22.5	10	22.5	22.5	22.5	–
Micro Enterprise Credit, Moldova	5	20	10	20	–	20	10
FEFAD Bank, Albania	7	25	15	20	20	20	–
Micro Finance Bank, Yugoslavia	14	16	16	16	16	16	16
Procredit Bank, Bulgaria	7	20	20	20	20	20	–

The activities in Belarus have, apart from a EUR 30,3 million SME-credit line of EBRD² to private entrepreneurs, so far been very limited and not enough experience could be gathered. In June 2000, a micro lending component was introduced under the SME line, which is on-lent through two private banks Prior Bank and Belgazprom Bank. Until October 2002 only 365 micro loans had been disbursed. Hence, the purpose of the ensuing analysis is first to present the micro-lending lessons from Belarus' neighbor country

¹ The Frankfurt-based Internationale Micro Investition AG (IMI) was especially founded to invest in microfinance banks. Its shareholders are IPC GmbH, IPC-Invest (GbR), DOEN, ProCrédito, DEG (KfW Group), IFC, FMO and Belgian BIO.

² See www.ebrd.com/country/country/belarus/showcase.htm.

Ukraine and then single out the prerequisites for a successful policy transfer to Belarus.

2. Micro-Lending in Ukraine: The German Ukrainian Fund

Since Ukraine declared its independence, the German Government has been supporting the development of the SME-sector in the country. Initially concentrating on technical assistance, it became almost immediately apparent that also finance had to be provided¹. Already back in 1996, the Kreditanstalt für Wiederaufbau on behalf of the German Government together with the National Bank and the Ministry of Finance of Ukraine founded the German-Ukrainian Fund (GUF). The GUF was registered as a legal entity under Ukrainian Law as a non-profit “special financial institution” with a total endowment of over EUR 16 million. The GUF was not only the first project to provide finance to SME’s in Ukraine² but also the first to which the Ukrainian government made a substantial financial contribution. The GUF has several complementary objectives:

- to provide credit to micro and small enterprises via Ukrainian banks;
- to strengthen private financial intermediaries with a demonstrated commitment to sound banking and lending to SME’s;
- to create sustainable micro and small lending facilities in Ukrainian commercial banks.

The GUF provides competitive refinancing for private Ukrainian banks, which have a strong commitment to work with SME’s. The partner banks have to qualify for participating in the program. Besides, indicators of financial prudence (minimum capital requirement, liquidity, risk weighted capital adequacy ratio, share of related party transactions, international audit) the banks have to meet institutional requirements (creation of special microfinance departments, number of specially trained loan officers, introduction of performance-related salaries) as well as challenging performance targets (number of loans granted per month). In order to help the banks meet these requirements the German Government has provided technical assistance funds for training the partner banks. At present, five private Ukrainian banks (Aval Bank, Privat Bank, Microfinance Bank, Forum Bank, Nadra Bank) with a total of 65 branches all over Ukraine³ take part in the program. Three of these banks are among the top 10 Ukrainian banks according to their capital and assets.

¹ For further information concerning German TA for Ukraine see www.transform.kiev.ua.

² Since 1998 the GUF program was complemented by the Ukraine Micro Lending Programme by EBRD. See www.microcredit.com.ua

³ Branches are located in Chernihiv, Chernivtsi, Crimea, Dnipropetrovsk, Donetsk, Ivano-Frankivsk, Kharkiv, Kherson, Khmelnytsky, Kyiv, Luhansk, Lutsk, Lviv, Mykolaiv, Odessa, Poltava, Rivne, Sumy, and Zaporizhia regions.

Technical assistance financed by KfW on behalf of the German Government and carried out by the Frankfurt-based microfinance consultancy firm IPC focuses on the following activities:

- selection and training of local loan officers;
- establishment of a credit technology based primarily on the analysis of the entrepreneur's character and personal history, the quality of his or her business and the feasibility and profitability of the proposed project;
- introduction of efficient loan processing procedures, including efficient rules for delegating responsibility within the partner banks.

The program's target group consists of micro and small enterprises in all sectors of the economy. Micro and small enterprises are largely defined as legal entities or private entrepreneurs employing 1 to 100 persons. Loan amounts range from USD 100 to 125,000. Annual interest rates at the end of 2002 vary from 12–18% for loans in EUR and 20–28% for loans denominated in Hryvna.

As of December 31, 2002, approx. 8,000 loans were granted to Ukrainian micro and small businesses for an amount of close to EUR 50 million. The type of businesses financed range from market traders to clothing manufacturers, from bakeries to dentists, and from goldsmiths to construction firms. Monthly output has increased to almost 600 loans disbursed per month, compared to an average of 65 loans disbursed per month in 1999. By the end of December, the outstanding loan portfolio of the GUF consisted of over 3,000 loans for an amount of EUR 9 million.

The average amount disbursed is steadily decreasing. In 1999, the average loan amount disbursed was at EUR 11,171 compared to EUR 4,144 in 2002. Access to credit to the lower-end of the market is thus increasing and by the end of December 2002, approximately 75% of all

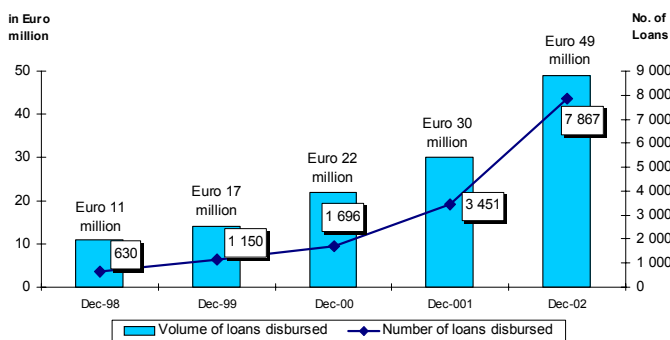


Figure 1. Volume and number of GUF loans disbursed (cumulative data since start of the program)

loans outstanding were for an amount below EUR 5,000. This reflects the partner banks' increased willingness to accept the target group as well as an increased awareness among the target group of formal micro finance.

Not only in quantity but also in quality, the portfolio of GUF loans excels. Only 0.9% of the portfolio are in arrears over 30 days. Less than 10 loans had to be written off over the last 6 years of operation.

All in all, one can state that the GUF had a visible and significant influence on the development of the Ukrainian small enterprise sector as well as on the financial sector. Conservative estimates suggest that a several 10,000 jobs have been created by DUF. However, there still remains a lot to be done and the shareholders already plan to introduce new credit lines, complimentary to the current SME program. In November 2002 the German Government has committed a EUR 5 million loan on IDA conditions for financing Ukrainian agriculture (farming, food-processing and related services). Also a credit line for financing energy saving related investments for the private sector is in the pipeline.

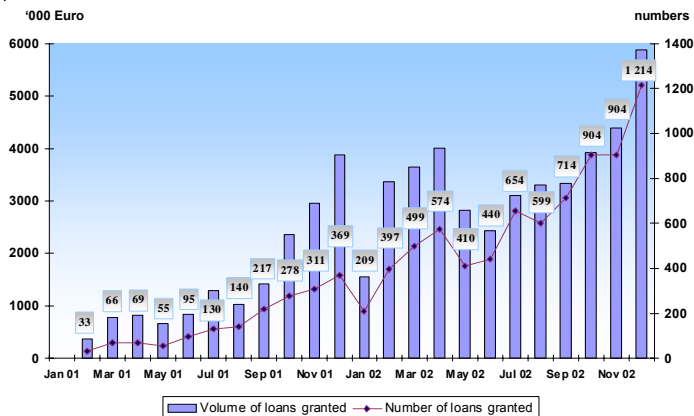
3. The Microfinance Bank Ukraine

To create a 'best practice' bank that targets the financial needs of micro and small enterprises and to increase competition in the sector, the Micro Finance Bank Ukraine (MFB) was founded in December 2000 with a capital of EUR 10 million and in complete compliance with Ukrainian banking legislation. Shareholders of the bank are EBRD (20%), GUF (20%), IFC (20%), Western NIS Enterprise Fund (20%), DOEN (10%) and IMI (10%). In its lending operations, MFB focuses primarily on micro and small enterprises and has already contributed substantially to invigorating the whole micro-lending sector in Ukraine. Since MFB was founded, other partner-banks of the GUF significantly increased their micro loan portfolio. MFB acts in this respect as a benchmark in the fast growing sector of micro lending.

In the year 2002, MFB disbursed 7,518 loans with a total volume of USD 39.8 million. The average loan amount at the end of 2002 was around 4,800 USD. Over 60% of all loans disbursed in December 2002 were loans under 2,000 USD. The quality of MFB's portfolio lives up to the highest expectations. At the end of 2002, only thirty-four business loans, totaling USD 125,954, were in arrears over 30 days. This represents 0.5% of MFB's outstanding credit portfolio.

To fulfill its mission of improving access to finance for Ukrainian micro and small enterprises, the regional expansion of MFB is of particular importance. In 2002, full-fledged branches opened in Donetsk, Kharkiv, and Lviv. Representative offices operate in Odessa, Dnipropetrovsk, Sumi, Poltava, Makyivka, Kramatorsk, Gorlivka, Bila Tserkva and Ivano-Frankivsk. The contribution of the regions to loan

disbursements is continually increasing from 54% in December 2001 to 76% a year later.



**Figure 2. Disbursements of MFB
2001–2002 in volumes and numbers**

While not deviating from its focus on micro and small clients, MFB will gradually develop into a full-fledged universal bank. Already today, besides its loan products, the bank offers a full range of domestic and international payment services, guarantees, letters of credit, credit cards and deposits. In the near future e-banking and ATMs will be added. Another challenge for the future for MFB will be its refinancing in local currency on the Ukrainian financial market. Whereas IFI's like EBRD, IFC and KfW provide credit lines in hard currency, long term refinancing in Hryvna can only be achieved by attracting more deposits and a possible launch of bonds in local currency in the still infant Ukrainian bond market.

4. Microlending in Belarus: What has to be changed in Belarusian Economic Policy?

Before singling out the major policy prerequisites for successful microlending in Belarus, first the banking systems of the two countries should be briefly compared.

After the banking crisis in 1998, Ukraine's banking sector¹ has witnessed remarkable progress and consolidation. In 2002, assets rose by 33.6% year on year, deposits of individuals increased by 70%, while

¹ See sites of the Association of Ukrainian Banks www.banks.kiev.ua and the site of the National Bank of Ukraine www.bank.gov.ua.

corporate deposits rose by 29%. Loans to businesses increased by almost 50%. These figures are even more impressive, if one takes into account the extremely low inflation of -0.2% in 2002. Interest margins almost halved. Bad loans decreased from 5.8% to only 4.5%. A prerequisite for this trend is the financial stabilization of the Ukrainian economy, which is underway for already 3 years. At the core of the stabilization lies the imposing of hard budget constraints on enterprises and banks since the year 2000. Low inflation, a stable currency, improvements in banking supervision and a largely independent central bank have returned the trust of the population and businesses to the banking sector¹.

In comparison to other FSU countries, in particular Russia, with its monopolized banking sector, where the state-owned Sberbank still absorbs more than 70% of private deposits, competition in the Ukrainian banking sector is rising and the role of state banks is continually decreasing. After the liquidation of Bank Ukraina, the former Agroprom Bank, among state-owned banks only Ukreximbank with 3.5% of total authorized capital and Oshchad Bank with 1.8% make it into the top 10 Ukrainian banks. State-owned banks in Ukraine account for 14% of assets, 9.5% of loans to the private sector and 18.6% of household deposits.

Ukraine is also gradually opening up its banking sector for foreign investment. Raiffeisen, HVB, ING, NRB, Alfa and others are serious players in Ukrainian financial markets. They represent 8.8% of total authorized capital and 8% of assets. At the end of 2002, the NBU decided to allow foreign banks to open branches, and thus eliminated one of the major obstacles for further strengthening the position of foreign-owned banks in Ukraine.

Despite numerous obstacles², the development of the Ukrainian banking system seems to proceed in the right direction and the progress over the last three years is significant, while the picture in Belarus appears more than bleak. The banking sector with its 25 mostly undercapitalized banks suffers, like many other sectors of the Belarusian economy, from a general standstill of the reform process and is still dominated by state ownership and interventionism³. The national bank, despite its commendable attempts to stabilize the

¹ For the current development of the Ukrainian economy see the Monthly Economic Monitor of the Institute for Economic Research and Policy Consulting, www.ier.kiev.ua.

² For an in-depth analysis of deficiencies of the Ukrainian banking system see Ukraine: The Financial Sector and the Economy, The New Policy Agenda, IBRD, Washington, September 2001. EBRD, Strategy for Ukraine, September 2002.

³ For an analysis of the political economy of Belarus see Mildner, K., Belarus: *Kritische Überlegungen zu Politik und Wirtschaft Lukaschenkos*, Berichte des BIOST, 12-2000.

Belarusian ruble and bring down inflation, is far from independent and often a hostage of political whim. Directed credit, for instance, for agriculture or construction, seriously undermines the stability of the banking system and crowds out scarce resources to the private sector's disadvantage. Other examples for state interventionism are partial controls of credit interest rates and margins as well as comprehensive privileges for state banks, for instance exemptions from minimum reserve requirements.

State-owned banks are predominant in the Belarusian banking sector. At the end of 2002, they accounted for 77.14% of total authorized capital and for 88.9% of assets. Year by year the state is increasing its stake in the banking sector. The most important state banks are the Belarusbank (savings bank) and the agricultural Belagroprombank, which have by far the widest branch network. The state has a majority stake in a further 4 banks in the top 10, the Belinvestbank, the Belvneshekonombank, the Slavneftbank and the Belarusian Bank for Development and Reconstruction. Even in most private banks, like Priorbank or Belgazprombank, the state has an indirect stake through state-owned enterprises.

The rising of bad debts is only dressed up by periodical state ordered write-offs¹. Bad debt risk in the banking sector is probably much higher than the officially reported 9% at the end of 2002. Total authorized capital, in particular in state-owned banks, has increased nominally by 84% only due to the transformation of mostly non-performing directed credit into authorized capital of Belarusbank and Belagroprombank.

Table 2

Banking Sectors in Comparison, Dec. 2002

	Ukraine	Belarus
Number of banks (of which foreign-owned)	157 (19, 7 banks with 100% foreign capital)	28 (23, 4 banks with 100% foreign capital)
Total capital of private-owned banks (in % of GDP)	4.6	0.51
Balance sheet total (in % of GDP)	29	4.25
Asset share of state-owned banks (in % of all Banking system assets)	14	88.9
Bad loans (% off total loans)	4.5	9
Credit to private sector (% of GDP)	17	6.0
Deposits in % of GDP (in state-owned banks)	8.5 (1.6)	11.8 (10.9)
EBRD index of banking sector reform (2002)	2+	2-

¹ See Belarusian Monthly Economic Review 2/2002, www.ipm.by

The presence of foreign-owned banks in Belarus is rather limited and has even decreased from 9.6% in January 2002 to 8.9% in August. While 20 banks have foreign, mostly Russian, capital, it remains low with only around 10% of authorized capital. Only in Priorbank is Western capital significant. In December 2002, Raiffeisen Bank acquired a 50,1% stake in Prior. EBRD owns 13% of this most important private sector bank in Belarus.

Taking the above-mentioned into account, serious reform steps are essential to make micro lending viable and successful in Belarus. As the banking sector can not be substantially better than the private sector in general, the main trigger to start comprehensive micro-lending operations in Belarus would be a paradigmatic change in the attitude towards the private sector, e. g.:

- phase out administrative interventions in the economy (price controls),
- impose hard budget constraints on enterprises;
- improve business climate (tax reform, streamline business licensing, reduction of business inspections);
- improve private property rights;
- speed up privatization.

In addition, structural change in the banking sector must accelerate, above all:

- reduce state ownership in the banking sector;
- abolish directed credit to specific sectors of the economy;
- impose hard budget constraints on banks;
- reduce state intervention in bank's lending decisions;
- lower transaction costs for financial intermediation (regulation of foreign currency operations, reserve requirements, reporting to national bank).

Some progress in the above outlined areas would pave the way for an engagement of the donor community in microfinance in Belarus along the lines of Ukraine. The establishment of a revolving loan fund similar to the German Ukrainian Fund and a microfinance bank similar to MFB would have a significant impact on the Belarusian transition. Microlending would not only significantly contribute to financial and private sector development but also alleviate poverty and support the creation of a middle class.

**HOW CAN INTERNATIONAL
DONOR ORGANIZATIONS
CONTRIBUTE TO THE PROCESS
OF MARKET
TRANSFORMATION**

3

3.1. WORLD BANK PROGRAMS IN THE REPUBLIC OF BELARUS. SUPPORT OF STRUCTURAL TRANSFORMATIONS

The World Bank Group was set up in 1944. It is one of the biggest world organizations that provide assistance in development. The group consists of five structures that specialize in supporting different aspects of development process. They use their comparative advantages in striving to achieve one common goal – to reduce poverty.

- International Bank for Reconstruction and Development (IBRD) provides loans and aid to support development of and middle income countries and poor countries that are creditworthy. Loans are provided on favorable terms at 6% interest rate for 15–20 years with 5-year period of payment suspension period. During this time the country recipient of the loan pays just interest on the loan. IBRD usually finances no more than 70–80% of total amount of the project. Belarus is a member of IBRD since 1992.
- International Development Association (IDA). It specializes in providing assistance to poor countries (with per capita income less than 885 USD) by providing it interest free loans, technical assistance and consultations on economic policy;
- International Finance Corporation (IFC) fosters private investment (both domestic and foreign) in developing countries of the World Bank by means of investment and consulting services;
- Multilateral Investment Guarantee Agency (MIGA) fosters foreign direct investment (FDI) by providing investors insurance against political risks (guarantees) and by providing funds for FDI attraction on the stage of transition;
- International Center for Investment Disputes Settlement (ICIDS) fosters settlement of investment disputes between foreign investors and countries-recipients of foreign investment;

At present, the World Bank cooperates with over 100 developing countries by giving loans in the amount of 20 billion USD on average. Its goal is to increase standards of living and to reduce poverty. By working out the strategy of cooperation, the World Bank works with state bodies, public organizations and private sector.

Main spheres of activities of the World Bank

By means of loans, economic consultations and technical assistance, the World Bank provides assistance to a wide variety of programs that are aimed at poverty reduction and increase of standards of living in the developing world. The World Bank uses both its financial

and human resources to every developing country that is striving for stable, sustainable and just growth by means of

- Human capital investment, in basic health care and education services in particular;
- Targeting social development, attraction of big social groups into this process, improvement of the government administration system and institutional development which is crucial for poverty reduction;
- Development of potential to increase quality, effectiveness and transparency of services that the state should provide;
- Environment protection;
- Support and encouraging of private business development;
- Encouraging reforms to achieve macroeconomic stability.

World Bank in Belarus

Belarus joined the World Bank in 1992. The general goal of the World Bank is to assist the country in implementing a strategy that stimulates economic growth and increase of welfare of Belarusian people. The World Bank program puts the emphasis on providing assistance in building foundations for long-term economic prosperity. Special attention is paid to healthcare, education, social security and environmental protection.

World Bank provides assistance in the form of loans, technical assistance and coordination of aid from other sources. Overall amount of loans given to Belarus is US\$ 192 million (see the list of projects in Supplement 1). These funds were directed at strengthening support of the government reform program, investment in environment protection and development of forestry.

The World Bank gave Belarus financial assistance in the form of grants in the amount US\$14 million (see the complete list of grant projects in Supplement 2). The grants were financed by the Foundation for Institutional Development. They were aimed at supporting activities to create social security system that helps those who mostly need assistance. Funds of Global Ecological Foundation were used to finance two grants “Belovezhskaya Pushcha” and “Termination of use of substances that destroy ozone layer”. This grant in the amount of US\$ 6.9 million was spent on stopping the usage of substances that destroy ozone layer in accordance with Montreal Protocol. The project resulted in a decrease of consumption of substances that destroy ozone layer from 1996 tons in 1989 to 274 tons in 2000. Simultaneously six big enterprises that produce refrigerator equipment and electronics modernized their production facilities. It increased competitiveness of Belarusian goods and kept high-skilled workers employed by them.

Now relations between the World Bank and Belarus are based on the World Bank’s Country Assistance Strategy for Belarus (CAS) which

was passed in March 2002. This document a) describes the strategy of the World Bank Group based on evaluation of priorities of the country, b) determines the degree and structure of assistance (loans, analytical work, technical work) that is scheduled to be provided within the Strategy and indicators of economic development of the country. CAS uses a realistic approach in the spheres in which partnership with the government, civil society and donor organizations will bring concrete results in solving high priority tasks in Belarus.

While working out the Strategy, the World Bank held numerous consultations in which more than 1,500 persons from 14 cities were involved. During these meetings experts of the World Bank got a chance to learn about people's problems that could be solved by carrying out new projects. The government of Belarus agreed to wide-scale participation of the public on the stage of working out the Strategy. Representatives of governmental structures of different levels took part in consultations with NGOs.

CAS presumes fruitful cooperation to develop economy and society, minimization of social and ecological risks. Special attention is paid to consequences of Chernobyl catastrophe and such global threats as spreading of HIV/AIDS and tuberculosis. Participation of the public is considered as an important element of achieving goals set forth in the suggested programs. It will make the whole work of the government sector more transparent and accountable. The Strategy puts an emphasis on areas which can be beneficial to the population, to help the country strengthen its social and structural tactics and institutes and also to improve its investment climate.

An important sphere of cooperation of the World Bank with Belarus is providing consultations by international experts in different sectors of the Belarusian economy. They also work out recommendations that take into account international experience in choosing the most effective way of development of this or that sector. This research forms a foundation for the overall evaluation of the current situation and determination of the areas in which assistance of the World Bank could be the most effective. In 2002, the following works were completed: "Analysis of Strategy of Development of Healthcare System", "Survey of Consequences of the Accident in Chernobyl Nuclear Power Station and Programs of Overcoming them", "System of Environmental Management in Belarus". Right now "Research of State of Poverty" is being conducted. The World Bank discusses with the government the report on issues of "Increase of Effectiveness of Government Expenditures", "Monitoring of Conditions for Business Development" is about to be completed. "Potential for Information Society Development" is being studied. Work on preparation of the "Country Economic Memorandum" was initiated. It will contain a thorough analysis of the Belarusian economy and prospects for the country's development.

The Strategy for Belarus provides for two possible scenarios of crediting: under a minimal scenario, which means giving loans in the amount of \$140 million, the support is provided to activities of social importance such as the project to fight HIV/AIDS and tuberculosis, the project to manage consequences of Chernobyl catastrophe, setting up the Foundation of Social Investment. A base scenario, which means giving loans in the amount of \$127 million, will be considered in case macroeconomic indicators and business climate in the country are satisfactory. Within this scenario, loans will be provided for all projects to support private sector development and restructuring of enterprises, reforms of healthcare system, implementation of the system of targeted social security assistance and restructuring of agricultural enterprises.

At present, a project aimed at the reduction of energy consumption by social objects (schools, hospitals) is being carried out (a loan in the amount of \$22 million). Just on the first stage of the project, when the advanced payment of \$1 million was spent, consumption of energy by reconstructed objects went down by 17%. The work on a project to prevent spreading HIV/AIDS and tuberculosis is about to be completed.

Supplement 1

Loans to Belarus from the World Bank

1. **Institutional Building Loan** (US\$ 8.3 million) was approved in August 1993. It is aimed at strengthening the potential of the government to work out and implement the program of economic reforms and also to provide assistance in building new market institutions to improve administration of economy. The project included the following components: (1) mobilization of resources and management of economy; 2) reform of enterprises, 3) banking sector reforms and 4) reform of social sphere.
2. **Rehabilitation Loan** (US\$ 120 million) was approved in November 1993 to support the government program of economic reforms aimed at lowering inflation, liberalizing trade and privatizing state enterprises and land. The loan was used to finance critical import (for example, pharmaceuticals) and to compensate for hard currency deficit.
3. **Forestry Development Loan** (US\$ 41.9 million) was approved in May 1994. The main goals of the loan were to support reform of forestry in order to rationalize the use of forest resources, improve the quality of scientific research work, to conduct monitoring of air pollution, use of lumber as fuel; reduction of risks of forest fires and spreading of radioactive contamination caused by these fires. The aim was also to improve the planning of forest resources and labor relations in the sector.
4. **Social Infrastructure Retrofitting Loan** (\$22.6 million). The means of the loan will be directed at the modernization of heating, thermal insulation and lightening systems in 450 buildings in different regions of the country. The project targets socially vulnerable groups such as schools, hospitals, orphanages, homes for old and disabled persons. The project also contains measures directed at the reduction of energy consumption.

World Bank Grants for Belarus

June 1992	Grant of the Global Ecological Foundation (US \$ 1 million). The project was aimed at keeping biodiversity of forests
May 1993	Grant of the Foundation for Institutional Development (US \$ 350 000) for privatization and banking sector development
June 1993	Grant of the Government of Japan (PHRD) (US \$ 923 000) to reform labor market and social security system and also to regularly monitor households in accordance with international standards
December 1993	Grant of the Government of Japan (PHRD) (US \$ 848 000) to prepare a project for the development of private entrepreneurship
April 1994	Grant of the Foundation for Institutional Development (US \$ 100 000) to improve legislation on state purchase
April 1994	Grant of the Foundation for Institutional Development (US \$ 195 000) to develop the system of city land register
June 1994	Grant of the Government of Japan (PHRD) (US \$ 505 000) to prepare a project on the development of priority infrastructure in the basin of the river Pripyat
June 1994	Grant of the Government of Japan (PHRD) (US \$ 497 000) to work out financial and organizational aspects of loans to energy sector
November 1994	Grant of the Government of Japan (PHRD) (US \$ 375 000) to determine and stimulate possible forms of cooperation among Belarusian enterprises and foreign partners
February 1995	Grant of the Government of Japan (PHRD) (US \$ 150 000) to prepare projects on energy saving in social sphere
April 1996	Grant of the Foundation for Institutional Development (US \$ 480 000) to reform legislation in the sphere of business development
May 1997	Grant of the Global Ecological Foundation (US \$ 6.9 million) to finance a project to remove ozone destructive appliances
March 1997	Grant of the Italian Trust Fund (US \$ 200 000) to train specialists in the sphere of government purchase
July 1997	Grant of the Government of Japan (PHRD) (US \$ 620 000) to prepare a project to modernize the system of city water supply
July 1997	Grant of the Government of Japan (PHRD) (US \$ 49 000) to apply Country Economic Memorandum on mutual understanding
November 1998	Grant of the Government of Japan (PHRD) (US \$ 122 000) to prepare a project on energy saving in social sphere
August 1999	Grant InfoDev (US \$ 100 000) to diagnose compatibility of critical computer systems to requirements of Y2K
June 2000	Grant of the Foundation for Institutional Development (US \$ 286 000) to strengthen the institutional potential that is necessary to introduce the system of targeted social assistance
August 2002	Grant InfoDev (US \$ 45000) to carry out a study of infrastructure in the sector of information and communication technologies and to evaluate the potential for the development of information society

3.2. INTERNATIONAL MONETARY FUND IN BELARUS

IMF has just indirect impact on decisions made by its member- countries in the sphere of economic policy. Nobody except for the government, Central Bank, enterprises and population of the country can change directly the country's economic policy. The role of IMF is to encourage and support such efforts in the sphere of reforms that are most likely to be successful.

*John Odling-Smee, Director of IMF European II
Department Minsk, November 2001*

By the end of World War II countries of anti-Hitler coalition considered different ways to restore order in international financial relations. The result of these efforts was the decision to set up International Monetary Fund by the Bretton Woods conference. The Fund officially started its operations in December 1945, when 29 countries signed its main document – Articles of Agreement.

Goals of the International Monetary Fund are:

- To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems;
- To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy;
- To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation;
- To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade;
- To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity;
- In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

IMF activities are supplemented by activities of the World Bank Group. For example, if the World Bank deals mainly with support of long-term initiatives in the sphere of economic development and poverty reduction, IMF priority is macroeconomic indices and macroeconomic and financial policy of the country.

The main source of IMF credit resources are deposits (or quotas) of its members that are made when a country joins the organization or when quotas are revised. In general, the size of the quota reflects the share of the country in the world economy. The bigger share of a country in the world production and trade, the bigger is its share in the IMF. The USA is the biggest country in the world economy and its quota is 17.6% in the Fund's capital. The quota of the Seychelles is just 0.004%.

Forms of IMF assistance:

- Analysis and monitoring of economy and financial sphere on the global and national levels;
- Providing consulting services for member-countries on the issues connected with working out the national economic program;
- Giving countries loans in hard currency to support the policy of economic and structural reforms that help solve problems of balance of payment and that ensure sustainable growth;
- Providing different kinds of technical assistance which includes training of the government and the National Bank employees.

Among *forms of credit mechanisms* that are provided by IMF to its member-countries, the following should be pointed out:

- Reserve agreements (stand-by). Their goal is to provide short-term assistance to level balance of payment in case of temporary and cyclical deficits. Funds are given in tranches and each next tranche depends on the country's performance and its fulfillment of necessary conditions;
- Expanded system of financing. Its aim is to support a country's mid-term programs that are to overcome difficulties in balance of payment which are caused by macroeconomic and structural problems. Criteria of effectiveness are applied;
- System of expanded financing of structural transformation (SEFST). It provides benefits for members of the IMF with low income and long lasting problems of balance of payment. The Fund gives low interest loans instead of purchasing currencies of other member-countries. These loans are given at 0.5% with 5 year period of detained interest payments on the loan and 10 year period of paying off the debt;
- System of compensational financing and financing in case of emergency. This is a particular instrument which is applied in member-countries that have temporary reduction of export and extremely high costs of cereals and also in case of the country's difficulties of fulfilling obligations to the IMF.

IMF mandate in Belarus

IMF activities in Belarus are directed primarily at helping the country to switch from centralized planned to market economy. The Republic of Belarus joined the IMF on July 10, 1992. In October of the same year, the IMF opened its Representation Office in Minsk. Since 1998, the IMF does not have a Representative in Belarus on a permanent basis. His functions are fulfilled by the Permanent IMF Representative in Lithuania and Belarus. This IMF official makes regular visits to Belarus to keep the dialogue and consultations with the authorities on current issues of economic policy.

Belarus' quota in the IMF is 386,4 million SDR (IMF monetary unit). It is about 486 million USD or 0.18% of the overall quota. Belarus has 4,114 votes in IMF which is 0,19% of all votes.

Within Mechanism of Systemic Transformations, the IMF provided Belarus with loans in the amount of 140 million SDR 1993 and 1995. The first tranche of the STF loan in the amount of 70,1 SDR was given to Belarus in July 1993. It equaled 103 million USD. The peak of cooperation between Belarus and IMF was in 1995 but in the end of this year cooperation within the Fund's programs was suspended.

On January 31, 1995 the decision to release the second tranche of the SFT loan in the amount of about 103 million USD was made. The loan was provided to support the program of reforms which was worked out by the government. The goal of the program was to stabilize the economy by reducing inflation and carrying out economic reforms. By the end of 1995, inflation was to be just 1% a month. The government made commitments to advance economic reforms. The program targeted at the reduction of budget deficit to 3% GDP and the internal financing of the budget deficit should not exceed 2% of GDP. The program also stipulated that the government would pursue tighter monetary policy. It was supposed to reduce the amount of "empty" money in the economy and to reduce inflation.

Liberalization of prices was also a part of the program. It had to be accompanied by social security reform that was supposed to end up in the country when low income persons would be provided with targeted assistance. The SFT program also stipulated carrying out privatization of both small and large enterprises. IMF experts believe that the result of the full implementation of the program would be a stable Belarusian economy. Belarus could advance considerably on the way to market reforms.

In August 1995, negotiations between the IMF leadership and the Belarusian government on releasing the next tranche of the stand-by loan were completed. On September 12, IMF Board of Directors confirmed the granting of the loan in the amount of about 293 million USD. The loan was to support the government's program of reforms in 1995–1998. The stand-by program envisaged price stabilization in the

first place and sustainability of the balance of payments. It was also to build market economy and ensure its sustainable development in the future. Inflation was supposed to be reduced to 0.5% by the end of 1996 and deficit of external financing was supposed to be reduced, too.

Belarus received only the first tranche of the stand-by loan. In the end of 1995 and beginning of 1996, the financing was suspended, as the government failed to fulfill the agreed program of reforms. In a few years, Belarus could have faced difficulties in paying off loans. Since that time, cooperation between Belarus and the IMF was reduced to consultations on Article IV of IMF Agreement. It means carrying out annual survey of the state of economy of each member-state of the IMF.

Program of monitoring

In 2000, during the annual meeting of IMF and the World Bank, representatives of the Belarusian government addressed the IMF representatives for assistance. The issue of holding a program of monitoring of economic reforms in Belarus was discussed. During the IMF missions that took place in November 2000 and February 2001, the IMF representatives and the Belarusian authorities agreed to hold an unofficial Staff Monitoring Program (SMP). It had to last for six months: from April 1 to September 30, 2001. That agreement did not include any loans from IMF to Belarus.

SMP contains target quantitative indicators in monetary and fiscal spheres, agreed structural measures in the sphere of price liberalization, liberalization of currency market, banking sector reform, privatization and improvement of business environment. The SMP Program ended with mixed results. While most of the target indicators were fulfilled (except for the budget deficit, tax arrears and expenditure arrears), a few measures in the sphere of structural reforms were not. At the same time, some progress was achieved in the sphere of structural reforms, too.

IMF positively evaluated the measures that were taken by the Belarusian authorities upon the recommendation of the IMF in the sphere of currency market liberalization (in particular, abolishing the practice of multiple exchange rates of the Belarusian rouble). It led to Belarus' joining Article VIII propositions 2, 3 and 4 on November 5, 2001. It meant putting an end to currency restrictions and free convertibility of the Belarusian rouble on current account operations.

Upon the completion of the SMP Program, the Belarusian authorities have kept their interest in achieving an agreement on stand-by program while IMF staffers believed that any stand-by agreement should be preceded by a period of demonstration of positive results in economic policy agreed upon with the IMF for at least 6 months.

During the following missions, IMF employees expressed their concern about the unrealistic nature of forecasts of the authorities on GDP growth, reduction of inflation, further increase of wages in the public sector, revenues from privatization and inflow of foreign direct investment. However, the authorities stated firmly that they were intended to keep its projected indicators for 2002 and 2003.

From January 28 to February 10, 2003 IMF mission headed by Mr. Thomas Richardson, deputy Director of the IMF Second European Department worked in Belarus. During its work in Minsk, the mission conducted consultations with the authorities on Article IV of the IMF Articles of Agreement. Missions on Article IV work in every IMF member-state.

A report on the results of the work of the previous mission on Article IV in Belarus was discussed at the sitting of the Executive Council of IMF Board of Directors in January 2002.

The main tasks of the latest mission were:

- To review economic development in 2002;
- To analyze the forecast for 2003 and for the mid-term period;
- To give recommendations on economic policy and to discuss prospects of further cooperation between Belarus and the IMF.

A preliminary conclusion of the mission is that despite evident progress in a few spheres of structural reforms, including reduction of cross subsidization and further liberalization of prices, overall results of economic development in 2002 were mixed.

The official information on economic development that stated that GDP grew by 4,7% in 2002 seemed to speak about sustainable development but stock of goods, tax and debt arrears soared. Though inflation was reduced due to a tougher monetary policy, it still remained the highest among countries of the former Soviet Union.

As for macroeconomic policy in 2003 the mission recommended pursuing a tighter monetary policy supported by a cautious fiscal policy. Nevertheless, the mission recommended not to cut social expenditures disproportionately. Instead, a few other measures were recommended, such as reduction of budget loans, termination of inflationary housing construction financing and reduction of ineffective support to agriculture and industry. The mission emphasized the importance of speeding up macroeconomic stabilization and structural reforms in the light of the authorities' intention to peg the Belarusian rouble to the Russian one starting from January 1, 2004.

The mission pointed out that Belarusian authorities still preferred slow economic reforms to accomplish important social tasks during transition to market economy. Though the mission shared the authorities' concern about social consequences of reforms, it maintained that advantages of rapid market reforms exceeded costs of slow transition in Belarus, which brought about slower growth and lowered the standard of living of the population for the longer period.

Taking into account the positive experience of applying in Belarus IMF mission recommendations on technical assistance, the mission approved expanding this kind of assistance. It includes visits of missions of experts on monetary operations, tax policy, budget transparency and possibly on money laundering legislation. In connection with that, forms of cooperation between the IMF and Belarus can include estimation of security of the central bank and assistance in speeding up Belarus' joining the IMF Special Data Dissemination Standard (SDDS).

The results of the mission's work on consultations within Article IV will be presented to the IMF Executive Board of Directors in the middle of April 2003. The successful implementation of a monitoring program or any other similar program for a certain period of time that could demonstrate positive results of implementation of economic policy agreed upon with the IMF could open access to IMF loans. IMF representative in Lithuania and Belarus Zuzana Brixiova said, "The IMF maintains its position that in order to receive a loan, Belarus needs to stabilize its macroeconomic situation and make significant progress with implementing market-oriented reforms. This is consistent with the message we have been conveying to the government and National Bank in the past, and also with requirements that the other transition economies needed to fulfill before receiving IMF loans."

3.3. INTERNATIONAL FINANCE CORPORATION'S EXPERIENCE OF ATTRACTING FOREIGN DIRECT INVESTMENT AND DEVELOPING SMALL AND MEDIUM-SIZED BUSINESS IN COUNTRIES WITH TRANSITION ECONOMIES

In cooperation with our Belarusian partners – namely entrepreneurs, state agencies and business support organizations – IFC will continue to do its utmost to foster the growth of small and medium-sized enterprises, which in turn will boost the Belarusian economy during a difficult stage of transition to a market economy.

*Carl Dagenhart,
Head of the IFC Office in Belarus*

International Finance Corporation (IFC) was established in 1956 as “an investment vehicle” of the World Bank Group. Presently, IFC comprises 175 countries, including Belarus. The member states have contributed to the formation of the IFC’s charter capital, which currently equals \$2.45 billion, and jointly manage its activities.

IFC focuses on financing private sector projects, helping companies in developing countries to mobilize resources and providing technical assistance and advisory services to companies and governments.

To date, IFC has invested in 2,264 companies in 135 countries, giving a fillip to the development of the recipient companies and the host countries.

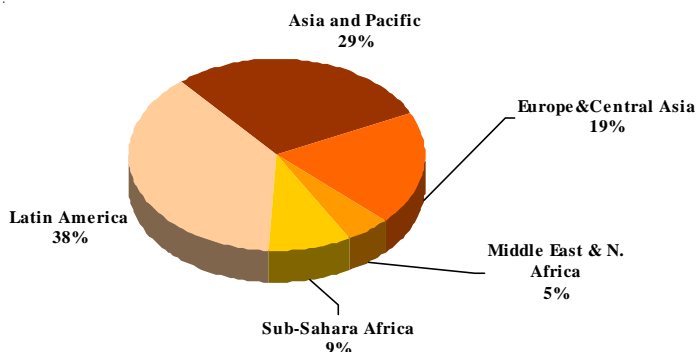


Figure 1. IFC Investment Broken down by Region

In the execution of its investment projects IFC cooperates with private companies, corporations, banks, international development and export finance agencies as well as other members of the World Bank Group. IFC aims to create not only an enabling entrepreneurial environment, but also both a legal framework and institutions that would be instrumental for the creation of a favorable investment climate.

IFC supports private sector ventures that are financially viable, benefit the economy of each host country, promote high environmental standards and provide a strong demonstration effect.

IFC acts as a catalyst of resource mobilization and its involvement boosts investor confidence. It should be noted that IFC's stake shall not exceed 25% of the project's cost at any time. IFC's share in the charter capital may reach 35% provided that it is not a majority stakeholder.

IFC charges market rates for its services and does not accept government guarantees.

IFC provides a wide range of advisory services, including restructuring and financial reorganization, business plan preparation, resource mobilization and securing of financial and technical partners. IFC offers these services as part of an investment project or separately for a fee based on market rates.

Apart from investment, IFC provides technical assistance to more than 70 nations, including 26 European countries. Over the last nine years, IFC has implemented 19 private enterprise development projects in Russia, Ukraine, Belarus, Armenia and Georgia alone. These projects attracted \$87 million in funding from the governments of Great Britain, Denmark, Canada, the Netherlands, Norway, the USA, Sweden, Japan and the IFC Trust Fund.

Over the last few years, IFC has been placing increased emphasis on the development of the SME sector. In particular, it aims to simplify the SMEs' access to local sources of funding by boosting the capacity of local financial institutions and the creation of an enabling environment for small business.

Since 1991 IFC has been actively involved in Eastern Europe and the CIS to foster the growth of the private sector and SMEs. IFC's activities in the former socialist countries have certain specific features, as the environment exhibited by these nations is not always conducive to foreign direct investment. This was the rationale behind the IFC's decision to launch technical assistance projects in these countries to build the foundation for the development of private sector and future investment.

IFC's technical assistance projects, implemented from 1991 through 1997 in Russia, Ukraine and Belarus alone, attained the following: (a) 22,000 retail outlets were sold off, (b) 3,400 major companies which employed 2.75 million people were corporatized, (c) 2 million hectares

of land were privatized and (d) 100 legal amendments were initiated to create an enabling business environment.

IFC possesses an extensive experience of executing projects dealing with the development of leasing, post-privatization support, agro-business, corporate governance, SME promotion, forestry and creation of local supplier networks for large scale investment projects.

Over the last several years IFC has stepped up its private sector investment in the CIS countries. For example, the IFC investment volume in Russia increased threefold in 2002 (see the Table 1 below).

Table 1

**IFC Investments in Transition
Economies as of June 30, 2002, in US\$ millions**

Russian Federation	317.7
Kazakhstan	117.4
Azerbaijan	97.3
Estonia	92.0
Georgia	57.1
Moldova	55.9
Lithuania	52.3
Uzbekistan	35.3
Ukraine	25.8
Latvia	25.0
Kyrgyz Republic	15.5
Tajikistan	13.0
Armenia	3.6
Total	907.9

IFC in Belarus

In November 1992, Belarus was the first CIS country to join IFC. It was the first former Soviet Republic to tap IFC's experience and funds to implement market reforms. At the invitation of the Belarusian Government, IFC launched its first technical assistance project in 1993. Over the last nine years of its involvement in Belarus, IFC has implemented the following technical assistance projects:

1. Small-Scale Privatization Project

Funded by the United States Agency for International Development, the project ran from 1993 through 2000 and developed a transparent auction-based model and a legal framework for the privatization of municipal property. With assistance from IFC, local governments conducted 558 auctions that sold off 1,009 communal objects, including cafes, stores and consumer service enterprises. Privatized business created a total of 2,400 new jobs.

2. Homeowners Associations Development Project

The Homeowners Associations Development Project was launched in August 1994 within the framework of the Small Scale Privatization Project to foster the establishment of condominiums in multi-story residential buildings. To this end, jointly with the Belarusian Housing Ministry, IFC drafted a Condominium Law which was adopted by the Belarusian Parliament in 1998. A total of 65 condominiums were established with assistance from IFC.

3. Post Privatization Project

The Post Privatization Project was implemented from 1995 through 1999 with funding from the British Know-How Fund. Under the project, IFC created two business centers and conducted an extensive training project for managers of private companies. Entrepreneurial customers of the business centers developed a total of 90 business plans and received \$6 million in funding from local sources for the implementation of their projects. The project also published a monthly legal bullet that tracked and clarified changes of applicable legislation.

4. SME Support

Following the completion of the Post Privatization Project, SME support became a component of the Small-Scale Privatization Project. Under this component, IFC conducted more than 100 courses, seminars and lectures, which attracted the participation of more than 4,000 people and distributed 20 legal bulletins and brochures with a combined circulation of 80,000 copies.

5. SME Development Project

The SME Development Project ran from June 2000 through September 2002 with funding from the United States Agency for International Development. The project sought to foster small and medium-sized business development through organization of targeted informational-training programs in partnership with business associations. A hot line service manned by experienced lawyers and economists was launched in all regional capitals and Minsk to offer legal advice to entrepreneurs. The project also set up a website that contains information of interest to SMEs and organized extensive training programs for SME managers, individual entrepreneurs and start-ups. In addition, it published a vastly popular analytical bulleting entitled "Small and Medium Business in Belarus."

6. Business Associations Capacity Building Project

Since October 2002 IFC has been implementing the Business Associations Capacity Building Project with funding from the Swedish International Development Cooperation Agency.

Designed for a period of two years, the project will seek to deepen contacts between Belarusian entrepreneurs and business associations and their Swedish counterparts. The project will also aim to build the capacity of Belarusian business associations through the expansion of their membership, broadening of their range of member services, improvement of their image and boosting of their lobbying potential.

Over its ten year involvement in Belarus, IFC has attained the following significant results:

- The IFC Belarus Small-Scale Privatization Project created a critical mass of privatized businesses in major cities throughout Belarus.
- IFC's informational-educational programs reached every fifth entrepreneur. The hot line service initiated by IFC provides about 500 entrepreneurs with free consultations monthly.
- Following consultations with IFC, the World Bank introduced a SME development section in its three year country assistance program. The International Monetary Fund also included a business environment section in its Staff Monitoring Program.
- IFC and its partner business associations have done a lot to improve legal environment for entrepreneurs.

IFC's involvement in Belarus could have been more extensive. If IFC's engagement in Belarus is to be expanded, the following measures should be taken:

- Administrative barriers for private business should be reduced;
- Unjustified interference on the part of the state in business activities should be drastically lowered;
- Legislation should be made more stable;
- The Belarusian authorities should demonstrate more political will to develop the private sector.

3.4. TACIS PROGRAM – PROMOTION OF DEMOCRACY AND ECONOMIC REFORMS IN CIS (INCLUDING BELARUS)

The legal foundation of the TACIS program is a respective decision issued by the EU Council of Ministers. Its main objectives and parameters were set forth in this document. All in all, three Decisions on this issue were passed. They cover the period of from 1991 to 2006.

1991–1995

TACIS was designed as the program of just technical assistance with two separate budgets: one – for Russia and the other for other CIS countries. Its activities were targeted at the development of market economy and were reduced to consultations, research and analysis of proposed transformations and training.

1995–1999

TACIS Program was based on principles of activities that were demand-oriented. One tenth of the budget was used for investment, in particular in infrastructure development and cross-border cooperation. Projects on cross-border cooperation were started in 1999. European parliament adopted a special budget to support cooperation with the Baltic states on cross-border issues. The practice of appointing priority regions or branches of economy was terminated. Number of intergovernmental projects was reduced from 25 to 7–10. The goal of TACIS was to create critical mass of projects specifically targeted at ensuring sustainable development.

2000–2006

TACIS switched over to a concept of activities based on the dialogue. Investments are made into “networks of strategic importance”. The Program is concentrated not on branches of economy but on three overlapping spheres of cooperation. Coordination of activities with other donor organizations was also improved. The Program began to use more local knowledge and expertise. The emphasis is made on wide-scale (over 2 million Euro) and long-term projects based on cooperation and partnership agreements. These agreements substituted Agreement on Nuclear Power and Trade, Commercial and Economic Cooperation, which was signed in 1989 with the USSR.

Thus, TACIS is tailored for partners from Eastern Europe and Central Asia as EU looks forward to building long-term partnership relations with these countries. The European Union supports those who show respect for democratic principles, human rights and aspire to build market economy. These goals are included into the Agreement on Partnership and Cooperation with most of the countries – partners. They also constitute a part of the General Strategy of relations with Russia and Ukraine and they become a part of the policy of integration. It reflects the importance of these activities for EU. These propositions were included into the document (99/2000) that regulates TACIS cooperation program (see Table 1).

Table 1

**Agreements on Partnership
and Cooperation between EU and CIS**

Country	Date of entering into force
Armenia	July 1, 1999
Azerbaijan	July 1, 1999
Belarus	Signed in March 1995 and did not enter into force. Interim agreement did not enter into force either
Georgia	July 1, 1999
Kazakhstan	July 1, 1999
Kyrgyzstan	July 1, 1999
Moldova	July 1, 1999
Russia	December 1, 1997
Turkmenistan	Signed in March 1995 but did not enter into force Interim agreement did not enter into force either
Ukraine	March 1, 1998
Uzbekistan	July 1, 1999

The main forms of cooperation within TACIS in transitional economies are:

- Providing assistance in carrying out institutional and administrative reforms;
- Providing support for private sector and assistance in economic development;
- Providing assistance in solving social security problems in the period of transition;
- Development of infrastructure;
- Assistance in environment protection and management of natural resources;
- Economic development of rural areas.

New TACIS programs are opening. Their sole goal is to better meet demands of development of the partner country. Quite large budgets of the programs help achieve effective structural and institutional transformations in transitional economies. They also help to build institutions of civil society (see table 2).

Table 2

Dynamics of TACIS funding in Belarus in 1991–2001 (million Euro)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Ecero
I. National Program	8.92	14.63	9.0	7.0	12.0	0	5.0	0	0	2.5	2.5	61.55
II. Inter-country programs:												
– Inter-governmental program*	5.4	4.6	5.1	2.6	3.3	6.5	6.3	4.6	1.7	2.0	No decision of EC	42.1
– Program on nuclear security*	0.3	0	1.5	0	0.6	0	1.1	0	0	0	No decision of EC	3.5
– Program on cross-border cooperation	–	–	–	–	–	3.0	1.2	4.7	3.7	7.3	No decision of EC	19.9
III. Program of small projects**	2.2	0.9	1.9	2.3	1.95	0	0	0	0	2.3	0	11.55

* Estimation based on the proportional share of Belarus

** Program of small projects is financed from budgets of national programs

TACIS integrated approach to providing economic assistance is based on the following principles:

- **Private sector development:** teaching SMEs skills of business administration; training local consultants and easing access to finance;
- **Business climate improvement:** giving recommendations to the government in the sphere of macroeconomics: taxation of trade and investment, improvement of business regulation, and development of new opportunities for exporters and investors alongside with providing technical assistance;
- **Assistance to new investment:** continuation of preparation and carrying out EBRD programs alongside with projects financed by TACIS and active support of domestic investment.

TACIS experts provide considerable financial and technical support to CIS countries including Russia, Ukraine, Moldova and Kazakhstan. Russia can be taken as an example of such support.

Financial crisis in 1998 brought destabilization of the stock market in Russia and bankruptcy of quite a few companies. Experts of the program began consultations in the sphere of capital market and investment (CMI) in 1998. The goal was to restore trust in the Russian stock market and improve professional skills and knowledge of market participants. The second task was to find an international partner and to establish contacts with international organizations. During the next three years 4.5 million Euro was granted to finance TACIS programs. More than 32 Russian companies were recipients of services of professional consultants of the group on capital market and investment (CMI). During the project implementation about 140 international experts consulted Russian businessmen in Moscow and in the regions.

With the help of the CMI project the EU provided help in restoration of financial markets in Russia. Results of CMI were further developed by initiatives directed at increase of stock holders protection. The best examples of corporate management were used to achieve that goal.

Within the program of assistance to enterprises in restructuring, TACIS offered Russia the TERF project. This project gives a few enterprises a chance to receive necessary financial, technical and marketing consultations and aid which they need in the process of restructuring. Within this project, companies should come up with initiatives and request services within the program TERF. Besides they must allocate a certain amount of resources to finance these activities. During the first stage of the project the size of the contribution of the Russian party was 12% and on the second stage it increased to 20%.

Apart from programs of technical and financial assistance to state and private enterprises there are many other TACIS programs. They are aimed at neutralizing negative social consequences of economic transformation. Labor protection programs, programs on safety measures at work were carried out in Ukraine. They were quite popular

and wide spread. Programs to improve the system of health protection were carried out in Uzbekistan. TACIS program assisted by the government of Ukraine was successfully implemented in the sphere of energy sector development and environmental protection. Funds to liquidate consequences of the Chernobyl disaster were provided. They were spent to strengthen nuclear security of the country etc.

TACIS in Belarus

First of all, it should be noted that from 1991 to 2001, 195 projects were carried out within the TACIS Program. Their overall budget is about 138.6 million Euro. See Table 2 for the dynamics of financing projects within TACIS Program in Belarus. Consulting services for many recipient organizations, training of Belarusian experts and supply of equipment were financed by the funds of the Program. A few demonstration projects (showcases) were also carried out. TACIS program facilitated the process of providing to Belarus a loan in the amount of 80 million USD. It was given by the European Bank for Reconstruction and Development. 60 million USD was spent on the reconstruction of the highway Brest – Minsk – Moscow and 30 million was spent for SME support.

Substantial reduction of financing of the TACIS National Program that started from 1996 is explained by deterioration of political relations between Belarus and the European Union. On September 15, 1997 EU Council of Ministers passed Resolution “On Relations between the European Union and Belarus”. According to Article 5 of the Resolution, “carrying out programs of EU technical support will be suspended except for humanitarian and regional programs or programs that directly add to the process of democratic transformations”. That resolution led to the situation when technical assistance to Belarus was provided only within multilateral TACIS programs (intergovernmental programs for nuclear energy and cross-border cooperation). From 2000, technical assistance within TACIS Program “Development of the civil society” was increased by 5 million Euro. Memorandum on financing of this program was signed between the European Commission and the Republic of Belarus on November 2, 2000 in Minsk.

Table 3 shows information about technical and financial assistance of the European Union to Belarus from 1991 to 2001. It can be seen from the data in the table that TACIS Program funds amount to about 50% of all other kinds of assistance of the EU to Belarus. One should note that financial assistance of the European Union to Belarus was provided in the form of loans while technical assistance was provided as grants.

The most important achievements of TACIS Program in Belarus in 1991–2002 are as follows:

Table 3

Technical and Financial Assistance of European Union and Belarus in 1991–2001

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total (million Euro)
I. Loans	0	102.0	0	0	30.0	0	0	0	0	0	0	132.0
II. Grants												
National Program TACIS	8.92	14.63	9.0	7.0	12.0	0	5.0	0	0	2.5	2.5	61.55
Multi-country TACIS programs *	7.9	5.5	8.5	4.9	5.85	9.5	8.6	9.3	5.4	9.3	na	74.75
Program on capital market and investment (CMI). **	0	0	0	0	0	0	1.0	0	0	0	na	1.0
Program ISTC **	0	0	0	0	0	0.06	0.64	0.83	1.15	1.48	na	4.16
Humanitarian aid	0	0	0.6	0.3	0.3	0.4	0.4	1.1	1.2	0.7	na	5.0
Total I+II	16.82	122.13	18.1	12.2	48.15	9.96	15.64	11.23	7.75	13.98	2.5	278.46

* Estimation is based on proportional share of Belarus in international intergovernmental programs (including the program of cross border cooperation, small projects and on nuclear security)

** Estimation is based on proportional share of Belarus in international intergovernmental projects of the Republic of Belarus

- Working out a business plan for the reconstruction of the highway Brest – Minsk – Moscow (to the border with Russian Federation). As a result, the reconstruction made the highway correspond with European standards;
- Assistance in providing Belarus a loan in the amount of 30 million USD to support SME and preparation of Belarusian banks to servicing the loan;
- Working out Energy Strategy of the Republic of Belarus until 2010;
- Training specialists to service the equipment for diagnosing thyroid gland cancer. The equipment was delivered within EU humanitarian aid program and cost 500,000 USD.
- Providing consulting services for Ministry for Foreign Affairs, Ministry for Education, Ministry for Agriculture;
- Publication of the bulletin “Economic Trends in Belarus”;
- Creation of the pilot system of early warning “Gamma – 1” on nuclear energy emergency situations;
- Working out recommendations to improve traffic on the trans-European corridors II and IX;
- Introduction of an international system of quality control of food products (SQCFP) in certain enterprises and further development of the system of services of quality of food products;
- Working out a concept of energy sector restructuring and turning state enterprises into joint stock companies;
- Carrying out a demonstration project on energy saving methods in the construction of houses based on one block of flats in Minsk;
- Working out and adoption of a new curriculum for agricultural educational institutions of Belarus;
- Establishing cooperation between universities of Belarus and universities of the EU countries within the program of inter-university cooperation “TEMPUS”;
- Construction of the customs office building at the border crossing point Kamenny Log.

The above-mentioned achievements are the evidence that TACIS Program has really contributed to carrying out socioeconomic reforms in Belarus. The importance and usefulness of EU technical assistance is admitted by most of the countries – recipients of this assistance. During 1992–2002 sustainable activities of TACIS in Belarus was ensured by the Coordinating Bureau. It was headed by the National Coordinator of TACIS and assisted by the European Commission.

Here are a few examples of TACIS projects that are being carried out in Belarus now:

In the framework of the regional program:

- Working out and implementation of measures to improve production, packaging, storing and selling iodinated salt in districts that suffered from the Chernobyl accident;

- Improvement of border management at Belarusian-Ukrainian border.

In the framework of the program on cross-border cooperation:

- Development of cooperation between Poland and Belarus in assessing and improving quality of water in the Bug river basin;
- Ensuring secure water supply for urban and rural population in the river Neman basin between Belarus and Lithuania, reduction of pollution;
- Demarcation of Belarusian-Lithuanian border;
- Preparation of documents for a tender to build the first part of the customs cargo terminal Kozlovichi-2. The cost of the project is 16 million Euro.

In the framework of the program on nuclear energy:

- Prototype system of international exchange of data on radiation situation in real time mode;
- Sustainable development of areas in Belarus, Russia and Ukraine that suffered from Chernobyl nuclear power accident.

In the framework of the National Program:

- Developing potential for training managers in Belarus;
- Women Crisis Center in Minsk;

In the framework of the program of small projects:

- Inter-university cooperation on exchange programs and teaching in the sphere of information, communication and mass media in Belarus;
- Dissemination, cooperation and reform of universities in the sphere of economics teaching in Belarus.

All these examples prove that TACIS Program made a considerable positive contribution to solving many problems in Belarus. It also includes the program “Development of Civil Society”. TACIS expands opportunities for Belarus on its way to market economy, democratic society and supremacy of law.

3.5. UNDP: THE CONVERGENCE IN POLICY ON POVERTY, ENVIRONMENT AND HUMAN DEVELOPMENT TO REDUCE THE SOCIAL COST OF ECONOMIC TRANSFORMATION IN BELARUS

UNDP's global mandate

UNDP is the UN's global development network, advocating for change and connecting countries to knowledge, experience and resources to help people build a better life. UNDP is on the ground in 166 countries, including Belarus, working with them on their own solutions to global and national development challenges. As they develop local capacity, they draw on the people of UNDP and its wide range of partners.

World leaders have pledged to achieve the Millennium Development Goals, including the overarching goal of cutting poverty in half by 2015. UNDP's network links and coordinates global and national efforts to reach these Goals. UNDP's focus is helping countries build and share solutions to the challenges of:

- Democratic Governance
- Poverty Reduction
- Crisis Prevention and Recovery
- Energy and Environment
- Information and Communications Technology
- HIV/AIDS

UNDP helps developing countries attract and use aid effectively. In all its activities, UNDP encourages the protection of human rights and the empowerment of women.

Democratic Governance

More countries than ever before are working to build democratic governance. Their challenge is to develop institutions and processes that are more responsive to the needs of ordinary citizens, including the poor. UNDP brings people together within nations and around the world, building partnerships and sharing ways to promote participation, accountability and effectiveness at all levels. UNDP helps countries strengthen their electoral and legislative systems, improve access to justice and public administration, and develop a greater capacity to deliver basic services to those most in need.

Poverty Reduction

Through the Millennium Development Goals, the world is addressing

the many dimensions of human development, including the halving by 2015 of the proportion of people living in extreme poverty. Developing countries are working to create their own national poverty eradication strategies based on local needs and priorities. UNDP advocates for these nationally-owned solutions and helps ensure their effectiveness. UNDP sponsors innovative pilot projects; connect countries to global best practices and resources; promote the role of women in development; and bring governments, civil society and outside funders together to coordinate their efforts.

Crisis Prevention and Recovery

Many countries are increasingly vulnerable to violent conflicts or natural disasters that can erase decades of development and further entrench poverty and inequality. Through its global network, UNDP seeks out and shares innovative approaches to crisis prevention, early warning and conflict resolution. And UNDP is on the ground in almost every developing country – so wherever the next crisis occurs, UNDP will be there to help bridge the gap between emergency relief and long-term development.

Energy and Environment

Energy and environment are essential for sustainable development. The poor are disproportionately affected by environmental degradation and lack of access to clean affordable energy services. These issues are also global as climate change, loss of biodiversity and ozone layer depletion cannot be addressed by countries acting alone. UNDP helps countries strengthen their capacity to address these challenges at global, national and community levels, seeking out and sharing best practices, providing innovative policy advice and linking partners through pilot projects that help poor people build sustainable livelihoods.

Information and Communications Technology

Information and Communications Technology (ICT) is an increasingly powerful tool for participating in global markets; promoting political accountability; improving the delivery of basic services; and enhancing local development opportunities. But without innovative ICT policies, many people in developing countries – especially the poor – will be left behind. UNDP helps countries draw on expertise and best practices from around the world to develop strategies that expand access to ICT and harness it for development. Working in 166 countries, UNDP also relies on ICT solutions to make the most effective use of its own global network.

HIV/AIDS

To prevent the spread of HIV/AIDS and reduce its impact, developing countries need to mobilize all levels of government and civil society. As a trusted development partner, UNDP advocates for placing HIV/AIDS at the center of national planning and budgets; helps build national capacity to manage initiatives that include people and institutions not usually involved with public health; and promotes decentralized responses that support community-level action. Because HIV/AIDS is a world-wide problem, UNDP supports these national efforts by offering knowledge, resources and best practices from around the world.

UNDP's work in Belarus

General mandate of UNDP in Belarus is formulated in the Agreement between the Government of Belarus and UNDP of 24 September 1992 and reads as follows: "to support and supplement the national efforts at solving the most important problems of its economic development and to promote social progress and better standards of life." Narrower framework for UNDP operations in Belarus is determined in the document called Country Cooperation Framework (CCF). Second CCF for Belarus for the years 2001–2004 stipulates that "UNDP provides support to enable Belarus people to maximize their own potential for creating conditions for poverty reduction and sustainable human development through equitable economic growth and democratization" and to this end "supports Government efforts to develop an enabling environment for people to realize their capacities to participate in and to contribute to market-oriented sustainable democratic development". The specific projects currently designed and implemented under the current CCF fall into two broad areas: economic and democratic governance and environmental conservation and management. Expected results of the UNDP work in the sphere of economic and democratic governance are: reform is facilitated, poverty is reduced; local economic development and democratic governance is accelerated; macro policies on important sustainable human development areas are formulated through participatory dialogue; access to the Internet is increased and information technology is better applied to support development. In the sphere of environmental conservation and management UNDP promotes developmental approaches to dealing with the continuing consequences of the Chernobyl disaster, sustainable use of natural resources and biodiversity conservation, improving energy efficiency and promoting renewable energy for climate change mitigation, focus on local level initiatives.

UNDP is one of the largest multilateral providers of the international technical assistance/technical cooperation to Belarus. However, compared to many other developing countries and economies

in transition, UNDP operations in Belarus are quite modest, with total delivery of over US\$ 2 million in 2002 – the highest level since 1992, when the UNDP Office Belarus was established.

The resources the UNDP has to implement projects in Belarus come from three main sources: “core” funds from the regular UNDP budget, donor contributions and Government’s cost sharing. Limited allocation of core resources to UNDP programme in Belarus (about 12% of total programme delivery in 2002) is explained by the high level of human development of Belarus compared to other countries supported by UNDP (90% of UNDP funds go to the least developed countries). Government cost-sharing comprised 5% of 2002 delivery, while donor contributions amounted to over four-fifth of the funds spent for UNDP projects in Belarus in 2002. Taking into account, that core UNDP funds stem from the contributions of the developed countries, it means that about 95 percent of money UNDP spends in Belarus came from the developed countries, basically from the European Union, United States and Japan. Most of these countries have their own by-lateral and multilateral technical cooperation arrangement with Belarusian Government, and provide certain technical assistance directly to the country. So far in case of Belarus UNDP is in many respects rather an instrument of technical assistance delivery, than an independent player. In the same time, the way UNDP delivers technical assistance/technical cooperation to Belarus makes it a clever and effective “instrument”, may the best instrument for international technical assistance delivery to Belarus. Being not in a position to considerably influence the rationale beyond the scope of the technical assistance allocated to Belarus by the developed countries, UNDP, however, is best positioned to help to deliver this assistance most efficiently and effectively.

Key elements of UNDP approach to implementation of technical assistance program and projects in Belarus are: cooperation both with the Government and civil society organizations; Belarusian organizations/experts are primary implementing partners; facilitating policy dialogue and access to information. UNDP experience proves that technical assistance projects have a chance to be successful only if their planning is primarily a response to locally driven needs and their implementation is locally owned. UNDP’s projects don’t intend to change national priorities, but take those as a core and work together with national stakeholders to improve the policies and techniques of achieving these priorities in the best way.

In terms of contributing to reduced social costs of transition in Belarus UNDP intends to foster public discussion of economic development and poverty reduction issues; to demonstrate ways social costs have been reduced elsewhere; to help build capacity for participatory planning processes, strategic planning, and monitoring and evaluation of the cross-sectoral effects of reform policies (e. g. training on comparative advantages and disadvantages of alternative

reform models in practice in comparable (transitional) social and economic settings); to help access funds (i. e. investment or loans), which could help reduce the social costs of transition.

UNDP's work on poverty reduction issues

Poverty as a socioeconomic phenomenon is characteristic of any society going through economic transformation, including Belarus. Most Belarusians fall into the low-income category. According to official statistics, 26,7% of urban population and 33,6% of country people in 2001 were living below the national poverty line. As in other CIS countries, children run a particularly high risk of poverty, especially in families with many children (3+) and in single parent households. In 2001, the proportion of low-income households was 27.5% among families with one dependent child, 39.2% among families with two dependent children, and 69% among families with three or more dependent children. Among households with many dependent children, consumption of staple foods was significantly below the amount covered by the food portion of the minimum subsistence budget. Poverty incidence is much higher in rural areas, and among population with low educational level. Pensioner households are less likely to be in poverty than other households. Gender differences in poverty rates are generally not significant.

An important characteristic of the poverty problem in Belarus is that poverty has become firmly entrenched in the national context, whilst the share of social expenditures in total public expenditures has remained almost as high as it was in the past – at 14%. The Ministry of Labor and Social Welfare is taking steps to improve government income and social security policies aimed at reducing and preventing poverty. These include introduction of targeted social assistance to the most needy, social rehabilitation programs for the unemployed, disabled and other vulnerable population groups, and self-employment promotion. However, the present arrangements for identifying households and individuals in poverty or at risk of poverty and delivering assistance to such people – in the form of benefits, allowances and other types of aid – remain imperfect and need to be adjusted to the context of the transition to a market economy.

To evaluate the poverty situation in Belarus, the Ministry of Statistics and Analysis of Belarus conducts quarterly poverty surveys, based on the findings of selective household surveys. However, due to the difficulty of assessing the cultural and social components of an extended definition of poverty – which requires a special base of statistical support – the Ministry bases its assessment of poverty exclusively on the criteria of access to resources and is guided by the absolute poverty definition method.

Given these factors and trends, as well as the need to reform

industry and agriculture, and the impact of globalization on the course of socioeconomic transition, poverty is becoming one of the greatest challenges and threats to sustainable development in Belarus. This calls for a new social policy and solutions to poverty, contingent on the presence of a national strategy for poverty eradication – a strategy that would reflect the complex and multi-faceted nature of this problem and advocate a comprehensive approach to its resolution.

To respond to this need, UNDP and the Ministry of Labor and Social Welfare have decided to develop a joint project aimed at assisting the Government in elaborating the basic foundation for national poverty reduction strategy in Belarus. In cooperation with the WB Poverty Assessment Team an in-depth analysis of poverty is supposed to be undertaken within the project, and recommendations on the key objectives of a National poverty strategy will be produced.

The situation concerning negative tendencies in poverty can become even more serious in the future. One reason is that two thirds of state-owned enterprises that dominate the Belarusian economy are currently insolvent. In 2001, 47% of all state-owned enterprises were unprofitable. Almost all are overstaffed.

The urgency to modernize the country's industrial sector has entered the Belarusian government's agenda. But industry reform is constrained by the fear massive lay-offs and rising poverty.

This fear is particularly high with respect to the so-called core enterprises, which form the backbone of the local economy in small communities throughout the country. There are over 150 one-factory towns in Belarus. The sheer number of enterprises in need of restructuring can potentially lead to a major rise in unemployment, poverty and social tensions, especially in small towns. In this context, restructuring of core enterprises is of relevance not to the enterprises themselves, but to the community.

The social risks created by the restructuring of core enterprises can be reduced through dialogue and partnership among governmental authorities, enterprise staff – managers as well ordinary workers – and the business community. Such action should help elaborate and implement steps to mitigate the negative effects of a possible restructuring process.

However, attempts at coordination among stakeholders that could lead to poverty prevention have been sporadic. There is no effective national mechanism in place to cope with the above problem.

The primary development objective of a new UNDP project BYE 02/M03 "Community-level dialogue and partnership to reduce the impact of enterprise restructuring on poverty and unemployment" is to assist the government, local administrations and communities in small cities in avoiding a major rise in poverty and unemployment as a result of restructuring in core enterprises. The project initiated and implemented by the Ministry of Labor and Social Welfare pilots a

mechanism to minimize the dangerous side effects of restructuring. The project site – small town Berezovka, Lida region, Grodno Oblast – a one-company town has a broad range of problems that may typically arise in the process of restructuring in a core enterprise. The pilot enterprise, located in Berezovka, the Glass/Crystal factory “Neman” employs 4473 workers, what is 71% of the economically active population of the town. About 500 workers are expected to be redundant that will definitely lead to social tension in the community.

The three concerns are addressed by the project:

- to facilitate dialogue and partnership among key stakeholders prior to restructuring
- to elaborate a joint action program for stakeholders to protect the community from the possible negative effects of restructuring on the employment situation and poverty
- to reduce the burden of restructuring on the people most at risk

SME development as a tool for alternative employment and poverty reduction

UNDP's main priority in socioeconomic area is to assist the government in redefining national economic and social policies to ensure that care is given to people-centered macroeconomic reforms, social development strategies and environmental protection measures. But the emphasis is done to growth and development of the SME sector as an instrument in raising the living standards of Belarussians and strengthening the material base for the civil society development.

A dynamic small business sector is prerequisite to an efficient economy and would help saturate the domestic market with quality goods and services, provide a source of additional incomes for the people and increase competitiveness of the national economy, thus making it leaner and healthier. Private enterprise serves as an important means to reducing social tensions that result from the crisis in the economy, bankruptcies and personnel cuts by enabling people to find alternative uses to their physical and intellectual abilities.

Despite its high capacity for private initiative, small business still remains out of the mainstream of the Belarusian economy and has yet to become an effective tool to achieve and maintain economic growth, increase employment and apply to a greater extent advancements in science and technology. There are only 2.8 small businesses per 1000 population in Belarus, compared to as many as six in Russia. Belarus continues to lag behind most industrialised nations in small business development. There are 74.2 small businesses per 1000 population in the United States, 46 in the United Kingdom and 68 in Italy.

Since 1996 UNDP has been creating a foundation for the private business development through the implementation of a range of technical assistance projects.

Implementation of the projects BYE/97/001 “Creating Small Business Support and development Infrastructure in Belarus” and BYE/97/003 “Creation of Credit Unions” devoted to the SME support has made a significant contribution through establishing and developing an efficient business support institutions, introducing a new mechanisms for financial support for micro business and individual entrepreneurs, such as microlending facility and credit cooperatives of businesses and citizens.

In context of poverty elimination, the microlending facilities created by the project should be mentioned as the most affective tool for (i) providing an easier and more democratic access to credit and other financial and business services to different social groups, including the unemployed, poor, and poorest, (ii) helping – by means of self-employment and organization of small and microenterprises – in creating new jobs and maintaining job motivation and entrepreneurial initiatives.

A new SME support project – BYE 02/002 “Promoting Enterprise Activity Through Public-Private partnerships” – is designed to continue fostering SME sector development.

At the national level it will be done by:

- Providing a wide range of analytical and advisory work addressed to the Government and aimed at overcoming the critical barriers to private enterprises related to excessive regulation and restrictive rules and procedures mandated by laws and other types of legislation, as well as those created by government authorities at different levels;
- Creating a loan guarantee fund. The initial experience of microlending indicates that lack of sufficient collateral remains the biggest obstacle to greater demand for finance and credit services among small businesses. According to data from the Belarus Fund for Financial Support of Entrepreneurs, over 90% of loan applications from small businesses are turned down due to insufficient loan collateral. Global experience suggests that financial services for small business can be made more accessible by loan guarantee schemes/funds;
- Developing extension of business incubator model to reduce social tensions resulting from a rise in unemployment in the process of enterprise restructuring. This will be accomplished by encouraging the unemployed to enter small business, based in the business incubators opened on the premises of the enterprise under restructuring.

At the local level the project will address typical problems affecting rural population, such as low personal income, rising unemployment and increased migration to cities to set up a pilot small business support center to assist in developing agro- and non-agrobusinesses. At present, 30% of Belarusians are living in rural areas, of whom 47.3%

are at employment age. Low personal incomes, deep decline in agricultural and industrial output, rising unemployment and increased migration to cities are all typical problems affecting rural areas. Support for self-employment and income generation should therefore become top priorities of the state's economic policies in rural areas. According to the Ministry of Statistics, there were 2,525 private farms as of 1 January 2001, farming a total of 82,800 hectares, or 1% of all agricultural land. By contrast, private farms are utilising 7% of all agricultural land in Russia and 4% in Ukraine. Furthermore, as many as 2,139 private farms in Belarus have gone out of business since 1992.

These targets could be achieved to a considerable extent by promoting rural enterprise, which should go beyond private farming to include support for micro-enterprises outside the agricultural sector. In addition to overall constraints to private sector development, the growth of rural enterprise has been affected by lack of specialist knowledge in rural enterprise, economics, accounting and management, as well as limited advisory and information services, restricted access to credit and lack of collateral. These barriers are in many ways the result of an inadequate infrastructure to support rural enterprise.

Recommendations

1. Given negative factors and trends, as well as the need to reform industry and agriculture, and the impact of globalization on the course of socioeconomic transition, poverty is becoming one of the greatest challenges and threats to sustainable development in Belarus. This calls for a new social policy and solutions to poverty, contingent on the presence of a national strategy for poverty eradication – a strategy that would reflect the complex and multi-faceted nature of this problem and advocate a comprehensive approach to its resolution.

2. Support for small business and private initiative has still not become a government priority. There is also a need for a stronger partnership between the government, civil society and business community in creating an enabling business environment, promoting rural enterprise, eliminating unreasonable barriers to business and creating an extensive business infrastructure.

3. Since any attempt to increase the efficiency of the Belarusian economy might result in the loss of 50–80% of currently existing jobs, joint efforts of all stakeholders – government and civil society – should be undertaken to reduce social tensions resulting from a rise in unemployment in the process of enterprise restructuring. In this respect, only a well-developed small business sector, capable of absorbing excessive workforce, can avert massive unemployment.

ECONOMIC DEVELOPMENT IN BELARUS

4

4.1. ALTERNATIVES OF BELARUS ECONOMIC DEVELOPMENT*

For the last several years Belarus has been making attempts to conserve the old centrally planned administrative system that proved to be highly ineffective and crisis-generating. This system is based on active interference of the state into all spheres of economic and public life. As a result, Belarus got into a deep systemic socio-economic crisis. Radical social transformation is long overdue. Does Belarus still have chances to carry out successful economic reforms? Economic transformation is impossible without broad popular support. Opinion polls show that market economy is supported by overwhelming majority of the Belarusian population. The population expressed this kind of attitude to market reforms in the beginning of the 1990s. At that time, people hoped that market reforms would increase their welfare. It is obvious that there is a window of opportunity for reforming the Belarusian economy now. Strange as it might be, the absence of real market reforms gives one advantage. A government of reformers could avoid serious transformational mistakes by using both positive and negative experience of other transitional countries, which were quite successful in their transformation.

Results of economic policy in 1992–2002

After gaining independence in 1992 Belarus failed to achieve substantial progress in carrying out market reforms. In 1992 the government was formed by the Central Committee of the Communist Party of Belarus. One could hardly expect from that government to take a course of market reforms. But reforms started in neighboring countries at that time. The Belarusian economy depended much on foreign trade and it had to adjust to dynamically changing external environment. That is why reforms in Belarus were inductive by nature, i. e. they were stimulated by influence from outside the country, primarily from Russia. Belarus also had to adjust to demands of international organizations which provided financial support for reforms.

Economic policy of Belarus that has been pursued since 1992 can be divided into four main stages, Table 1 see.

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Table 1

Some results of economic policy

Period	M0	CPI	Exchange rate	GDP	Number of privatized enterprises	EBRD index of reforms	Deviation from average
1992–1994	1039	1826	1144	–10.0	358	1.43*	–0.48*
1995–1996	190	119	160	–4.0	477	1.84*	–0.62*
1997–2000	149	141	58	6.9	319	1.49*	–1.18*
2001–2002	65	40	26	4.4	95	1.59*	–1.19*

Source: authors' calculation based on data from the Ministry of Statistics and EBRD

Note:

- 1) M0, CPI, exchange rate and GDP – average growth rate for the period;
- 2) number of privatized enterprises – average for the year,
- 3) index of reforms by the European Bank for Reconstruction and Development – average index of reform for Belarus for the period.
- 4) deviation from average – deviation from the average EBRD index of reform based on 25 transitional countries

* data for 2001

In May 1992 banknotes of the National Bank of Belarus were put into circulation. In 1994 they became the single means of payment on the territory of Belarus. Since 1994, the Belarusian National Bank pursued an independent monetary policy. When Belarus was in the ruble zone, the average annual inflation rate was about 2,000%. During that period GDP decreased by 10% a year on the average. That kind of situation was typical for most transitional countries, though Belarus even at that time was the country that was not in a hurry to carry out reforms.

In 1994 through the first half of 1996, Belarus achieved the most serious progress in transforming its economy. At the same time, other transitional countries were more active and determined in market reforms. In 1993, Belarus took the 17th place among 25 transitional countries as far as EBRD reform index was concerned. In 1994, it fell to 19th position. In 1995, Belarus began to roll up reforms. It was lagging more and more behind other countries in the sphere of market transformations.

The main results of economic policy in that period were inflation decrease to 39% in 1996 and regaining of GDP growth. But the stabilization policy of the National Bank was not assisted by real sector reforms. In addition, as in the second half of 1995 to the first half of 1996 the rate of the Russian ruble was stable the Belarusian government got a chance to stimulate export to Russia at the expense of quick devaluation of the Belarusian ruble, which ensured high price competitiveness of Belarusian goods in the Russian market. It led to the renewal of expansionary monetary policy in 1997. High export

growth created conditions for getting rent by some economic entities by means of the introduction of multiple exchange rate regime of the Belarusian ruble and obligatory selling of hard currency revenue.

The Russian financial crisis in August 1998 and further devaluation of the Russian ruble led to the loss of price competitiveness of Belarusian enterprises first in the Russian market and then in the domestic Belarusian market. The expansionary monetary policy of the National Bank led to substantial acceleration of devaluation growth rate of the Belarusian ruble and inflation rate too. By the end of 1998, the spread between market and official rates of exchange reached 400%. In 1999, inflation exceeded 250%. Macroeconomic instability increased and had a negative impact on the standard of living of the population. In some periods more than half of the population lived below the poverty line.

In 2000, the National bank began to pursue the policy aimed at achieving macroeconomic stability. Firstly, the devaluation of the official rate of exchange of the Belarusian ruble got accelerated. In September, the official and the market exchange rates merged, i. e. there was the unification of the exchange rates. As a result, hard currency revenue of economic entities considerably increased. It meant that the supply of hard currency also went up. It enabled the monetary authorities to stabilize currency market and increase reserves. Secondly, deposit real interest rates went up considerably (during six months they were positive). Ruble issuing was also reduced. As a result, price rise slowed down. In 2000, inflation was 108%, in 2001 – 46% and in 2002 – 35%.

At the same time, the stabilization of ruble and currency markets led to the growth of the real exchange rate of the Belarusian ruble. During 2000–2002, the real exchange rate of the Belarusian ruble to the Russian ruble increased by almost 80%. As a result, the competitiveness of Belarusian goods fell significantly. In particular, it led to an increase in the share of Russian import and reduction of share of Belarusian export to Russia.

Though price growth rate has gone down, inflation in Belarus still remains one of the highest among CIS countries. In 2001–2002, prices for utility services grew fastest as the goal was to increase them to the level when they cover production costs. But as this price rise was not accompanied by reforms of the utility sector it did not lead to increase of utility sector effectiveness.

The decision of the country's leadership to increase wages to the level of 100 USD by the presidential elections in 2001 damaged the economy much. In addition, the program of socioeconomic development of the country for 2001–2005 was passed. It stated that wages should grow further to the level of 250 USD by 2005. It should be noted that the wage rise was not a result of labor productivity increase and it led to considerable deterioration of the financial status

of enterprises in the real sector. As a result, in the beginning of 2003, more than half of Belarusian enterprises were loss making. At the same time, unsold goods inventories of industrial enterprises went up too. It gives even more evidence to the fact that most of Belarusian enterprises are not consumer demand oriented but oriented toward fulfilling administrative tasks to increase production.

Difficult financial status of enterprises led to deterioration of the situation in the labor market. Besides there were many more problems with paying wages. During 2002, wage arrears were much higher than in 2001. The officially declared rise of real income of the population went hand in hand with poverty increase.

In 2003, when enterprises are administratively set production targets, we can expect further GDP and industrial production growth. In the absence of reforms of the real sector, the financial status of enterprises will deteriorate even further. As a result, employment will be reduced and unemployment will rise. The difficult financial status of enterprises will evidently cause budget revenue problems. It will require reduction of budget expenditures. Based on the experience of last years, we can say that support of real sector enterprises will be cut. Consequently, the pressure on banking sector is likely to increase. Banks will claim more resources from the budget and the government will increase pressure on the National Bank to print more money to finance budget deficit. It will be the major factor of macroeconomic instability in 2003 and in the mid term.

Alternatives of economic development

Possible scenarios of economic development

Today there are two scenarios of economic development for Belarus. According to the first scenario, the current economic policy is continued and output growth is achieved by carrying out institutional reforms and structural transformation of the economy. The result of pursuing such policy for the past eight years is production growth achieved by means of ineffective use of resources. It failed to increase standards of living of the population. Most people still live below or at the poverty line. The difference between the level of economic development of Belarus and the countries that are really reforming their economies is growing. Since 1998, Belarus has taken the last but one place in the list of 25 transitional countries ranked on EBRD reform index. In 2003, it took 148th place on the index of economic freedom by Heritage Foundation.

The second scenario presumes the restoration of democratic institutes and carrying out of market reforms. It will open opportunities for integrating Belarus into the world economy, achieving long-term economic growth, raising standards of living and reducing poverty.

Costs of absence of reforms

Supporters of the current economic policy claim that market reforms will have a negative impact on the economy and welfare of people. However, such position is unfounded and it is not proved by the experience of other states. The countries that carried out radical market reforms had already passed the period of transition. Now they are in the process of dealing with problems of successful integration into European Union.

The absence of reforms in Belarus has already led to the situation when international organizations that deal with investment risks put Belarus in the end of the list where countries with highest economic and political risks for investors are. In this situation the country can not get access to modern technologies and experience of effective organization of business. Besides, many credit lines of International Monetary Fund, International Finance Corporation, EBRD, projects of specialized funds and European Union are blocked. Belarus does not receive even the minimal amount of aid to liquidate consequences of the Chernobyl accident.

Economic risks that arise as a consequence of the lack of reforms turn to be much higher than the risks of not carrying out reforms. Market institutions create rational motivation for economic entities and lead to economic risks reduction.

Starting conditions for carrying out reforms

From the population's point of view, Belarus remains one of the most market oriented countries in CIS. The growth of supporters of market economy in Belarus is connected with the fact that most part of the society is disappointed with state regulation of the economy. Most directors of state enterprises, businesses, regulatory bodies, mass media and academic structures do not have doubts about effectiveness of market economy. The society in general also accepts the idea of necessity of carrying out market reforms.

However, to achieve success, the absence of resistance to reforms is not enough. A team with vision and technologies of carrying out market reforms is needed. Besides, market institutions that are created in the process of reforms should have qualified users. At present, Belarus has the minimal amount of entrepreneurial capital which can be used right after the beginning of reforms. In addition, high skilled labor and well-developed production and infrastructure are traditionally considered as factors of competitiveness of the Belarusian economy. However, it should be noted that the more reforms are delayed the less important these factors become.

Guidelines for reforms

The goal of reforms is to raise the level of welfare of the population. It is achieved by ensuring long-term economic growth. The main source

of GDP growth in the transitional period is not attracting new resources into the economy but redistributing existing resources by means of structural reforms, which will make it possible to increase effectiveness of the economy. Evidently, Belarus should follow the example of the most successful countries in the region that achieved considerable increase of the welfare level of their people. To carry out market reforms, a new government should fulfill the following tasks:

In monetary policy – to ensure macroeconomic stability and to form trust of businesses and households to the national currency by means of ensuring independence of the National Bank, considerable reduction of inflation, supporting positive interest rates, ensuring stability of exchange rate and carrying out banking reform.

In fiscal policy – to ensure balanced budget, i. e. to meet revenues and expenditures of the budget, elimination of cross subsidization by means of making budgets of all levels transparent, creating stable and predictable legislative base, reduction of tax burden and expanding the tax base, reduction of ineffective government investment and improving the structure of government expenditures.

In the sphere of market institutions formation and private sector development – price liberalization, utility sector reform, reduction of the average import tariff, abolishment of duties on intermediary goods, raw materials and investment export, removal of non-tariff barriers of market entry and creation of market institutes. Taking these measures are necessary for effective functioning of market economy.

In the sphere of industrial enterprises restructuring – carrying out privatization and active restructuring of enterprises, attraction of foreign investment, development of stock market, financial restructuring of enterprises and banks, creation of equal conditions for economic functioning for all entities.

In the sphere of agriculture restructuring – introduction of private property on land, abolishment of National bank's money-issuing-based crediting of agriculture, restructuring of still operating agricultural enterprises, farmers and entrepreneurs' support in agriculture.

In the sphere of foreign economic policy – creating conditions for Belarus' integration into the world economic system by means of passing adequate legislation that meets international standards and norms, creating conditions for integration of Belarus into the European Union.

In the sphere of social policy – ensuring targeted social assistance to the most needed citizens, creating effective system of professional training, flexible labor market, easily accessible information system on job vacancies inside the country and abroad. This data system should also include information about training programs, price dynamics, market demand, and basic analytical info for different social groups of the population. Health care system reforms should be launched.

Pension reform, science and education reform are also important parts of social reforms.

Another necessary condition for success of reforms is creation of an open political system that ensures conditions for political competition. In the end of the 1980s and in the beginning of 1990s many people believed that successful transformation of transitional economies was possible only by strong executive power which could act quickly and decisively. The experience of economic transformations in Central and Eastern Europe (including Belarus) showed that in the countries where the executive branch concentrated much power, while the parliament had limited authorities, reforms were much slower and were blocked.

The research of the European Bank for Reconstruction and Development (EBRD 1999) showed that the countries in which reforms were done by coalition governments were more successful in economic transformations than countries with concentrated political system. In addition, there is a dependence between the average term of the government in power and the success of reforms. Frequent changes of governments are associated with more progress in economic reforms, as high political competition, which leads to periodical changes in government, reduces seriously the impact of negative consequences of lobbying of various interest groups. Openness of political system, large influence that the society has on political appointments – these factors do not allow the government to make privileges for various groups or individuals, as it can have a negative impact on the results of the next voting. In the process of political competition, not only corruption is scaled down and the pressure of lobbyists is lessened but also the best economic solutions are worked out.

Another important condition of political system reform is restoration of the principle of division of power. The functions of the state power should be granted to legislative, executive and judicial powers that are independent from one another. They should build relations based on mutual control and the principle of check and balance. The executive power – the government – should be formed by the parliament. The dominant on the post-Soviet area practice when executive power is concentrated in the hand of the president turned to be highly ineffective and discredited itself. It creates insoluble contradictions between the legislative and executive branches of power. The parliament usually refuses to pass unpopular but important for functioning of the society laws which the government introduces, because in case of their failure, the parliament takes up responsibility. In case of success, the government reaps the benefit. Only if the government is formed by the parliamentary majority and it is responsible both for success and failure of economic policy, it is likely to pass necessary legislation quite quickly. Another important principle that must be restored is the principle of rule of law. It presumes the

restoration of hierarchy of legal acts that is accepted in the civilized world. It means that all bodies of power, including the president, obey the law.

Only responsible professional government that is closely controlled by the public can carry out reforms with the least social costs. Public dialogue in which all social groups can take part as equal partners is necessary. They should represent those who face high costs of reforms and those who get most of benefits from reforms.

Political decisions that can be the result of the open public dialogue can be the base for distribution of political and economic power. This balance enables the country to keep national consensus about the future and continuity of reforms. As a result, the change of government and victory of this or that political force on the parliamentary elections will not cause radical changes in the economic policy. Hence, stability of public life and sustainability of economic development will be ensured.

4.2. BELARUSIAN ECONOMIC GROWTH: ENIGMA OR MIRAGE?*

1. Introduction

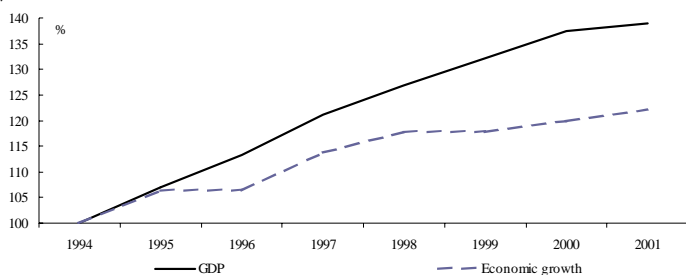
There are many indices that characterize the degree of economic freedom in different countries. Based on studies of factors that have the most important impact on the formation of institutional environment favorable for economic growth (Index of Economic Freedom (2001)), various components of these indices are singled out. Then they are evaluated and aggregated into an index. There are indices that are calculated separately for transitional countries, for example liberalization index which was designed by De Melo, Denizer, Gelb (1996). Now it is used by the IMF. Transformation indices of EBRD (Transition Report (1994–2002)) and also indices of economic freedom, rule of law and democratization introduced by Freedom House (Nations in Transit (1998–2001)). The existence of such indices creates opportunities for empirical research of the factors that brought different countries either to success or to failure of transformations in former socialist countries.

In the middle of the 1990s it became evident what model of transformation each former socialist country had chosen. After ten years of reforms leaders and outsiders of the reform process became evident, too. Besides the economists who studied economic growth in these countries revealed a number of problems. In several countries economic growth was not explained by existing models with “stylized facts” – indicators that characterize the situation in the country. Poland and Belarus are most frequently referred to in this case. GDP growth in these countries was called “hovering eagle” and “Belarusian enigma”.

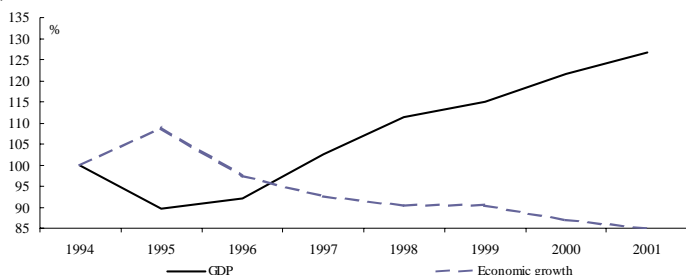
The problem can be illustrated in a graphical form. In Figure 1a and 1b one can see the trajectory of GDP dynamics and index of economic freedom of Heritage Foundation (HF). In 1995–2001 GDP in Poland increased by 40%, economic freedom – by 22%. “Elasticity” of growth on economic freedom is 1.75. GDP in Belarus for the same period grew by 27% and economic freedom decreased by 15%. “Elasticity” of growth on economic freedom factor is minus 1.78. Paired regression made for 24 transitional countries gave suitable metaphors provided the index at the economic freedom equals one. – i. e. “hovering eagles” (higher than it can be predicted with the equation, growth rate in Poland) and “enigma” (negative elasticity of growth on economic freedom for Belarus).

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1a



1b



Source: Transition Report (different issues); Index of Economic Freedom (different issues); calculation of the author

Note 1994 = 100.

Figure 1. GDP and economic freedom in Poland (1a) and Belarus (1b)

This article gives a short analysis of GDP growth in Belarus. Estimates of reliability of GDP statistics and quality of growth in 1996–2002 are also given in the article.

2. Factors of economic growth in transitional countries

The peculiarity of transitional countries is that their institutional environment is unstable and mid-term growth will depend on what kind of environment will be created. All transitional countries began transformations having highly inefficient institutions of socialism but none of them created institutions of capitalism. Differences in the character of reforms determine perspectives of economic and social development of these countries. Reforms lead to formation of new environment for economic agents, i. e. new incentives of economic behavior appear which finally are main factors of growth in transitional economies.

Analysis of works dedicated to economic growth in transitional countries (see for example De Melo et al. (1997), Havrylyshyn et al. (2000), Fisher and Sahay (2000), Chubrik (2000a и 2000b), Chubrik, Rakova and Pelipas (2002)) enables us to make the following conclusions:

- Key factors of economic growth in transitional countries are macroeconomic stabilization, structural reforms and reduction of government expenditures. Development of market institutes is an important but not the main factor of economic growth. In freer transitional countries growth rate is higher. Reforms have a positive impact on economic growth. Consistent wide scale reforms are more beneficial to growth;
- Starting conditions had an impact on growth due to a few reasons. Firstly, large structural distortion of economy requires more time and their correction leads to bigger reduction of output. Secondly, though availability of natural resources stimulates investment inflow but it restrains reforms as it is a kind of “resource cushion” for the budget and businesses. Thirdly, proximity of Western Europe and relatively short period of socialist economy had a positive impact on abilities of economic agents to adjust to new institutions. It made the economic policy more liberal;
- Main macroeconomic indicators stimulate inflow of foreign direct investment and institutional factors stimulate inflow of portfolio investment;
- The largest growth of welfare was achieved by the transitional countries which aimed at joining the EU;
- Foreign direct investment remains an important factor in transitional countries. Dynamics of foreign direct investment are closely connected with indices of economic freedom and liberalization, democratization and the index of reforms. Parameters that characterize investment climate in which economic agents operate have the largest impact on investment.

Macroeconomic stability and structural reforms were key factors of GDP growth in transitional economies. It is proved by empirical data for countries with low inflation and wide scale systemic reforms (table 1).

The equation in which GDP growth depends on inflation growth illustrates well the economic growth in Belarus in 1989–1999 (average deviation of actual growth rate from predicted one is 0.45%), but it does not explain at all dynamics of GDP in 1996–2002 (deviation is 9.82%). The equation in which GDP growth depends on EBRD reform index on average given too high estimate of growth in 1991–1995 (by 6.96%) and it gives too low estimate of growth in 1996–2001 (by 5.8%) on the average. Thus, the factors that are described in literature on economic growth in transitional countries fail to explain quite high growth rate in Belarus in the second part of the 1990s. It is an empirical basis for using the expression “Belarusian enigma” in reference to GDP growth in Belarus in 1996–2002.

Table 1

GDP growth factors in transitional economies

Explanatory variable	Index at explanatory variable
Inflation (logarithm)	-2.73
Composite index of reforms made by EBRD	12.7
Components of index of reforms made by EBRD	
Banking reform and interest rate liberalization	10.0
Policy of competition stimulation	10.2
Management and restructuring of enterprises	12.0
Infrastructure reforms	3.6
Privatization of enterprises	7.7
Price liberalization	5.7
Stock market and non-banking financial institutions	6.1
Small privatization	7.7
Foreign trade and currency system	7.8

Source: author's calculation

3. Alternative estimates of GDP growth in Belarus

Russian economist G. Khanin in his work "Dynamics of economic development of the USSR" summed up the results of his earlier research in the sphere of alternative evaluations of economic growth in the Soviet Union. He noted that "favorable conditions for distorting economic information are 1) quick renewability of production of a production unit, 2) sharp changes in prices in economy". It is true to any economy of the Soviet type which aimed at a high rate of economic growth and output. Belarus is not an exception. In the middle of 1999, the Council of Ministers passed two resolutions that enabled setting a new higher price for a new good. The enterprises used this opportunity to raise prices by quickly changing the range of goods. The statistical bodies used it as an opportunity to increase GDP as "new" goods were not deflated and were included in GDP at new prices. Unfortunately, the absence of data on dynamics of the range of production of Belarusian enterprises did not allow us estimating the degree of GDP increase because of this factor.

The second loophole for setting the volume of output too high was high inflation. In the environment of regulated prices and high inflation, it is easy to set GDP growth too high. To do it, you should consider price rise as output increase (Table 2). As most Belarusian enterprises were ordered administrative production indices¹, the

¹ Institute for Privatization and Management polled directors of 324 privatized and state enterprises. Only 5.4% of respondents did not receive administrative orders to ensure output growth (www.ipm.by/index.pl?topicid=e65b3b37&briefid=ca78b4ba38c72e3a).

probability of increasing GDP is quite high. Besides, when inflation is measured in double or triple digit numbers ordinary statistical mistake can lead to even more mistakes in calculation of the growth rate of real GDP.

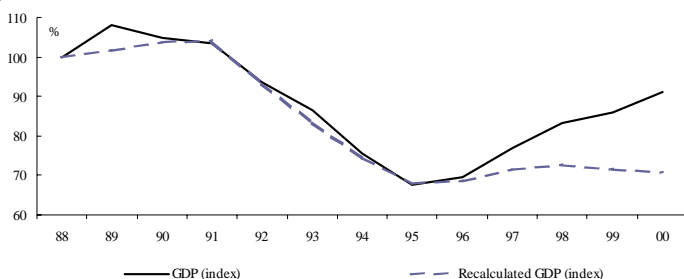
Table 2

Possibility of overstating GDP in inflationary environment

	Price rise		Revenue	Output increase	
	Output	Price		Output	Price
Period 0	100	1	100	100	1
Period 1	100	1.2	120	120	1

Increase of production prices by 20% which at constant volume of output leads to revenue increase by 20% can be presented as increase of output from 100 to 120 units at constant prices.

GDP dynamics can be estimated based on dynamics of other indicators (for example consumption of electric energy). Beginning from 1996, GDP and electric energy consumption ceased to be indicators with synchronized dynamics. Calculated on energy consumption economic growth in 1996–2001 is 20.5 percentage points lower that officially given GDP¹ (graph 2).



Source: calculation of the author based on data of Ministry of statistics and analysis of the Republic of Belarus

Note: 1988 = 100.

Figure 2. GDP growth and electric energy consumption

When there were many rates of exchange, GDP was overstated from 1996 to 2000. The reason was that net export was included in GDP at official rate of exchange of the Belarusian ruble. As net export was

¹ Regression estimated for 25 transition countries over the period of three years establishes that the elasticity of the increase in GGP by the increment of the electricity consumption equal to one. The same holds for Belarus according to dynamics of the electricity consumption and GGP growth over the period of 1990–1995.

negative, GDP was constantly overstated by the amount that equals the product of the dollar equivalent of net export multiplied by quotient of market and official rates of exchange. For these five years, overstatement of GDP rate growth was just 1.8 percentage points. However, in 1998 it amounted to 7.6 percentage points (Chubrik 2001).

A. Aslund in his work "Myth about collapse of output after communism" (2001) showed that including gray economy into GDP enables us to more accurately estimate the depth of transformation recession. In particular, GDP decline in Belarus in 1991–1995 was smaller by 2.2 percentage points. We can conclude that if recently the share of gray sector in the economy grew, then GDP growth in Belarus was lowered. In particular, GDP growth in 2000–2001 can be partially explained by the legalization of a certain share of gray economy (an indirect indicator for this is increase of gross revenue after the unification of the exchange rate by \$440 million in 2000 and \$980 million in 2001. Thus, all mentioned above arguments are relative: in state sector GDP is overstated and in private sector it is understated and Belarusian enigma remains unsolved.

4. Conclusion. Opportunity costs

Economists that deal with problems of economic development note that GDP growth is not a goal in itself. Economic growth should lead to welfare increase of the population particularly its poorest part. (Easterly (2002). In Belarus GDP growth did not lead to welfare increase of the population. In 1996–2000 GDP per capita grew by 45% but the average income of the poorest 40% of the population grew by just 12%. In the absence of reforms we can say that Belarus faced opportunity costs (Chubrik, Rakova, Pilipas (2002). While countries-reformers are doing restructuring and taking their shares in the system of international division of labor, the countries that refused to carry out reforms and stuck to administrative regulation of economy have their competitiveness lowered. Economy is getting less and less effective. Even comparison of a few indicators of development of three countries – Belarus, Poland and Lithuania enables us to estimate opportunity costs of the absence of reforms in Belarus (Table 3).

Annual average inflation growth in Belarus is 3.3 times higher than inflation in Lithuania and 4.1 times higher than in Poland. Besides inflow of foreign direct investment to Belarus was small – just 123 USD per capita, which is 5.3 times less than in Lithuania and 6.1 times less than in Poland. In 2000, the average wage in US dollar terms in Belarus was 3.9 times less than in Lithuania and 6.6 times lower than in Poland. In spite of the declared social orientation of economic policy, the level of social protection of the population in Belarus was much lower than in Lithuania or Poland. Minimal wage in Belarus was 36 times lower than in Lithuania and 51.7 times lower than in Poland.

Pension age was 2.5 and 6.8 times lower respectively. Unemployment allowance in Belarus was 9.4 times lower than in Lithuania and 20 times lower than in Poland. In 2000 more than 40% of the population lived below the poverty line. Average life span in Belarus dropped down by almost 2 years compared to 1990 while in Lithuania and in Poland it went up by 2 years. Mortality rate in Belarus grew by 2.7 pro mil and in Lithuania and in Poland it dropped down by 6.8 and 3.4 pro mil respectively. What did Belarus lose by rejecting market reforms? Firstly, it has lost investment. Reforms could attract much investment to Belarus. They could bring new technologies, jobs and highly trained management. They would help modernize fixed capital (depreciation of fixed capital in Belarus exceeds 80%), increase productivity and raise welfare level. Secondly, Belarus has lost competitiveness. While countries reformers reoriented much of its foreign trade to western markets, the main market for Belarus is still Russia. It is worth noting that recently Belarusian export to this country has declined, while import of Russian goods to Belarus has grown.

Table 3

**Belarus, Lithuania, Poland:
some results of economic transformation**

Main macroeconomic indicators	Belarus		Lithuania		Poland	
GDP in 2000 (1989 = 100), %	85.0		65.0		127.0	
Average CPI (1989–2000)	240.8		73.0		58.1	
Foreign direct investment per capita for the period 1990–2000, in USD	123.0		646.0		751.0	
Standard of living (data for 2000)						
Average wage in USD	70.0		273.0		465.0	
Minimal wage, USD	3.0		108.0		155.0	
Average age pension in USD	31.0		78.0		210.0	
Unemployment, %	2.1		11.0		14.0	
Unemployment allowance in USD	5.0		34.0–60.0		100.0	
Poverty level, %	42.6		16.0		6.9	
Social indicators	1992	1999	1990	1999	1992	1999
Average life span, years	70.0	68.4	70.3	72.1	71.1	73.2
Mortality index	10.7	13.4	15.4	8.6	9.9	6.5

Source: Chubrik, Rakova, Pilipas (2002).

Thirdly, Belarus has lost an opportunity for income of the population growth. In Poland, in 1996–2000, 1% of GDP growth corresponded to 2.54% of wage growth. At such elasticity average wage in Belarus in 2001 should be 168 USD and not 89 USD as it was in reality. It means that only in 2001 every worker could have earned 840 USD more.

Besides during all the years of GDP growth and absence of reforms population of Belarus shrank. Of course, the reduction of birth rate

and growth of mortality rate are complex phenomena but low standard of living and the lack of prospects for the future do not add to birth rate growth in Belarus. As a result of mortality rate growth and birth rate decline population in 1994–2002 was reduced by 375,000 persons.

Finally, the absence of economic reforms alongside with increasing authoritarian trends in political sphere, considerable distortion of democratic institutions and pressure on existing structures of civil society create quite unfavorable image of the country in the international community.

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4.3. ECONOMIC GROWTH IN BELARUS: FACTORS, PECULIARITIES AND PROSPECTS*

The main long-term goal of macroeconomic policy is to support high growth rate of the main macroeconomic parameter – gross domestic product. Ensuring high growth rate of GDP is the economic basis to provide for the main goals of reproduction – increase of welfare of the Belarusian population.

An analysis of the recent economic development shows that alongside with considerable negative processes there are also positive trends in the GDP change. An increase in the number of loss making enterprises, decrease of profitability, growth of overdue debts, fast depreciation of fixed capital, lack of innovative, investment and entrepreneurial activity of enterprises are just a few among negative factors. They create a threat to further development of positive trends. Moreover it is evident now that to support positive GDP growth by means of old methods and instruments of economic and macroeconomic policy is quite difficult as the potential of the state administrative system has almost been used up and methods of market self-regulation were much restricted in use.

However, it is not right to state that transitional economic policy in Belarus is wrong. One should take into account the difficulties that Belarus has to face in its modern history.

Since 1991 Belarus followed the general direction of reforms in Russia and other countries. It broke institutions of central planning and pursued the policy of liberalization of domestic market (liberalization of prices in the first place) and foreign trade. However, as old institutions were hardly able to function and new market institutions have not been formed (lack of market management and absence of the most important institutions of an independent state should be mentioned here) liberalization failed to bring desired success on the initial stage of the transitional period. Market impulses that were formed in the economy did not receive adequate responses.

As a result of this, GDP was catastrophically declining. In fact “institutional vacuum” was formed in the beginning of economic reforms. And the fact was that there were attempts to fill out this vacuum. But creating formal (legislative) and which is more difficult informal (moral norms, traditions etc.) institutions of civilized market economy takes much time. As a result, economic entities became disoriented. The lack of formal limitations that are formed by institutional environment brought to antisocial forms of appropriation.

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Many entities made attempts to monopolize different spheres of economic activities. They used means and ways of unfair competition. At the same time, the country faced galloping prices, regular payment delays, corruption, inability of the state to perform social functions, criminalization of economy and other negative phenomena. Simultaneously, liberalization enabled the government to balance merchandize market, activate the process of the creation of new institutional environment of a market type.

After the first presidential elections in 1994, Belarus initiated the process of forming, strengthening and setting up strong state institutions with simultaneous slowing down of the liberalization of the economy. While the country was heading towards economic catastrophe, such policy was justified. The task was to stop the process of economic decline and simultaneously to set up necessary institutional environment and market infrastructure by means of direct subsidies, tax stimulation, toughening control and responsibility on all levels.

The result of such policy was the absence of wide-scale privatization and toughening of control and administrative functions of the state. At the same time, the state kept high domestic demand by means of credit and monetary expansion and kept most of enterprises afloat. GDP and industrial production grew. Official unemployment was low. The situation on the country stabilized and huge income inequalities were stopped from being further deepened.

Thus, Belarusian economy grew mostly by means of restoring and strengthening of functions of the state which weakened or destroyed in the beginning of perestroika processes. At the same time, the recent development proves that possibilities of the existing state regulation are limited. The experience of modern Belarus shows that mechanisms that are based on expansionary monetary policy are getting less effective. The use of resources at artificially low prices (labor, energy resources, etc.) is getting increasingly problematic.

Recently the process of gradual decrease of money-issuing support of the economy directed at financial stabilization, lowering rate of devaluation and inflation has been started. It also gives new quality to economic growth as it is based on financial incentives in the environment of tight budget constraints. However, the main obstacle of economic growth today is unfavorable institutional environment and its part that coordinates macroeconomic processes.

The state plays the most important and decisive role in solving the problem of formation and functioning of market institutions. The strategic goal of the state in the transitional period is to assist systemic formation of new economic relations. It means support of private entrepreneurship, management of the process of state enterprises restructuring and property transformation, working out rules of the game and control over them and many other things. In fact, the state should

create conditions for further liberalization and debureaucratization of the economy, lowering administrative barriers of market entry and for doing business. It means that the state should create conditions for reduction of its own direct administrative intervention into the economy to give boost to entrepreneurial activity. The state should cease to be an overwhelming care taker which brings about dependency and unfounded guarantees. At the same time, the state should rigidly enforce law that regulates property rights and market behavior.

Not denying the overall positive and active role of the state in market conditions and particularly in the time of moving towards the market, we should note ineffectiveness of the functions that the state performs today using administrative tools of active involvement in the current activities of enterprises. The comeback to direct administrative means of state regulation in the environment of poorly developed (or rather non-existent) market-type institutions and deep social economic crisis have been justified. However, today such administrative system is a major brake in social economic development as it blocks using all of entrepreneurial energy. Moreover, as there are no mechanisms of responsibility and control over activities of state officials, prerequisites for abuse of power, for ignoring interests of the country in general and for making decisions in favor of individual or group interests are being created. This negative development can be explained by low wages of state employees. It leads to an outflow of the most qualified people to commerce and to overall lack of competence and professional skills of government employees. They are not qualified to carry out systemic reforms and systemic regulation of the economy.

In connection with this, the primary task is forming a systemic consistent legislative base that regulates market type economic relations and carrying out administrative reform which will exclude as much as it can operational executive and administrative functions of state regulation. They should be concentrated primarily on political and regulatory functions based on mechanisms of market self-regulation. Thus the main task of the state is creating an institutional basis for self-development.

At present, it is necessary to come back to the framework of market reforms, to speed up liberalization of the economy, to free entrepreneurial energy and to make use of the potential of foreign investors. Today unlike in the beginning of perestroika processes, the legislative base is much better. Market type structures are much better developed. Informal institutions changed much and population, to a greater extent supports, market reforms.

Today, in order to ensure economic growth it is necessary to speed up restructuring and privatization of large enterprises. It is also important to create conditions and to increase support of small and medium business. It will allow to achieve the following:

- To accumulate own and credit means of the population to set up private entrepreneurial structures;
- To demonstrate other countries and international structures devotion to market principles and freedoms;
- To create jobs;
- To form prerequisites to form middle class which is the basis of social stability in the society;
- To increase stability and flexibility and adaptive possibilities of the Belarusian economy.

In terms of building institutions, it is necessary to simplify registration (incorporation) procedure. The principle of informing the authorities instead of asking for their permission should be applied for certain types of activities. It is also necessary to reduce the number of licensed kinds of activities to those that can constitute a threat to national and economic security of the country, its environment, health and lives of people.

Favorable institutional environment and better macroeconomic policy should allow the government to solve the difficult problem of fixed capital depreciation. This stage of reproduction in the country is characterized by sharp decrease of index of restoration of fixed capital and keeping the index of depreciation almost at the same level. For example, in the Belarusian industry the index of renewal before transitional processes was 6–8%. During the last 3 years, it varies from 1,5 to 2,4%. It means that in the past, complete renewal of fixed capital could be completed in 12–16 years. Today, this period of time is 42–66 years. In such branches of industry as chemical, petrochemical, machine building and metal processing the index of renewal of fixed capital is the lowest. It would take much longer to modernize the fixed assets.

The consequence of low level of renewal and fast depreciation is inability to produce competitive products. The dynamics of depreciation of active part of fixed capital is especially threatening (see graph 1). As statistical data show the level of wear and tear of active part of fixed capital in the economy in general exceeded the limit of economic security of this index (60%) and it keeps growing. The most dangerous situation is in chemical and petrochemical sectors (the level of wear and tear of the active part of fixed capital is 85.4%), machine building and metal processing sectors (84.7%), production of construction materials (76.3%), light industry (79.3%) construction (79.1%) and agriculture (79%). The high degree of wear and tear not just has a negative impact on competitiveness of the economy of the country and perspectives of its growth but it creates real threats to environment and health of workers who use depreciated means of production. The danger of accidents increases as the equipment is old and requires repairs. At the same time, costs of means of production major and current repairs are growing.

We should note that in market economy the role of material factors is extremely important. That is why constant renewal of fixed capital and its growth takes place, which leads to its qualitative modernization and improvement. The role of investment in this process is extremely important.

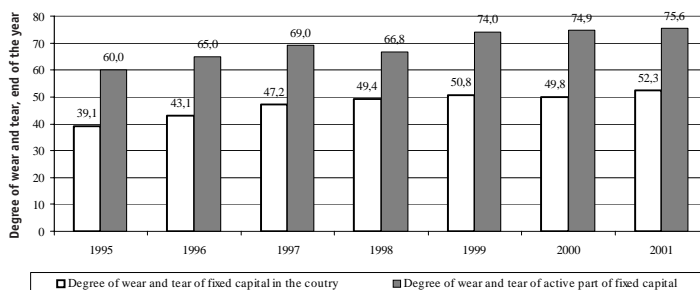


Figure 1. Degree of wear and tear of fixed capital in the country

Recently the share of investment in fixed capital in Belarus was 16–18%. Such share is quite sufficient for a developed country. It lets the country modernize its production facility. However, as it was noted earlier such process is not going on in Belarus. It is mainly due to the fact that GDP is disproportionately small to the amount of fixed capital in use. In other words the share of investment would be much bigger or (and) fixed capital for its production would be smaller. Consequently, it is necessary to achieve more output using the existing fixed capital. However, due to low productivity of production and partial use of production facilities as the goods are not competitive enough in price and quality factors one can not achieve higher volume of production on the existing fixed capital without attracting investment.

One of the sources of investment can be increase of gross accumulation and the share of investment in GDP. It can be achieved by the following: firstly, by reducing final consumption; secondly, by attracting foreign investment, which leads to trade balance deficit, as a rule.

The first way is restricted in the environment of low standards of living and poverty of the population. It can be used by means of gradual growth of gross savings which should be higher than the growth rate of final consumption. At the same time, GDP should be growing, too. It means that the problem of wear and tear of fixed capital can be solved in the near future. To do it the share of investment in GDP should be doubled.

The second way is more acceptable as it does not mean reduction of growth rate of consumption of the population of the country. Moreover, foreign investments does not just bring import growth of

investment goods into the country but they lead to using full capacity of Belarusian enterprises that produce investment goods. As a result, we have GDP and consumption of the population growth. Moreover, as experience shows foreign investment brings more output as they are based mainly on modern fixed capital and management.

Change of investment structure could generate some possibilities for modernization of the active part of fixed capital. It is necessary to support the recent trend to increase production investment and the share of investment into machines and equipment in it.

The substantial reserve for acceleration of reproduction of fixed capital lies in reduction of unfinished construction. As of January 1, 2003 there were 17,045 unfinished construction objects. 8,353 out of them are of production character. The balance value of the unfinished construction objects was 4175 billion BYB which almost equals the annual investment program. Such considerable number of unfinished objects is the outcome of the old disease which is dispersion of capital investment in the situation of budget constraints.

In these conditions the problem can be solved only in the following way: firstly to introduce moratorium on introduction of new objects into the state program; secondly, to sell the unfinished objects and attract means of foreign and domestic investors; thirdly, to conserve objects which can be finished later; fourthly, bad unfinished objects should be dissembled.

At present, the government of Belarus approved the draft of the Program of Reduction of Number of Unfinished Objects for 2003–2005. It should assist if not radically in reduction of the number of unfinished construction objects. To match GDP and fixed capital, it is reasonable to write off the facilities that are not used. The production facilities that are not used or are used rarely are a heavy burden on the finance of the enterprise. They prevent the enterprise from financial stabilization. They stimulate setting high prices on the manufactured goods. The equipment that is not used is taxed and depreciation costs are included into the costs of production. As a result, the cost structure is distorted and potentially profitable enterprises turn to be loss making.

To free enterprises from spare unused facilities, it is reasonable to conserve these facilities (till the time when there is demand for the production made on this kind of equipment), to stop paying property tax and stop including depreciation costs into the overall production costs. Unused equipment and facilities should also be sold (taking into account their low liquidity they can be sold at prices below those indicated in the balance). The equipment that is really in bad shape and can not be sold at any price should be destroyed and written off the balance.

To attract investment into Belarusian economy it is necessary to create normal investment climate which is defined by social, economic,

organizational, institutional and political factors and prerequisites. Today though the investment climate in Belarus has some drawback, it is constantly improving. But to attract investments particularly foreign ones it is necessary to carry out consistent reforms aimed at improving institutional environment and creating macroeconomic conditions for investment. It is necessary to ensure firm guarantees of property rights for foreign and private investors, to reduce administrative barriers of market entry for business, to increase quality and to ensure stability of main institutions that regulate financial and economic relations. Market infrastructure should be formed more actively. Credit possibilities of the banking system should be expanded also by means of privatization and selling state shares in banks to foreign investors. Inflation should be lowered to the moderate level. National currency should be stable and fully convertible. Land market should be created, which will ensure the creation of the institution of property rights for land. Tax burden should be reduced on producers that operate in Belarus. Insurance system to lower investment risks should be developed. Information support of investment activities should be enhanced. Cooperation with international financial organizations primarily with IMF should be developed.

As the world experience shows, the important factor of attracting foreign investment into a country is its taking part in privatization of medium and large enterprises. Taking into account the fact that privatization in Belarus is on the initial stage, we can expect positive results from this factor. At the same time, as the fixed capital is getting older and there is a threat of complete loss of competitiveness this process should be accelerated.

Domestic investment also plays an important part in modernizing fixed capital. New depreciation policy, leasing development, lowering credit interest rates alongside with inflation reduction, giving budget funds on competitive basis should stimulate its growth. To attract investment into the economy, it is necessary to ensure the growth of gross savings of households, enterprises and the state. They should be used for gross accumulation and investment in fixed capital. At the same time, the share of financial operations (accumulation of currency reserves, outflow of capital, net paying off of the state debt etc.) should be lowered.

Taking into account the orientation of the economy towards the growth of the norm of accumulation, the growth of final consumption should be high enough but a little bit lower than GDP growth rate. We believe it is reasonable to continue the policy targeted at high growth rate of the wage in dollar terms. Such economic policy will allow to do the following: firstly, to create stronger incentives to work; secondly, to ensure creation of better conditions for reproduction of the main factor – human capital; thirdly, to restrain outflow of the most qualified people abroad; fourthly, to stimulate growth of aggregate demand;

fifthly, to create basis for gross savings which can be transformed into investment in fixed capital if adequate market mechanisms exist.

As recent data showed household consumption contributed the most to GDP dynamics (see table 1). It is particularly true for 2001. However and first of all in the last two years, the growth of effective demand of the population was covered to a great extent by import. GDP was reduced due to this factor. In general, though export demand in real terms grew, the external component during the last years had a negative impact on GDP dynamics. It makes the problem of import substitution more topical.

Table 1

**Contribution of different factors
of final consumption to GDP growth, %**

	1996	1997	1998	1999	2000	2001	2002
GDP growth	2.8	11.4	8.4	3.4	5.8	4.7	4.7
Contribution of factors of final consumption							
Including							
Final consumption – total	106.2	71.0	110.8	189.9	102.3	226.7	139.1
Including							
Household consumption	114.2	57.4	96.5	154.9	78.8	213	136
Government consumption	-9.3	12.4	13.5	32.7	22.3	13.1	3.2
Consumption of non-profit organizations	1.3	1.2	0.8	2.3	1.2	0.6	-0.1
Gross savings – total:	64.4	33.2	65.2	-170.5	42	10.3	9.6
Fixed capital accumulation	-27.6	40.7	73.0	-84.6	-4	-12.3	15.4
Change of stock of material turnover capital	92.0	-7.5	-7.8	-85.9	46	22.6	-5.8
Export – import balance	-70.6	-4.2	-76	80.6	-44.3	-137	-48.7
Export				12.5	135.9	64.9	132
Import				68.1	-180.2	-201.9	-180.7
Total	100	100	100	100	100	100	100

Taking into account the peculiarity of the situation, it is important to take active measures to raise competitiveness of the Belarusian economy and simultaneously to take measures of temporary protection and support of national goods manufacturers in both domestic and foreign markets.

To achieve high growth rate of output and income of the population, the fundamental element of economic policy is its orientation at development of production with high valued added share which is

typical of production process that uses the latest achievements of science and technology and manufacture end products ready for consumption. Vice versa, in extractive industries the share of value added is low.

In strategic sense, it is very important for the development of the country to choose correctly sectoral priorities, which would correspond to the level of economic development. Support of these priorities would accelerate social economic development. Officially state priorities of the first two five year plans (1996–2000 and 2001–2005) alongside with other sectors are foodstuffs and housing. The need to support these priorities requires special attention.

Of course, housing construction is important for the country in which a few hundred thousands of people need a house. However, direct solution of this problem especially in difficult conditions of the transitional economy is ineffective. Building houses involves using much of imported products. According to our estimate, the annual construction program on all stages of production uses about 1\$ bln. worth of imported products. Thus, by developing construction sector the country increases demand for import. In the situation of trade balance deficit and deficit of hard currency it creates big problems. Besides, increasing housing construction diverts substantial resources from investing into real production. This trend leads to the situation when the fixed capital is old and loses competitiveness. This is what is happening in Belarus.

To guarantee food supply for the population is important for any country. But to set the task to produce the most important products in the country where most of districts are risky for agricultural production is not correct. It leads to inefficient use of resources rather than to increase of economic security (if we consider this category in a systemic way). Moreover, it jeopardizes economic security. To solve the problem of food self-sufficiency, the government applied the method of extensive agricultural production rather than increase of its effectiveness. As a result, reforms of the agricultural sector were hardly started. Low interest loans are given to all producers including those which are loss making and unable to pay them off. Money is wasted and the country tends to produce less food products thus it is getting less self-sufficient in food.

While stating priorities of the economic development of Belarus, it is necessary to take into account its peculiarities as a small country with an open economy, world economic processes, national, spiritual and cultural traditions of the people, economic and geographical location, natural and climate conditions, mineral and raw material basis, labor potential, state of material and technical base, professional level of workers and scientific and technical potential. A systemic analysis of initial prerequisites shows that the priority of a small non-independent country like Belarus should be export based on the full

development of its competitive advantages and restricted resources that it has (see Table 2).

Ensuring priority development of these sectors and sectors that cooperate with them can create the basis for increase of welfare of the population, for improving health of the population and for creating financial prerequisites for mass housing construction. The development of other sectors should be determined by requirements of economic security and by spontaneous market forces that ensure capital flows.

To ensure high growth rate of GDP in the long run, measures of fiscal, monetary, currency and price policies should be implemented. They should lead to improvement of financial status of enterprises of the real sector of economy, to creation of normal business and investment climate in the country and conditions that stimulate favorable reproductive processes. These factors should also become competitive advantages of Belarus.

Liberalization of economy, expansion of liberties of entrepreneurship, increase of activity of entrepreneurial entities are closely tied to decrease of the level of centralization of state financial resources primarily by lowering tax burden. Lowering tax burden is a priority in economic policy of Belarus, as it is aimed at increasing competitiveness of Belarusian goods both in the domestic and foreign markets.

Table 2

The most important ways to increase competitiveness and priorities of structural changes of the economy

Competitive advantages of Belarus	Main ways to increase competitiveness	Priorities of structural changes of the economy. Basic growth sectors: (points of growth)
High quality of human capital, low price of labor, effective system of training of high-skilled workers Well-developed scientific and technical potential	Support of education, science and innovations through the budget. Creation of institutional basis for effective use of human capital Creation of complex scientific production centers and schools to work out and implement breakthrough technologies and organization of production of competitive products. Budget support of science and innovations. Support of small innovation business	Development of high tech and science oriented productions, providing intellectual, scientific, education and training services. Development of productions based on technologies and equipment of the fifth and sixth technological levels that ensure access to world markets and production of large share of value added.

Competitive advantages of Belarus	Main ways to increase competitiveness	Priorities of structural changes of the economy. Basic growth sectors: (points of growth)
Advantageous economic geographical location	Attraction of investment in development of transport system, telecommunication and infrastructure. Equipping transport corridors, modernization of transportation infrastructure and means of transport.	Development of transport services and telecommunication sector
Well developed production infrastructure	Creation of normal investment climate as a part of institutional environment as an additional factor to locate production in Belarus	Increase the share of investment in reproductive structure of GDP
Availability of main oil and gas pipe lines that cross the territory of Belarus	Attraction of investment in developing of productions that use organic raw materials. Creation of conditions for increasing of oil and gas transit through the territory of Belarus	Development of chemical and petrochemical industries
Availability of big resources of renewable forest resources	Attraction of investment to deepen processing of timber, expanding the assortment and improving quality of manufactured products	Development of wood processing and pulp and paper industry
Vast land resources, favorable climate for production of forage, flax, potato growing	Agricultural reform, attraction of investment in sub-sectors of effective specialization of agriculture of Belarus while simultaneously keeping standards and observing criteria of food security	Development of production of fodder, cattle breeding, potato growing and flax production
Large reserves of potash fertilizers	Creation of new complex fertilizers, winning new markets, proving state protectionism in foreign markets Modernization of means of production	Development of the sector of extracting and processing of potash fertilizers
Availability of considerable reserves of clay, cement and other raw materials	Attracting investment for modernization of production and improvement of quality and expansion of assortment of products	Production of bricks, facing stones, cement and other kinds of construction materials with improves characteristics
Availability of cultural and historic values, attractive natural landscapes	Attraction of investment in development of tourism infrastructure, keeping historical and cultural monuments in good shape.	Development of the sector of tourist services
Availability of productions that manufacture	Attracting investment to support and increase competitiveness, creation of normal general	Development of corresponding competitive

Competitive advantages of Belarus	Main ways to increase competitiveness	Priorities of structural changes of the economy. Basic growth sectors: (points of growth)
competitive goods both in the domestic and foreign markets (tractors, fridges, TV-sets, hard and soft drinks etc.)	institutional, macroeconomic, tax, credit, price conditions for reproduction of competitive productions. Creation of integrated corporate structures. Development of the system of scientific support and sectors that cooperate with it. Increase of professional level of management	productions and sectors that cooperate with them
High level of complex development of territories	Support and development of branches that closely cooperate with one another. Development of clusters. Improvement of institutional bases of reproduction in the region.	Increase of investment, accelerated development of branch territorial specialization, complex development of territories

Another task is to keep tax burden at the level of our neighbors.

It should be noted that reduction of tax rates does not necessarily lead to reduction of tax revenues. In particular, introduction of single income tax rate in Russia at 13% resulted in growth of revenues from it by 1.5 times. It is due to the fact that many people decided to legalize their income.

Lowering tax burden should be accompanied by abolishment of individual benefits and tax breaks and reduction of number of taxes and non-tax payments and improvement of their structure. The pace of tax reduction and non-tax burden should not be very high (2–3 percentage points of GDP a year until 2005) as sharp reduction of taxes can cause budget problems which are connected with concrete budget expenditures.

In general, tax and non-tax burden on Belarusian enterprises should be lowered to the level of neighboring countries and primarily to the level of its main economic partner – Russia, as Belarus forms a customs union with it. It will require restructuring of budget expenditures. Taking into account the necessity to increase competitiveness of the country when it is reasonable to increase budget expenditures on science, reproduction of human capital and investment into fixed capital, it is necessary to reduce other budget expenditures and expenditures of off-budget funds namely expenditures on force structures, subsidies to agriculture, to cover costs of production of utility services etc. Taking into account the revived structure of revenues and expenditures the annual budget deficit should not exceed 2% of GDP. It should be financed by non-inflationary means.

Measures to improve structure and reduce the number of applied taxes and fees should include the following:

- Unification of taxes that have common tax base and tax payers;
- Reduction of taxes and fees that are applied to revenues (from 5% to 1–2% of revenues);
- Unification and abolishment of numerous payments to budget and off-budget funds;
- Increase the role of direct taxes, reduction of tax pressure on wage;
- Increase of fiscal importance of ecological and property taxes as the basis for expanding possibilities of local budgets.

Ways of tax collection and tax base of many taxes should be changed too. In the context of these changes taxes on unsold goods should be abolished. VAT and excise taxes should be calculated according to the principle of the country of destination in trade with Russia and CIS countries.

It is reasonable to gradually reduce standard VAT rate to 16–18%. It is also necessary to reduce rates of income tax to 10–15%.

Taking into account the world experience of giving tax breaks and also losses of the national budget (6–8% of revenues), it is reasonable to reduce the number of these tax breaks as soon as possible. Tax benefits should be given in the form of tax credits or – which is less desirable – in the form of reduction the tax rate and base. Such measures should not be applied to individual enterprises but to spheres of activities.

Solving these tasks should be done gradually based on the Tax Code of the Republic of Belarus, which is harmonized and unified with basic principles and propositions of the similar Russian document. The process of introduction of the tax code should be done in parts and should be completed in 2005.

Success of liberal macroeconomic policy of economic growth can be achieved only based on carrying out effective monetary policy which is simultaneously directed at making normal monetary basis for the process of reproduction, stabilization of the rate of the Belarusian ruble and reduction of inflationary processes in the country to the moderate level.

Tight monetary policy in the liberal environment of economic relations is the basis which allows making the best use of market incentives of reproduction and it prevents the country from becoming anarchy. At the same time, it is necessary to take into account that tools of monetary policy are more subtle and should be used with great caution. If it is ignored as it happened in 1997–1999 even good intentions in this sphere could lead to deep financial crisis, which finally can create many problems for real sector development. Moreover, it could give it a powerful blow.

The peculiarity of the moment is that another extreme is possible in monetary policy. The desire to quickly reduce inflation could lead

to the situation when its reduction will prevent structural changes in the economy. It will be the reason of stagnation of a few sectors, which, due to some reasons, cannot be adjusted to tight budgetary policy. But these sectors are economically important for the country.

Finally, it is important to keep in mind that monetary policy is pursued not for the sake of its own, not for the sake of beautiful indices of inflation, devaluation etc. but for the purpose of creating favorable conditions for social economic development of the country.

It is reasonable to pursue monetary policy based on direct inflation targeting. Lowering inflation should be aimed at achieving economic growth. As the international experience shows, inflation should be reduced gradually as fast reduction of inflation and fast transition to tight monetary policy can bring stagnation of enterprises.

The gradual lowering of inflation lets policymakers to support production that face difficulties of transitional period in a moderate way and to carry out structural reforms primarily not by closing enterprises but by restructuring them and by developing competitive productions.

If predictable interconnection between the real exchange rate and economic growth are established, it is reasonable to take into account the following factors. Setting exchange rate too high could have a negative impact on economic growth. That is its growth should be tied up with growth rate of labor productivity and structural changes with increase of quality of production and competitiveness of national economy in general.

On the other hand, excessive lowering of the real exchange rate conserves the existing ineffective structure of economy. Raising profitability of export by means of lowering the exchange rate of the national currency stimulates the development of raw materials sectors (or sectors with a low degree of processing), export dumping, redistribution of resources in favor of exporters. It increases the degree of state intervention into the economy, makes it more difficult to service government debt. Besides price disproportions appear (primarily in the sphere of natural monopolies and services).

At present, the difference between the official exchange rate and the parity exchange rate is quite large due to several factors. The most important of them is low competitiveness of Belarus. The experience of other most successfully developing transitional countries show that in their cases the deviation of the exchange rate from the parity is not as large as in Belarus.

One should keep in mind that there are a few non-inflationary factors that cause slowing down devaluation of exchange rate, in particular, it is the state of the production potential, inflow of foreign investment, administrative orders, possibility to reduce energy and raw materials consumption, active foreign trade policy (in particular, the creation of distribution network for goods, service network,

advertisement, quality etc.). It means that not in all cases inflation should be accompanied by devaluation of the Belarusian ruble.

Taking into account that Belarus primarily exports industrial production, it is reasonable to change the exchange rate and match it not with CPI but with index of prices of producers of industrial products (IPPIP). In its own part a certain share of CPI increase is the result of leveling prices for so called non-tradable goods and services (accelerated rise of domestic tariffs for utility services and passenger city transport). In this case it does not have an impact on competitiveness of industrial export. Moreover, the abolishment of cross subsidies will prevent prices for industrial goods from rising.

We should also take into account the size of currency reserves, inflow of hard currency to capital account of the balance of payment, cumulative effect from lowering inflation and devaluation etc.

As international experience of transitional countries shows, lowering the rate of devaluation of national currencies compared to inflation rate is mainly due to inflow of foreign currency into domestic market, to the capital account of the balance of payment (private foreign investment, credits of international financial organizations for modernization of economy etc.). As a rule, the creation of attractive institutional environment, privatization of state enterprises and liberalization of economy add to keeping the situation for a long time when the supply of currency from outside exceeds supply of national currency due to the tight monetary policy. That is why inflation that is caused by change of relation between growth of goods supply and national currency (prices for non-tradable goods and services will grow) can take place in the environment of the highly unstable exchange rate. That is why in the perspective period of supporting competitiveness of Belarusian products based on modernization of national enterprises, lowering tax burden and improvement of distribution networks, it is possible for devaluation to lag behind consumer price index growth. It will enable not only to increase welfare of the population and liquidate subsidies and programs of house construction, to reduce amount of preferential crediting to agriculture but also to really stimulate development of sectors that are domestic market oriented. At the same time, position of exporters will not be worsened.

Exchange rate policy should take into account firstly the necessity to support the balance of demand and supply of currency; secondly, the adequacy of export stimulation; thirdly, the protection of national producers from competing import while keeping adequate prices on goods that are not produced in the country; fourthly, the necessity to create substantial gold and currency reserves; fifthly, the effectiveness of balancing accounts of the balance of payment.

Taking into account higher GDP growth rate in Belarus compared to its world growth rate and expected considerable price rise on non-

tradable goods and services in the coming years, the level of devaluation can be lower than inflation growth rate by 3–5 percentage points a year. It means strengthening the real exchange rate of the Belarusian ruble. In general, it is reasonable to get the official (and market one, at the same time) exchange rate which is 50–60% from the purchasing parity power (at present less than 20%).

The growth of money should go alongside with these inflationary devaluation processes. It should also take into account the suggestion to reduce speed of money circulation in the environment of lowering inflationary expectations and keeping positive interest rates on ruble assets. It is the equivalent of the growth of the coefficient of monetization of the economy.

Liberalization of economy means further price liberalization. Many financial problems that our enterprises face are the result of overregulated and distorted prices that arose due to unjustified intervention of the state into free price formation.

Among negative phenomena that were the result of administrative regulation of prices are the following:

- Periodical deficits, big deviations of demand from supply;
- Distortion of economic reference points as relative price rise on products should stimulate flow of investment into the sphere of production of these goods;
- Indirect subsidizing of consumers of neighboring countries by Belarus as borders with these countries are quite open;
- Creation of unfavorable investment climate as overregulation of prices makes investment into Belarusian economy ineffective;
- Lowering real contribution of the worker in the structure of the price as cutting wages in the environment of administratively regulated prices is the main way for the enterprises “to make both ends meet”;
- Increasing costs of industry and the budget as a consequence of cross subsidization.

Today, it is necessary to maximally reject administrative intervention into prices (except for limited number of goods that are produced by monopolies and those that produce socially and strategically important goods and services). Cross subsidization and budget price support should be abolished. It will create favorable conditions for accelerated reproduction of the economy.

We believe that to abolish price subsidies it is not necessary to wait until income of the population grows. The process of liquidation of subsidies itself will create conditions for wage and income growth. Wages in dollar terms will grow and the system that will enable us to reject equal subsidization of the poor and the rich will be created.

**POSSIBILITIES OF ECONOMIC
REFORMS SUPPORT IN
BELARUS BY INTERNATIONAL
COMMUNITY**

5

The concept of reforms was worked out by a group of experts and analysts: **Pavel Daneyko** (President of IPM), Dr. **Igor Pelipas** (Director of the IPM Research Center), Dr. **Elena Rakova** and **Alexander Chubrik** (economists of the IPM Research Center), **Jaroslav Romanchuk** (President of Scientific Research Mises Center), Dr. **Alexander Sosnov** (Deputy Head of IISEPS), **Evgeniy Lobanovich** (NGO «Private Property») and others.

5.1. PECULIARITIES OF BELARUSIAN MODEL OF SYSTEMIC SOCIAL AND ECONOMIC REFORMS IN BELARUS

Taking into account the broad experience of systemic transformations both in Central and Eastern European countries and countries in Asia and Latin America, the results of modern research in the sphere of economic theory and institutional development, Belarus can considerably reduce the social and economic costs of the transitional period. It can quickly create a solid foundation for sustainable development, long-term economic growth and integration of all social groups into a new system of economic relationships.

The reforms that are suggested herein for Belarus have a few peculiarities that reflect the nature of Belarusian institutions and subsystems. They also show the economic context which in many ways determine the necessity for deep reforms.

1. *Reforms in many countries stumbled and were suspended because new legal and judicial institutions were not created.* As a rule reforms in this sphere were undertaken after the basic stabilization, liberalization measures were taken. As a result, the courts, prosecutor's office, attorneys and other elements of the legal system continued to work in the old way. They effectively blocked reforms and prevented the first positive results to be enhanced by further measures. Thus the first important peculiarity of the Belarusian path of pursuing reforms will be the simultaneous implementation of wide scale legal reforms and macroeconomic stabilization and liberalization. The legal component of the systemic reforms will not lag behind monetary, fiscal and administrative reforms. The legal reforms will result in a stable clear framework for these reforms.

2. *The second peculiarity of Belarusian reforms will be the joint implementation of fiscal and pension reforms.* Such an approach is necessary due to the current state of government finances and the foundation of social security in particular and to demographic factors. Belarus cannot use the model of tax and pension reforms of other countries in the region as they are quite contradictory and partial. Fundamental change of the role and functions of the government in Belarus requires synergy in carrying out fiscal and pension reforms. This approach will ensure that the government meets its commitments within a sound fiscal and institutional framework.

3. *The third peculiarity of Belarusian reforms is that privatization revenues will be used to carry out pension, legal and administrative reforms.* Privatization revenues will not be used for current

consumption and to support corporate welfare programs (export stimulation and import substitution). They will be used to create and strengthen new institutions of market economy and to ensure credit of trust to the team of reformers and their policies.

4. *Another peculiarity of the Belarusian program of reforms is the introduction of a ban on budget deficit both on the national and local levels from the very beginning of systemic reforms.* This norm will be observed as the whole budgetary and tax policy will be changed. Protected lines of expenditures will be introduced which will be covered by all revenues of the budget. Tough financial discipline will let the reformers neutralize resistance of local bureaucracies and lobby groups. Experience of other transitional countries proves that if the state keeps its peculiar status in the financial market and lack discipline it will bring about serious problems in mid-term perspective. As a result reforms stumble and grind to a halt.

5. *The fifth peculiarity of Belarusian reforms will be the carrying out of radical banking reform at the first stage of systemic market reforms.* The state should not be the owner and holder of financial institutions of the country. That is why real sector restructuring should be done simultaneously with restructuring and privatization of state banks and banks where the state has a share in authorized capital. At the same time conditions for entering the market of financial services for foreign investors will be liberalized. It will create conditions for the integration of the Belarusian financial system into the European one. Unlike many CEE and CIS countries Belarus will not postpone banking reform and will create the framework for its civilized development right from the start.

6. *The sixth peculiarity of Belarusian reforms will be a distinctly different approach to government regulation of business.* The new approach to licensing and certification, to control of business activities by companies, to price and trade policy will greatly reduce compliance costs and create favorable conditions for new job creation. The principle of registration (incorporation) will be changed. A person will just inform the state about his decision to set up a business. Registration will take place in one window, during one day for one minimal fee. The state will regulate only those activities that may be a source of direct threat to life and health of a citizen. The main function of each state employee will be to support and develop competition in each segment of the market.

5.2. NEW ECONOMIC LEGISLATION AND ADMINISTRATIVE REFORM

5.2.1. Current situation

The rule of law is the most important prerequisite of economic reforms. This principle in place and working it provides guarantees for protection of property rights and meeting contract commitments. That is why one of the goals of reforms is the creation of clear, stable and transparent economic legislation, which reflects the interests of all economic entities and a judicial system which ensures contract enforcement.

Judicial power is independent and has coequal status with the legislative and executive powers in a state based on law. The judicial system of Belarus should be considered an essential part of systemic reforms of the state. It is the first step on the path to wide scale legal reform. This interdependence of the various subsystems of the state and society predetermines the principles that lie at the foundation of a state based on law:

- the superiority of rights and freedoms of the individual, their protection by the state;
- the rule of law in all spheres of public life;
- joint responsibility of the individual and the state and other participants in legal relationships
- the division of powers among legislative, executive and judicial branches;
- the availability of effective forms of control over the process of protection of rights and freedoms of citizens and other participants in legal relationships.

Court system reform is a prerequisite for building a state based on law in Belarus. The main objective of the reform is the formation of an independent judicial power which should be the main guarantor of citizens' rights.

One of the factors that determines the necessity of judicial reform is the existing judicial system that was formed in the 30–40's of the XX century in the totalitarian Soviet Union. The old system could not fulfill functions of a judicial system of a state based on law. The free individual in the future democratic society will need impartial professional legal protection. At presents courts at all levels are highly susceptible to interference and pressure from political power. They cannot function as independent structures and ensure objective law enforcement.

At present the court has incompatible functions in the criminal process: investigation, accusation and decision making on a case. It simultaneously collects and analyses evidence, corrects investigators,

opens criminal cases, returns criminal cases for additional investigation etc. The court system did not develop the function of rehabilitation. It bases its opinions mainly on prosecutor's statements and the evidence of the state representatives. The adversarial principle does not work in the court procedure. The court is not an independent arbiter in the dispute of two equal parties. It takes too long to consider cases and a lot of mistakes are made by the courts, which is evidence of the poor quality of the court system.

The whole judicial system should be reformed as it has the structural flaws of the totalitarian regime. The judicial system did not change in the beginning of the 90's. In the period of so-called political "thawing" the judicial system fell prey to the political forces that took power. Later it became an obedient tool in the hands of the Belarusian authoritarian regime.

5.2.2. Main aspects of judicial reform

The judicial reform will consist of a series of measures to ensure legal and administrative support for the court system in the Republic of Belarus.

Goals of the judicial reform are:

- The creation of a court system that will enable the functioning of a state based on law;
- Ensuring the independence of the judicial power as the main guarantor of rights and freedoms of citizens and the rule of law;
- The creation of legislation based on democratic principles that are compatible with international law. The Belarusian judicial system should integrate the achievement of world jurisprudence and modern legal know-how

The reform of the judicial system should include drafting, passing and implementation of the Concept of the judicial system, the new law "On judicial; system and the status of the judge", new Criminal and Procedural, Civil Procedural, Administrative Procedural and Economic Procedural Codes. Amendments should be made in other laws and legal acts.

Property rights protection, introduction of rigid financial discipline, clear and transparent procedures that regulate the process of bankruptcy, restructuring, functioning of natural monopolies and procedures that stimulate competition and the creation of modern liberal economic legislation will become key elements of economic legislation reform. Changes of legislation should reduce costs of setting up and running a business in Belarus. In order to create conditions for dynamic economic development it is necessary to establish the trust of owners and creditors to legal protection.

Absence of rule of law and reliable protection of property rights, corruption and lobbying of interests of special groups are the results of

low quality government management and administration. The experience of many countries shows that bad government administration and slow economic development go hand in hand whereas high quality management, i. e. functioning market institutions and reliable legal protection stimulate successful economic development.

The formation of strong institutions begins with making amendments to the Constitution of Belarus and in the laws that define the character of relationships between “state – citizen – tax payer”, “state – voter”. There is a risk that if the government is weak it will not be able to perform its contract enforcement functions. Complex procedures that regulate economic activities can lead to negative consequences.

The following changes are necessary:

- Restoration of the principle of division of powers;
- Redistribution of powers in favor of the parliament, restoration of trust to institutions of the civil society;
- Definition of clear mechanisms of financing of the legislative power, the process of drafting laws, control over expenditure policy of the executive power;
- Ensuring the independence of the judiciary through the procedure of financing, appointment, employment, clear definition of rights and duties and social security measures;
- Passing the law “On Elections” and definition of mechanisms of financing and formation of election commissions, vote counting and voting itself;
- Passing the law “On the distribution of powers between republican and local bodies of power”. This law should state clearly rights and obligations of each branch of power. It should define the number of levels of power, size of each territorial unit, sources of finance and the order of privatization of property that belongs to local bodies of power. The law should also restrict local bodies from levying taxes and introduce the ban on deficit financing on the local level.
- Passing the law “On regional development”. This law will determine the development of infrastructure in each oblast, participation of Belarus in European programs, development of cross border cooperation with neighboring countries, development of the network of border and customs crossing points and simplification of the procedure of crossing the state border;
- Introduction of administrative and criminal responsibility of state employees for violation of property rights and definition of the procedure of compensation for such.
- Change of the structure of administration of the executive power including the Cabinet of Ministers, Administration of President, reduction of number of state employees, liquidation of redundant structures;

- Passing the law on fighting organized crime, corruption, tax evasion, money laundering and other such crimes. This law should be in conformity with the standards of similar international laws.

It is important not just to pass good laws but also to ensure their proper enforcement. Strict enforcement of the principle of the rule of law will ensure the employment of high skilled people in the state structures. Following the law should be easy and cost effective. An independent judiciary and its effective functioning is indispensable for the smooth functioning of the executive and legislative powers.

5.2.3. Forms of assistance provided by international organizations

Launching judicial reform in Belarus will be much more successful if international assistance is provided in the following areas:

- Conducting a thorough analysis of the concept of judicial reform that was drafted by the group of Belarusian lawyers;
- Providing expertise of programs of concrete measures that should be taken to implement reforms. Main propositions of draft laws, volume of financial assistance and terms of implementation of the reform should be indicated;
- Providing expertise of sources and financing of the judicial system reform (based on the previous analysis). It is necessary to make a list of organizations that will give Belarus financial, intellectual and technical assistance;
- Formation of joint Belarusian European (international) institutions, defining their mandates and procedures in carrying out judicial reform;
- Providing expertise for the monitoring of the judicial reforms and legal practices after the beginning of reforms;
- Training lawyers and administrators who will be able to perform in the new legal environment;
- Informing Belarusian policy makers about the positive experience of judicial reform in other countries;
- Providing expertise for a PR campaign to ensure public support for the judicial system reform. The essence of the judicial reform should be explained to the people. Key authors of the judicial reform should be in touch with the population both by means of holding seminars and conferences and through mass media;

Further improvement of Belarusian legislation, not only on the court system but in other aspects of law. New laws will not be based on the Soviet legal system but on the experience and the best achievements of the countries that are generally recognized in the as models of civilized states based on modern law.

5.3. MONETARY POLICY

5.3.1. Current situation

The monetary policy of Belarusian authorities is unique compared to the monetary policies of other post-socialist Central European countries. Accumulated growth of consumer prices for the period 1992–2002 is 2272661 times. Violating existing legislation the government and the National Bank use the “money printing machine” as a source of financing for loss-making and insolvent enterprises. In doing so it levies a huge inflation tax on the population. Pursuing such policy they have achieved dubious economic growth and maintained high employment. As a result the economy of the country found itself in financial and technological deadlock.

In spite of a certain degree of success in the monetary sphere achieved in 2000–2002, the rate of price growth remains unacceptably high. As a consequence of ruble monetary increase of almost 60% in 2002, the consumer price index increased by 34,8% and exceeded the projected target of 20–27%. At present Belarus is the regional leader among CEE and CIS countries in inflation (as it was in the previous years). Liberalization of currency market operations and initiation of the policy of targeting the exchange rate by the National Bank since 2001 led to a considerable slowdown of devaluation rate of Belarusian ruble (in 2002 it was 21,5%). Nevertheless it is premature to talk about stability of the national currency.

The core reason for inflation in Belarusian economy is still there – a high growth rate of money in circulation. Non-payments and deficit of turnover capital in the real sector of the economy, which is an expected outcome of low quality of economic performance create a steady demand for financial resources. In order to prevent bankruptcies of loss making enterprises and reduction of employment the government uses emission crediting (printing new money) as a source of finance. They do not have other sources (foreign loans, and private investment).

The National Bank has to continue printing new money in order to finance current cash imbalances and the deficit of the national budget in general. Besides other ways of non-economic coercion of commercial banks to credit state programs in agriculture are used. In this case banks are forced to use their own resources.

5.3.2. Guidelines for monetary policy

To successfully carry out market reforms the macroeconomic policy should correspond to *the following principles*:

- Consistency and integrity – coordination of measures and parameters of monetary, fiscal, foreign trade, structural and institutional policies. Financial stabilization policy should be assisted by active privatization and creation of conditions for real sector restructuring. A stimulating institutional environment for the development of entrepreneurship and the attraction foreign investment should be created.
- Balanced character of the goals of macroeconomic policy – wide scale and full inventorying and revision of (sequestering necessary) gross production indexes of state programs (housing construction, agriculture etc.). They should match financial possibilities of the state.

Goals and tasks of monetary policy

The main goal of monetary policy for the near future is to pursue the policy that makes households and businesses trust the national currency. In order to achieve this goal it is necessary to fulfill the following tasks:

- To lower inflation during the next three years to 5% per year;
- To support positive real interest rate on all financial instruments that are denominated in the national currency. An attractive deposit policy allows the increase of the share of fixed date ruble deposits in monetary base. This money is the main source of finance for the real sector of economy. As a result of growing trust in the national currency dollarization of economy will be reduced, the structure of the monetary base will be improved and as the share of national currency will be bigger, the index of monetization will be higher.
- To introduce a regime of free floating of the national currency. Activities of the National Bank should be restricted to neutralizing demand shocks that have an impact on the rate of exchange and may lead to speculative imbalances in the demand and supply of hard currency. It is rational to introduce this regime of currency exchange rate as it best suits the interests of a small transitional country that is export oriented, as the degree of business activity and how production facilities are used depend directly on the demand for Belarusian goods on the world market. This exchange rate ensures the competitiveness of domestic goods by means of balancing the real exchange rate to its effective level. Taking into account moderate inflation in the period of stabilization (contrary to fixed rate regimes) burdensome currency interventions can be avoided.
- To create a legislative base for the system of private financial institutions that is capable of servicing domestic and foreign payment operations and to ensure security of savings of enterprises and households;

- To balance revenues and expenditures of the state budget.

Main elements of monetary policy:

1. Discontinuing crediting budget deficit by the National Bank. It will help eliminate the main internal source of inflation and devaluation of the Belarusian ruble;
2. Regulation of the growth rate of aggregate domestic credit (ruble and currency) proportionally to expected GDP growth;
3. Ensuring steady annual growth of net foreign assets of the National Bank until they fully cover the monetary base in national currency at the market exchange rate;
4. Creating the conditions (accumulation of net foreign investment) for pegging the Belarusian ruble to the euro with further integration of the country into the European Economic Community. It is important to announce this policy to demonstrate that the country adheres to an economic vector of development and acceptance of civilized market rules.

All above-mentioned measures should be carried out consistently and in coordination in order to help increase trust in the national currency and gradually crowd out the dollar as a means of savings and exchange. These measures will also lead to increase of hard currency reserves of the National Bank. Such policy is a prerequisite for the integration of Belarus in the European community.

5.3.3. Possible spheres and forms of assistance of international organizations in carrying out stabilization policy

As international experience indicates, at the first stage of reforms carrying out the program of financial stabilization on the macroeconomic level is accompanied by an intensification of social and financial problems, recession and other negative phenomena. These are consequences of implementing socially unpopular measures. That is why success of stabilization program and creation of prerequisites for irreversibility of market reforms will to a large extent depend on the assistance of international financial organizations, primarily the IMF and World Bank in the following spheres:

1. Technical and consulting assistance in working out programs of macroeconomic reforms for Belarus;
2. Monitoring by IMF experts of a program of measures agreed upon with the government and the National Bank.
3. Providing credit assistance for market reforms in the framework of stand-by credit lines.

5.4. BANKING SYSTEM REFORM. FINANCIAL RESTRUCTURING AND RECAPITALIZATION OF BANKS

5.4.1. General characteristics and the current situation

The two tier banking system headed by the national Bank that was formed in the Republic of Belarus after it became independent, formally fits the world standards. Its legal basis is the Banking Code of the Republic of Belarus that came into force January 1, 2001. This document defines main goals of the National Bank as follows: ensuring internal and external stability of the Belarusian ruble, liquidity, financial standing and reliability of the banking system.

As of January 1, 2003 there are 28 banks in Belarus. They have 482 branch offices. 23 banks are set up with participation of foreign capital. There are also 5 banks with 100% foreign capital. In spite of such broad representation genuine foreign capital is represented in the banking system in a very limited way. According to the Instructions on Procedures of Registration and Licensing of Banks and Non-banking Credit and Financial Organizations (approved by Resolution of the Board of Directors of the National Bank of the Republic of Belarus № 175 as of June 28, 2001) the limit of participation of foreign capital in the banking system of the Republic of Belarus was set. This limit is calculated as a ratio of the overall capital that is owned by non-residents in authorized funds of the banks with foreign capital and the authorized capital of branch banks of foreign banks to the overall amount of authorized capital registered on the territory of Belarus. This limit is confirmed by Board of directors of the National Bank and is approved by the President of the country and is required to be published in a specialized publication of the National Bank. At present the limit is 25% and the actual participation of foreign capital that regulates liquidity, solvency and risk reduction in general corresponds to recommendations of the Basel Committee on banking supervision. However the credit potential of the Belarusian banking system is evidently lower not only than the potential of the developed countries but the potential of transitional countries that are carrying out successful market reforms as well. As of July 1, 2002 the overall assets of the banking system of the country amounted to 9,15 trln. ruble or about 510 USD per capita (in Czech Republic it is 7000 USD, in Poland – 2740 USD, in Russia – 620 USD). By the end of 2002 the capital of banks reached 1212,8 bln. USD or 4.8% of GDP. The weakness of the resource base can be explained by the low level of monetization of the economy. This index plummeted in 1991–1994 and 1998–1999 when

an expansionist monetary policy was pursued. Prices rose much faster than the monetary supply in national currency.

The most important peculiarity of the Belarusian banking system is the high degree of dependency upon the executive power. This due to the existing administrative model of the national economy based on the domination of state property. It is characterized by hypertrophic functions of the central government, which is involved in all embracing central planning. Recent macroeconomic policy was aimed at stimulation of economic growth by means of wide scale monetary expansion. This kind of policy could be pursued only under strict administrative control over the banking system and by means of violating the universal principle of central bank independence. As far as the banking system is concerned the state bodies of power extensively used administrative tools of its regulation in terms of crediting budget deficit both by emission of the National Bank and by means of attracting resources of commercial banks which had to buy government bonds. For example in 2002 the banking system, including credits of the National Bank and purchase of government bonds by the commercial banks, financed the deficit of the budget in the amount that exceeded twice the projected parameter set forth in the law on the budget for 2002. It amounted to 1,8% of GDP. The National Bank financed the budget deficit in the amount of 198,3 bln. ruble (including loans to cover cash account deficit). It exceeded the projected parameter by 30,5% which was set at 152 bln. ruble. The banks and other commercial entities bought government bonds for 254,5 bln. ruble. The projected index of just 75 bln. ruble (or 3,4 times more)¹.

Besides commercial banks have an even higher burden in terms of crediting financially insolvent and loss making enterprises and branches of economy. In this context it is worth noting that in the overall volume of loans made in 2002, the share of loans given under non-economic coercion (loans given upon resolutions of the president and the Council of Ministers) amounted to about 20–25%. About 80% of these loans were spent to pay off wage debts.

¹ In the first quarter of 2003, there was a deviation from this trend. The excess of bank liquidity brought about a decrease in interest rates in the market of inter-bank credits, from 41.9% per annum in January to 27% in February and 22.7% in March. In those conditions, in order to prevent large banks from placing too many surplus funds on the National Bank's deposits, the National Bank also reduced its interest rates on those deposits with the terms from eight to 14 days by 5–6 percentage points to 24–25% per annum. As a result, there emerged conditions that stimulated the demand for government bonds; their average yield in the first quarter of 2003 amounted to 37.7% per annum. However, there are no serious reasons to maintain that the existing situation will live on into the future, since the excessive liquidity in the first months of the calendar year is a characteristic seasonal feature in the Belarusian economy.

It obviously shows that monetary expansion in the Belarusian economic model plays an important part in keeping loss making enterprises afloat. Their share is about 37%. You can hardly find any other explanation as to why many enterprises can survive and avoid bankruptcy (4000 on average) while they keep making losses and fail to pay off their debts.

Thus the economic model in Belarus creates a high degree of monopolization of banking resources in a few banks that are controlled by the state. The state represented by the National Bank and state enterprises owns shares in 14 banks (as of January 1, 2002). Its biggest share is in the Saving Bank "Belarusbank" and "Belagroprombank". These are state banks. In other banks the share of the state varies from 30 to 80%. The biggest share of resources is concentrated in 6 authorized banks (system – forming banks as they are called): "Belarusbank", "Belagroprombank", "Belpromstroibank", "Priorbank", "Belvnesheconombank", "Belinvestbank". They are authorized to service various state programs. Their share in active operations of the banking system is about 90%. They control about 80% of the capital of the banking system. The state support goes to these banks. At the same time they are burdened with "bad" loans that are accumulated as a result of crediting loss making and insolvent enterprises. In 2002 authorized capital of the banks grew by 2,6 times while the volume of the banks' own capital grew twofold. The share of the authorized banks in this increase is 80%.

This increase of authorized capital of the banks was due to transfer of the banks' debts to the government that was formed as a result of cheap loans granted by the Ministry of Finance to these banks. Apart from that we can give an example of the state support in the form of writing off hopeless debts at the expense of the special reserve which was set by the Resolution № 103 of the National Bank as of May 30, 2002. Due to this, the volume of bad loans in the overall credit volume was reduced by the end of 2002 to 10,2% (376,5 bln. ruble as of December 1, 2002).

Beginning from 2000 up till now due to gradual tightening of the monetary policy and sustaining a high level of real profitability on ruble deposits, we observe a steady increase of savings of the population. At the same time the banking system, while attracting money of the population faces serious difficulties in their effective allocation. This is due to expensive credits and high interests rates and a limited number of reliable creditworthy clients in the real sector. As a consequence of such policy, there is a considerable imbalance in the structure of assets and liabilities of the banks, creating a systemic threat to stability of the banking system.

5.4.2. Main guidelines of the banking system restructuring

The analysis of the banking system of the Republic of Belarus shows that there are many problems that prevent its dynamic development. A number of measures should be taken to solve these problems. The main goals of the banking system restructuring is restoration of its stability and solvency and strengthening of its financial stability by means of the liquidation of insolvent banks or their merging with financial stable banks. It also aims at minimization of the volume of hopeless debts. Restructuring of the banking system is a complex process. It includes not just taking measures of banking regulation but also transformations of economic and political character that are connected with the formation of institutional and legislative bases for banks functioning.

Taking into consideration the thorough analysis of the banking system we conclude that the reform should follow the following guidelines:

1. Though there are quite a few unsolved problems of a purely internal nature; the main problems of banking regulation are of exogenous nature. First of all we should note the low effectiveness of enterprises of the real sector. This is a consequence of the lack of market reforms, restructuring, foreign investment etc. In this context the proposition is that the banking sector is secondary to the economic basis of the economy i. e. its real sector is the fundamental basis. The weakness of the national banking system, as compared to banking systems of developed countries and successful transitional countries, is just a logical consequence of the low competitiveness of Belarusian enterprises in the world market. The availability of reliable, financially strong clients that are enterprises of the real sector of economy is an indispensable prerequisite for the formation and sustainable development of the banking system. Ignoring this circumstance over the last few years brought on an expansionist monetary policy, that lead to the current situation in which Belarus is a leader of the transitional countries in terms of inflation and devaluation of the national currency. Thus it is impossible to reform and stabilize the banking system without wide scale economic reforms of the real sector.

2. One of the most important prerequisites for achieving financial stabilization is to increase the institutional independence of the National Bank in terms of working out and implementation of monetary policy and increasing the responsibility of the national bank for its results.

This measure along with lowering the share of the state in authorized capital is meant to protect the banking system from pressure of the executive power and the necessity of following its orders on management of financial resources. In particular the National Bank should be responsible to the National Assembly in terms of approving

its charters, appointment of the Chairman and members of the board, nomination of the auditor of the National Bank. According to Article 24 of the Banking Code these rights are vested with the president of the country. Article 36 should also be revised. It states that the Chairman of the National Bank is a member of the government. It hampers his ability to pursue an independent monetary policy within the framework of decision making by the government. A majority vote of the government can change the parameters of the monetary policy, which contradicts the main goals of the National Bank. The legal norm that bans budget deficit financing should be restored in legislation.

3. The effectiveness of banking system restructuring will depend a great deal on the quality of the legislative base. An integral part of the reform is to draft and pass necessary legislation that will ensure smooth banking sector reform. In this sphere international financial organizations traditionally provide technical support to transitional countries including Russia. As Belarus lacks experience it can hardly work out regulatory procedures by itself and launch the restructuring and liquidation of commercial banks.

4. International experience of the banking system restructuring proves that this process is quite painful and expensive for the state though there are major differences in various countries. As a rule the burden of restructuring costs (stabilization crediting, recapitalization of banks by adding to their capital, buying out overdue debts etc.) lies on the government. Stabilization credits will be given to banks both in cash and in the form of government bonds in exchange for bad debts. "Bad" assets of banks will also be bought in order to give these banks additional liquid resources.

Based on the estimate of bad debt restructuring, costs on this article will reach 200–250 mln. USD or less than 2% of GDP. If the program of banking sector restructuring is worked out with participation of international organizations within the joint projects of technical assistance it can be financed through credit lines. Taking into account the long-term character of the task of restructuring, such an approach allows the sustaining of tight financial discipline in using the credit resources and their successful return. Reaching a rational balance between state assistance of the banks and market principles of using loans provides for making commitments by the banks that will use such loans to pay them off in time and to use them in a transparent way.

5. The transition of Belarusian banks to international reporting and accounting standards will allow the determination of the real state of Belarusian banks, an objective analysis of risks and determine the value of bank assets.

6. The reform of the system of banking supervision provides for the creation of an independent institution responsible to the government. It is reasonable to separate the function of current

operational supervision and the control over the financial status of banks on the one hand from the tasks of macroeconomic and monetary policy on the other hand as this separation ensures adequate warning against bankruptcies. The experience of other countries shows that the unification of these functions of supervision and monetary regulation causes contradictions between these functions and cannot be resolved within the central bank.

7. Attracting foreign capital into the Belarusian banking system, privatization of the national banks. One of the factors that will define the interest of big international banks in buying Belarusian banks will be the selling price, which will be lower than setting up a new banking system of the same size.

5.4.3. Support of banking system restructuring

International financial organizations should support the following elements of the banking system restructuring:

1. A very important stage that precedes the banking sector restructuring is estimating its real financial status. It is difficult to do so without switching to the standards of international accounting. To make this transition technical assistance of international organizations is needed. Along with the introduction of international standards in accounting it is necessary to estimate the risks and real value of bank assets and to define other parameters of the banking system. Technical assistance will be needed in drafting necessary laws and other normative acts, in training Belarusian specialists and providing consulting services in the process of evaluation of the status of the banking system.

2. The success of banking system restructuring will depend a great deal on the quality of the legislation that regulates activities of banks. Legislation on bankruptcy procedure, liquidation and restructuring of banks, should be drafted and passed. International financial organizations traditionally provide assistance to transitional countries in the sphere of drafting legislation that regulates different aspects of banking activities.

3. In order to ensure stability, sustainability and security of the banking system it is necessary to improve the system of prudential control over the banking system. Prudential standards that fit international standards should be worked out. The Basel Committee for Banking Supervision standards should be the basis of such norms. The assistance of financial organizations is important not only in creating a legal base for banking reform but also in administrative issues such as the formation of an independent structure for banking supervision that reports to the government. To establish such a body, experts should be trained and the necessary infrastructure should be set up. It is reasonable to separate operational control and control

over the financial state of banks that is aimed at preventing bank bankruptcies, from the tasks of macroeconomic monetary policy.

4. Based on the estimate of the current state of the banking system in Belarus and the volume of so called “bad” loans expenditures on restructuring could be about 200–250 mln. USD or less than 2% of GDP. Part of these expenses can be financed by international financial organizations in the form of open credit lines. Taking into account the complexity of the task, such an approach will enable the government of reformers to support tight discipline in using funds and to pay off loans while carrying out the banking sector restructuring.

5.5. FISCAL POLICY

5.5.1. Current state of budgetary policy

At present the state budget of the Republic of Belarus is just one of the sources of finance of state expenditures. Mechanisms, revenues and expenditures of the presidential fund are not known. Many budgetary lines are secret. Revenues from these sources are used for cross subsidization of regions and branches of economy. It is a common practice for the state bodies of power to force enterprises to provide additional financing of state programs and initiatives. The Ministry of Finance has access to cheap resources that are provided by the National Bank and by commercial banks (coercive financing of state programs, purchasing of government bonds etc.). Lack of transparency of fiscal policy makes an accurate analysis of revenues and expenditures of the consolidated budget extremely difficult.

The Belarusian tax system stimulates the development of a gray economy. It punishes any company or entrepreneur for profitable work and creates additional sources of income for bureaucrats. The tax system is used to stifle competition and to remove from the market those enterprises that do not have proper connections and administrative protection. The Belarusian tax system cannot ensure the carrying out of systemic reforms in the economy in general. The transformation of relationships among economic entities in the framework of the existing tax system is not possible. 36 taxes and fees that amount to about 50% of GDP block economic growth. Almost every government structure has wide powers to change the direct and indirect tax burden for various groups and economic entities. As there is no complete data available on all revenues and expenditures of the state, the analysis below is only as detailed as possible when using open sources of information on the budgetary policy. One of the priority tasks of the new government will be to make a thorough analysis of all revenues and expenditures of the budget and all other sources that are used to finance state programs and projects.

Taxes are the most important source of revenues of the budget. In 2000 taxes made up 87.4% of all revenues of the consolidated budget (without off-budget funds). Indirect taxes made up most of the revenues. The share of taxes on goods and services in 1998 was 39% of the overall revenues of the consolidated budget. In 2000 it was 42.4%, in 2002 it grew to 46,2%. Direct taxes (corporate and personal income taxes) do not exceed one fifth of the revenues of the budget. For example in 2002 the share of personal income tax was 10.8%, and the share of corporate income tax was 9% (in 2000 it was 12.6% and in 1999 – 13.5%. Revenues of the budget from property and foreign trade

activities dropped down. Almost one fifth of the current non-tax revenue is fines and financial sanctions (1.9% of all revenues).

Analyzing the expenditures of the budget we can say that this part of the budgetary process has not been reformed yet. The system of budget administration is very cumbersome and contradictory. Budgetary policy is based on providing corporate welfare transfers to legal entities in the form of subsidies, tax breaks, and special tax status in relations with local and republican budgets.

Due to considerable state intervention in the sphere of investment the private sector is being crowded out. Markets are heavily distorted due to misallocation of resources. Reserve means in branch funds add to these negative processes. Money is not effectively managed and invested. There is no auditing procedure on social expenditures of the republican and local budgets.

Since Republic of Belarus gained independence the share of expenditures on real sector of the economy shrank from 41.8% in 1992 to 12% in 2002. At the same time expenditures on social and cultural projects went up (from 34.2% in 1992 to 41.2%). The share of expenditures to finance state bodies of power and local self-government went up from 1.8% in 1992 to 2.9% in 2002. Expenditures on Chernobyl programs were reduced by 315 times from 12.6% in 1992 to 0.04% in 2002.

Local bodies of power introduce local fees and taxes in order to increase their revenues which substantially increases the tax burden on enterprises. In 2002 about 30% of local budgets received subsidies from the national budget. This is evidence not only of a weak regional base but of the low quality of the budget administration.

Formally the budget deficit during the years of reforms did not exceed 3.5%. In 2002 it reached the record low level of 0.17% of GDP due to revenues from selling "Savviest" shares. However the peculiar character of keeping the record of liabilities of the state to commercial banks and enterprises and vice versa along with arbitrary changes of budget indicators by the president and a lack of transparency of many off-budget financial flows – make it difficult to estimate the real budget deficit in Belarus.

5.5.2. Guidelines of Budget Reform

The fiscal policy reform is aimed at achieving transparency of the budgets, reliability and predictability of legislation, lowering the tax burden while keeping the tax base broad, reduction of ineffective public investments, and improvement of the structure of public expenditure.

The budget policy is based on the following premises: no deficit of budget of all levels, meeting budget commitments to people and legal entities. One of the most important elements of the suggested fiscal reform is to reach a balanced budget in the first year of reforms. During

the second and third years budget deficits should be banned by law. It is planned to introduce a legislative ban on budget deficits. Transparency of the budgets of all levels is secured by an obligatory periodic publication of the reports on the national and local budgets by all sections of budget classification. Transparency will also be ensured by introducing the norm of providing information to mass media on implementation of public programs and works by the authorities. To reach a high degree of coordination of the systemic reforms it is essential to achieve a higher degree of centralization of the financial resources in the state budget. That means abolishment of off-budget funds and a strict distribution of powers and responsibilities among budgets of different levels.

The budget policy reform will be pursued by the following scheme:

1. Restructuring of the budget expenditures is done based on reduction of the public sector economy (privatization), reform of state bodies of power (administrative reform) and law enforcement structures, reduction of subsidies and other forms of real sector financing with their subsequent abolishment and target subsidies to consumers of a number of services and goods.

2. Auditing of the revenues and liabilities of the republican and local budgets. Belarusian legislation on social and corporate commitments (mandates) is highly unbalanced. At the same time off-budget funds will be audited, including the Presidential fund. Distinct inventory and orderly arrangement of all expenditures will make it possible to determine priorities of financing and to work out a number of practical recommendations. Inter-budgetary relations will be rearranged. Decentralization of public revenue and expenditure will be sought. Redistribution of revenue will be made in favor of local budgets; functions and sources of financing of the republican and local budgets will be clearly differentiated. In the budget of the first year of reforms so called protected expenditure lines are foreseen that are not subject to cuts under any circumstances.

3. A system of budget commitments and balance of commitments and resources will be worked out. A list obligatory for financing laws of and programs will be worked out, changes will be made in those pieces of legislation that are not among priorities requiring unconditional financing from the republican or local budgets. The transition to mandatory and additional budgets will be made with priority on social expenditure. Expenditure of the additional budget is to be financed, provided additional revenue is obtained and invested in capital assets that would result in additional revenue. Revision of the structure of budget expenditure also pursues the task of setting up a base for the transition to a centralized system of budget planning when structural units of the state financial system will perform planning within the framework of an earlier-determined amount of resources proceeding from a general analysis of the budget situation.

4. Transition to the principle of financing social commitments of the State from all sources, centralization of tax receipts to the treasury and development of its territorial structures will take place.

5. A new optimal structure of the government (in its broad sense) will be worked out. It will match the strategic objectives and tasks of the reform program. That will make it possible to cut expenses on public administration

6. A new structure of the Ministry of Finance will be developed. It will provide for higher responsibility of officials while performing their functions as well as insuring social rights of public employees. Forms and procedures of interaction of the treasury with budget recipients will be defined in more detail, too.

7. Revision of the system of public assistance to the real sector of economy will be undertaken in order to determine the areas of potential social tension when carrying out wide-scale reforms. Targeted social support will be provided according to a strictly defined criteria of poverty. At this stage criteria of poverty will be worked out, and lists of the people who meet these criteria will be prepared. Individual accounts in the banks for monthly disbursement of social assistance will be opened. The group of priority budget support will include persons who have monthly income below the poverty line in accordance with UN criteria (1 dollar per day) – pensioners, disabled people, families with many children, and families that have lost the breadwinner.

8. The sources of financing of current priority and other commitments as well as long-term debt liabilities including external and internal debt should be determined. A system of competition should be set up among recipients of budget resources. In the medium-term perspective, transfers will be made to budget financing according to the principle of “money follows the pupil” or “money follows the sick”, i. e. allocation of money proceeding from the number pupils (the sick). This will ensure a targeted character of spending. The budget institutions are to be financed according to their budgets, and will be strictly controlled.

9. Revision of investment programs of the national budget will be made. So-called construction projects with an excessively long term of completion will be abandoned. Priorities will be determined for the remaining resources after financing of social commitments (infrastructure, computerization of the schools, equipment of the hospitals, etc.). The State will cease to be a corporate investor, i. e. a competitive field will be created for the activity of private financial institutions (banks, insurance companies, investment, joint, and pension funds, etc.).

10. Rules of presentation of reports by budget organizations and auditing of their activities by independent organizations will be worked out.

Tax reform

The reform of the tax system presumes a reduction in the amount of resources redistributed through the State, neutrality, justice, transparency, simplicity, and an end to double taxation. The development of a tax system that meets such requirements will make it possible to optimize tax revenues to a great extent, rationalize budget revenues, and to determine the potential of the Belarusian economy to redistribute resources.

The experience of recent years has shown that attempts to remove drawbacks from the current tax system by introducing single non-systemic changes in tax legislation are meaningless. The problem can only be resolved by passing a single, interconnected and comprehensive act, in which the interests of the taxpayers and the State in terms of its commitments to the citizens are balanced.

The main elements of the tax reform will have the following aims:

- Lowering the tax burden;
- Simplifying the tax system, fewer taxes and lower rates;
- Abolition of tax benefits and subsidies;
- Setting up an effective system of tax administration;
- Amnesty of income of the population;
- Simplifying accounting rules, international standards of accounting will be applied, i. e. accounting of sold products and income by the method of accrual instead of cash basis accounting with simultaneous introduction of the method of cost accounting at the moment these costs are made;
- Reshaping powers of control bodies as well as their number and functions. Rights and obligations of the taxpayers in the case of checkups will be defined. Unscheduled checkups will be prohibited;
- Amending rules and norms of presentation of the financial information to independent audit and mass media.

The tax burden will be reduced by means of lowering marginal tax rates and reducing the number of taxes. Numerous programs of corporate assistance will be terminated, inventory of the investment projects in the republican and local budgets will be carried out, expenditure structure of the budget will be revised (reduction of law enforcement structures, reform of the state system of economic administration). All these measures will make it possible to avoid a sharp increase of the budget deficit in the transitional period. In the medium-term perspective when the tax base under a new tax system is known to a great extent, required adjustments will be made in the revenue and expenditure sides of the budget.

Numerous research studies show that, from the standpoint of sustainable economic growth and increase of the social potential of the budget the optimal will be the system in which public expenditure makes up about 20% of GDP. During the first two years of the reforms amount of public deductions will be decreased down to 30% with

subsequent achievement of the optimal figure in the mid-term perspective.

Execution of the tax reform by applying the above-suggested measures will substantially reduce compliance costs, which is equivalent to an additional reduction of tax burden.

At the first stage of the reforms, laws enabling the State to meet its basic budget commitments should be passed. A simple tax system presumes a minimum number of taxes and an easy universal means of payment. The tax reform will be carried out in two stages.

At the first stage (1 year) the following taxes will make up the basis of the Belarusian tax system:

- Value added tax: three rates – 0, 10 and 20%;
- Individual income tax: one flat rate – 10%;
- Excise tax: rates – 10–90% (cigarettes and hard drinks);
- Income tax on legal entities: single rate – 24%;
- Regressive social tax: 35% (monthly income to 100 dollars), 30% (monthly income 101–200 dollars), 20% (monthly income 201–500 dollars), 10% (monthly income 501 dollars and higher);
- Customs duties: three rates – 0, 5, 10% (average customs duty rate – 4–5%);
- Property tax (real estate and land): rate – 5%.

A system of patents will be introduced for small businesses and entrepreneurs. This presumes a one-time tax payment to the budget based on the trade turnover in the previous period, with its subsequent recalculation based on economic results of the reported period. The government determines the single rate of patent payment for all types of business activities.

During the first stage of the tax reform measures will be taken to optimize the number of taxes, rates of taxes and fees will be unitized, tax benefits on main taxes and fees to the specialized budget funds will be abolished, the system of revenue distribution will be transformed. Thus, the tax burden will be lowered.

During the second stage income tax rates on legal entities will be reduced to 10%. Only corporations with over 50 shareholders will pay income tax. The small and medium business pays income tax. The average rate of import customs duties will be lowered to a level of 4%. Thus, the tax burden to GDP will be further reduced.

In Belarus over 7 million people get various benefits from the state. The existing system of social benefits does not target low income and poor people thus it cannot protect them in times of economic crisis. Revision of the system of social security and simultaneous abolishment of corporate benefits are aimed at the identification of those persons who really need assistance from the State. The current system diffuses social funds. Middle class and people with high incomes are its beneficiaries. The complex tax system of various perks and benefits is a source of corruption and higher transaction costs. The abolition of

tax benefits is aimed at broadening the tax base and will also lead to the creation of equal conditions for all economic entities irrespective of their form of property or origin (in many cases foreign companies are discriminated against). This measure will lead to considerable reduction of budget expenditures. Recourses will be concentrated on social security component of the reforms. Rigid conditions for providing targeted social assistance are to be specified in the corresponding legislative acts (Laws "On the Government", "On local authorities", "On President", "On Parliament"). Powers of these authorities in the sphere of planning of revenues and expenditures of the budget should also be redefined. It is also planned to create equal conditions for the economic entities of any form of property, to abolish special access to the public resources, and to annul guaranteed state purchase system for selected enterprises without holding a tender.

The system of effective tax administration with simplified taxation requires distinct definition of functions, powers, and social guarantees for tax bodies employees and taxpayers as well. Indicative tax planning of tax authorities will be discontinued. The number of audits and checkups of one company by all control bodies should be limited to one a year. That will demand coordinated actions on the part of the control bodies to avoid duplication. Off-schedule audits will not be permitted without the prosecutor's approval. Implementation of court decisions on payment of taxes and faster and simplified procedures of appeal against decisions and actions of the tax authorities should be regulated in a very thorough manner.

Improvement of the system of tax administration presumes adoption of a special law "On Control Bodies". Higher income motivation and prestige of employment in tax inspection will prevent the loss of highly-skilled professionals to the private sector. The functions of tax administration are vested into the State Tax Service (STS). This body runs tax police and foreign currency and export control services.

Transition to the international standards of accounting presumes ensuring the right to include into production costs all related costs of production and sale, liberalization of depreciation policy, and simplification of the system of reporting.

An integral part of the success of the tax reform is its information support, including an effective promotional campaign for enterprises and people. It should explain advantages of the new tax system, that it is beneficial to pay taxes and should point out its solidarity and moral aspects.

5.5.3. Main forms of fiscal reform support

Budgetary and tax reform is the most important central part of systemic market transformations. The contents of the reforms in this sphere should

be strictly coordinated with reforms in other spheres. Tax policy of the country is one of the fundamentals of an attractive investment climate that ensures a high rate of economic growth on the one hand and the fulfilling of obligations of the state to its citizens on the other hand. In the past several years a great deal of experience in this sphere has been gathered. In order to ensure successful fiscal reforms and avoid costly mistakes this experience should be taken into account. As this reform is very difficult and complex the government of reformers should seek for assistance in the following spheres:

1. *Expertise in the carrying out of concepts of the main sectors of the social security system.* These have been worked out by the group of Belarusian reformers. They include:
 - pension reform,
 - healthcare system reform,
 - labor market reform and the concept of integration of youth into the labor market,
 - education system reform;
2. *Providing expertise of concrete programs of reforms* (based on the analysis of earlier drafted programs and concepts). They should describe main propositions of draft laws, amount of necessary financing and terms of implementation;
3. *Providing expertise of the Concept of the new tax system and the draft law “On Taxes in the Republic of Belarus”.*
4. *Providing expertise for the plan of switching from a system of state finance into international standards of accounting and audit, drafting the law “On accounting”.*
5. *Providing expertise of mechanisms of monitoring of social reforms and adequacy of social security financing under loan agreements and technical assistance programs.*
6. *Training personnel for administration of fiscal reforms in Belarus and also for ensuring good communication between Belarusian government and the international community;*
7. *Working out programs to inform decision makers of Belarus about positive and negative experiences of fiscal transformations in different countries;*
8. *Expertise of the program of PR campaign to ensure public support of reforms launched by the government, explanation to the population about the meaning of activities and measures undertaken by the government, ensuring reliable communication of policy makers with the general population and mass media;*
9. *Ensuring communication of Belarusian reformers with structures of the civil society and influential NGOs that support fiscal reforms in different parts of the world;*
10. *Creating infrastructure* (educational, training, information and legal) to stimulate market mechanisms in the labor market;
11. *Expertise of mechanisms and forms of integration of low income*

- families and youth into the market, defining criteria of providing targeted social assistance, its forms and sources of financing;
12. *Expertise of mechanisms of* passing social security objects from balances of enterprises to the balances of local bodies of power, defining sources of financing and the parameters of a competitive environment in the sphere of social services as this sphere is the centerpiece of all reforms in Belarus.

5.6. PRIVATE SECTOR FORMATION

5.6.1. Current state

In spite of the availability of all the necessary laws and other tools and institutions for the regulation of entrepreneurial activities, Belarus has very few small and medium-sized enterprises. The World Bank states that the number of small and medium sized enterprises in Belarus is 2.5 per thousand people while in Ukraine it is 5, in Russia – 6, in Poland – 22, in the USA – 74,2, in EU countries – 45. Moreover Belarus is the only transformation economy where the number of SMEs is falling. According to the Ministry of Statistics in 1999 there were 26787 SMEs in Belarus. In 2001 there were 25404 SMEs.

A repressive tax system, administrative regulation of business, legislation on licensing, certification, price regulation and cost formation along with frequent control inspections of numerous control bodies, permanent re-registration campaigns – all make the formation and development of the private sector extremely problematic. As a result of such policies the private sector produces just 10–20% of GDP.

Instead of privatization and restructuring that are necessary to raise productivity and competitiveness of the real sector, the government chose an active industrial policy. Its essence is to stimulate a high rate of industrial production growth. However the plants that need restructuring badly fail to produce added value. Moreover, the number of loss-making enterprises grows every year. Debts of economic entities and the state are piling up too until they almost equal the size of the GDP.

The speed of the new private sector formation has an impact on the speed of reforms in general. The restructuring of state enterprises will lead to unemployment growth. Thus this phenomenon can block reforms and its strength depends on the speed of private sector formation. A dynamic SME will employ people and lessen tension on the labor market. Besides which, the experience of reforms shows many entrepreneurs also take part in the formation of market institutions. The development of market institutions also stimulates private sector development.

To stimulate new private sector development it is important not only to create the institutional environment that ensures private property protection and low barriers of market entry but also to ensure access to capital, new knowledge and managerial experience for the new private sector. The key element of restructuring is banking sector reform and ensuring private sector access to finance. Likewise it is important to attract foreign investment and to launch enterprise restructuring.

At present the policy of the government towards the private sector is very inconsistent. On the one hand some measures formally directed at SME support were undertaken. On the other hand barriers to market entry became higher and off-court interventions into private business became even more widespread.

Belarusian legislation on entrepreneurs is highly volatile. Laws and other normative acts are changed constantly. The number of presidential decrees that regulate economic activities increased in comparison with the period 1995–1996. The increasing legislation is characterized by the desire of the state to rigidly regulate entrepreneurial activities, increase the number of auditing inspections and controls of a business and increase fines and sanctions. Economic courts do not ensure equal protection of enterprises of different forms of property. The courts discriminate against private enterprises and favor state entities.

In Belarus wide scale privatization has been suspended. Since 1992, 3667 enterprises of national and municipal property have been reformed. 728 open joint stock companies were set up. 193 enterprises (27%) are private without any share of state property. In 98 enterprises (13.7%) the share of the state is less than 25%. Thus only one third of enterprises became really private in the process of commercialization, In 46.7% of enterprises the share of the state exceeds 50% + one share. In fact these enterprises remained state owned. The institute of “golden share” was introduced in 20 enterprises. It gives a representative of the state the power to block any decisions and to pursue its own policy.

The period between 1995 and 1997 were the most intensive as far as privatization is concerned. Up to 500 enterprises changed the form of property annually. But then the authorities changed their attitude to privatization. In 2000 only 176 enterprises changed the form of property. In 2001 there were 100 of them and in 2002 – 194 enterprises. As of January 1, 2003 only one third of all Belarusian enterprises were transformed into joint stock companies. Formally exist all the institutions in Belarus necessary to carry out successful privatization. Legislation on bankruptcy was adopted; crisis managers who can administer the process of bankruptcy and restructuring were trained. However political will is necessary for this law to work as there are many informal restrictions on its implementation.

Formally Belarus has all the institutions in Belarus necessary to carry out successful privatization. There is legislation on privatization but state policy blocks the implementation of this legislation and does not encourage privatization of state assets. There are quite a few elements of privatization legislation that block it. They are:

- Cumbersome bureaucratic procedure for getting consent on privatization of various bodies: workers, management of the enterprise, local authorities, Council of Ministers and the president;

- Requirements put forth by the state to keep social infrastructure balanced and to abide by many other regulations (keeping the production profile of the enterprise and a ban on laying off workers);
- Evaluation of enterprises based on the balance sheet which results in an excessively high price of assets;
- Legal entities that take part in privatization can not use loans to buy assets;
- Investors are very cautious about the institution of “golden share” that enables a representative of the state to block any decision of all other share holders;
- Shares that belong to workers of the enterprise and were acquired by them at a discount price or by means of exchange for vouchers were not allowed to sell them before the end of voucher privatization.

A law on bankruptcy was passed and crisis managers were trained to carry out the process of restructuring and bankruptcy. But political will is needed to make this law work as there are many informal restrictions than effectively block implementation of this work.

Legislation that regulates stock market; stock exchange and securities commission exists but the stock market does not function. To make it work it is necessary to take measures of financial stabilization that ensure a predictable level of inflation at less than 30%. Certain amendments should be made in the legislation that increases the responsibility of all market participants and makes their activities transparent.

The Civil Code which was passed in Belarus sets up the legal framework for activities of joint stock companies but these norms and the existing court practice do not ensure effective corporate management of these companies, nor do they ensure protection of stock holder rights especially minor ones.

One of the risks of privatization is corruption. Its main source is the power of state employees to influence the decision-making process of passing property rights to certain people for cash perks by creating favorable conditions for a person or for a group of people.

To lower the risks of corruption it is necessary to make privatization process transparent. All information and documents on privatization deals must be open to the public and mass media. Every step of the process of privatization should be explained and made clear to as many citizens as possible through advertising and training.

Agriculture of Belarus is even in worse shape than industry. During the past 10 years the agriculture of Belarus has been based on kolkhoz – sovkhos system (collective farms) that had all the drawbacks of the Soviet system. Belarusian producers are pushed out of the traditional Russian market. Moreover Russian producer out-competed their Belarusian counterparts on the Belarusian domestic market. The import of food products from Russia increases every year.

Expenditures for agriculture in the state budget were reduced from 23% in 1990 to 16,6% in 2002. The speed of depreciation of fixed assets is much higher than the speed of their modernization. About 75% of fixed assets is already depreciated. Though agriculture annually receives about \$500 mln. of subsidies, grants and cheap loans its profitability is negative. Belarusian producers are provided with fertilizers at prices set below the costs of production, which leads to bankruptcy of fertilizer producers. On the other hand government purchase of agricultural goods at fixed prices brings agricultural producers to the state of bankruptcy. Agriculture faces a deficit of mineral and organic fertilizers and substances to protect animals and plants.

The financial status of agriculture remains critical. During the last two years accounts payable increased by more than 5 times. They amount to 14,3% of all accounts receivable. Solvency of agricultural enterprises is just 2,5%. In spite of price and financial discrimination, the private sector in Belarusian agriculture continues to develop. By 2002 households and farmers produced 5 times more vegetables than state agricultural companies. They produce 6 times more potatoes and the output of private producers was higher than that of state companies.

5.6.2. Guidelines for reforms in the sphere of SME development, privatization and restructuring

Development of a new private sector will be effective if the following measures are taken:

1. Revision of legislation on incorporation (registration) and liquidation of legal entities. It implies:
 - Introduction of the notification principle of incorporation and liquidation of enterprises (not the principle of granting people the right to form a business by a state body), allowing registration at the home address, setting requirement for low authorized capital (50–100 minimal wage units), ensuring the right of free choice of kinds of economic activity;
 - Definition of a single list of documents that are required for registration;
 - Introduction of the principle of registration in „one window” when further procedures are performed (like tax inspection registration) by state employees;
 - Introduction of the principle of liquidation of the legal entity can be made only by the owner or the body indicated by him or by the court;
2. Price liberalization:
 - Abolition of restrictions on profitability of so called natural monopolies;
 - Abolition of obligatory cost calculation and its registration by the

- state bodies (excluding a limited group of so called natural monopolies);
- Abolition of obligatory economic justification of economic foreign trade transactions
 - Abolition of wholesale, retail and import added value regulation;
 - Reform of energy sector tariffs, utility and transportation prices. Tariff reforms provide for their steady administrative increase based on an increase of production costs on ineffective monopolies. At present people pay for energy and gas at prices that are higher than costs. Utility and housing sector reform should be launched in order to create competitive environment and to change motivation of workers. One of the aspects of this reform will be installation of appliances to control water and gas consumption.
3. Changes in the Tax Code that make the tax system simpler and lower tax burden;
 4. Passing laws that regulate relations between the state (owner) and contractors or tenants (lessees) in the sphere of non-residential buildings and land lot rent, abolition of monopoly of the state on lease of houses, trade and production facilities, introduction of private property on land;
 5. Considerable reduction of the number of activities that require a license;
 6. Liberalization of legislation in the sphere of certification of production and services, simplification of the procedure of certification and lowering prices for it;
 7. Change of the legislation on privatization that would speed up this process;
 8. Passing the law "On the unified procedure on imposing economic sanctions and fines", abolition of other legal acts that regulate this sphere;
 9. Revision of legislation that regulates activities of individual entrepreneurs in order to simplify taxation and accounting and to ensure protection of the rights of entrepreneurs;
 10. Increasing the effectiveness of the state system of business support by means of assisting local authorities in building infrastructure and also providing information and consulting services in the sphere of business development;
 11. Foreign trade liberalization
 - Abolition or setting low import tariffs on raw materials, intermediary or capital goods which are necessary to produce competitive export oriented production;
 - Lowering the average import tariff to 4–5% in the long-term perspective (at present it is 12%). This is the standard tariff practice in the EU and WTO;
 - Abolition of non-tariff restrictions: quotas, licenses, special procedures of certification of imported goods;

- Current and later capital account national currency convertibility;
- Ensuring equal access of all entities to participation in government held tenders for goods and services provision;
- Abolition of various forms of interference in foreign trade activities of the enterprise (ordering plans to increase export, minimal export prices, additional requirements for export of goods etc.)
- Abolition of preferences and favorable regimes.

Foreign trade liberalization, integrated and systemic reforms, absence of state protectionism are necessary conditions for Belarus' joining the WTO and other international organizations.

Privatization program

A new government that will carry out privatization will operate within a new legislative framework that will abolish restrictions. It will be supported by the proper infrastructure. The rule that prohibits sale of shares distributed for employees of privatized enterprises on preferential terms will be abolished. Another rule that prohibits use of loans to buy privatized companies will be abolished too. The institute of "golden share" will also be repealed.

Privatization will be carried out using the following methods:

- Selling the control package of shares to a strategic investor. This method enables the restructuring of an enterprise in the quickest and the most effective way. This method will be used primarily for key enterprises in the Belarusian economy;
- Selling shares of privatized enterprises on the stock exchange. Privatization of effective profitable enterprises will be done in this way if they meet requirements of listing on the stock exchange; This method allow the state to get the maximum price for privatized assets;
- Selling state companies at auctions for domestic and foreign investors. This method allows the sale of state property at the market price. It is most suited for small and medium sized enterprises;
- Selling the company or a part of it to a group of its managers;
- Selling the company to its employees.

It is necessary to finish small privatization during the first year in office of the new government. This will enable it to improve the financial status of enterprises in the sphere of trade, catering and household services. To stimulate the active participation of local bodies of power in small scale privatization it is necessary to keep 100% privatization revenues from the sale of municipal property in a special development fund of this territorial unit. Local council should decide how to distribute these funds.

It is reasonable to hold more "Dutch" auctions and to apply the procedure of selling an enterprise for one minimal fee. In order to increase attractiveness of shops, catering and household service companies that are located in built-in facilities they should be

privatized together with these facilities. During the first year of reforms the government should create the conditions to enable the application of all these methods. It should do the following:

- To carry out the wide scale process of turning state companies into joint stock companies and to set up bodies of management of new companies. The Supervisory Board should be given more powers and responsibility. It can be expanded to include property liabilities;
- To set up a well-functioning stock exchange;
- To introduce necessary changes into legislation that regulates activities of joint stock companies.

Privatization revenues should be directed to a specialized social reforms fund. This fund will be used to carry out pension, education and health system reforms. The parliament will decide on how these funds will be spent.

Restructuring of enterprises

The experience of reforms in a transitional economy shows that the crisis of the banking system and debts of enterprises are among the most difficult problems of reforms in the first stage. The introduction of strict budgetary constraints, lowering inflation brings about a worsening of financial problems of enterprises and banks.

The restructuring of enterprises will be done in the following way. The enterprise – debtor addresses the bank that is its biggest creditor and it is decided whether to start restructuring or not. If the bank decides that the enterprise has good prospects and has prepared a consistent business plan of internal reorganization and development, then an agreement procedure is initiated. This could lead to the signing a settlement agreement according to which all creditors including the state budget write off or restructure debts of the enterprise or do a swap operation (equity for debt). No bank will initiate restructuring if most of benefits will be reaped by the state as it has a privilege priority right to satisfy its financial requirements at the expense of any revenues. Thus the key condition of restructuring should be the state's consent to give up its privileged position as the main creditor.

Goals and tasks of financial restructuring are:

- Restructuring of enterprises that can survive in a market economy and become profitable economic structures;
- Liquidation of loss-making insolvent enterprises that do not have any prospects for long-term growth;
- Liquidation of so called "hopeless debts of commercial banks and debts of enterprises to each other.

Tools of financial restructuring will be:

- An agreement procedure and refusal to initiate mass bankruptcy;
- Conversion of debt into assets and refusal to initiate mass privatization;

- Selling debts.

Conciliatory procedures

A possibility of signing a so called “peaceful agreement” between the creditor and debtor will be the basis of procedure of financial restructuring. It is ensured by the Civil Code and the existing law “On Bankruptcy”. Banks will be granted the right to introduce conciliatory procedures. To ensure their success the following rules are introduced:

- The leading bank or a group of banks can initiate the court procedure if they are holders of at least 10% of liabilities of the enterprise. The bank or a group of banks can initiate the procedure if they own at least 10% (if this sum is the equivalent of more than 50.000 USD) or more than 20% of liabilities of the debtor or the next creditor as far as the amount of debt is concerned if the first creditor does not initiate the procedure;
- The following claims are excluded from the procedure: social insurance claims, wage debts claims of employees, contributions to the pension fund and employment fund, mortgage debt claims and suspended but unpaid taxes claims and payments into off-budget funds. Claims that are connected with mortgage debts can be regulated upon agreement of creditors involved. If the creditors refuse to include these claims into the conciliatory procedure the debtor should issue documents that confirm this debt after the conciliatory procedure is finalized.’
- Creditors can sign a “peaceful agreement” if they own 50% of liabilities of an enterprises. The courts can oblige all other creditors to stick to the agreed-upon plan of restructuring if it has been approved by the Ministry of Finance and Ministry of Privatization.
- Budget liabilities are not given any priority status and the state participates in the agreement procedure on equal terms with other creditors. Representatives of tax bodies take part in the conciliatory procedure as observers. They represent the interests of the state and have the right to approve the peaceful agreement only on certain terms.
- Creditors cannot exercise their right of seizing assets of the debtors before the enterprise makes a business plan for restructuring. During the whole period of the conciliatory procedure the enterprise is protected from bankruptcy. Peaceful agreement is based on the restructuring plan of the enterprise. It includes closing of loss-making structural units, selling or liquidation of useless assets and employment reduction.
- The most important methods of financial restructuring are revision of schedule of debt payment and partial writing off of the main debt and interest payments and conversion of a certain amount of debt into a share in the joint stock capital of the company.
- If during the conciliatory procedure all or part of the debts are

written off, the revenues of the debtor are not increase by this sum. The creditor is granted the right to exclude the sum of the written off debt from the taxable income. They enables the creditor to avoid any additional tax burden.

- The state is obliged to agree to writing off debts on the same terms as any other creditor. Market value of debts that are owned by banks will increase in time as the state reduces its financial requirements. Commercial creditors can offer the state to underwrite more debts if it brings private investment into the enterprise.
- If the enterprise – debtor does not present a business plan or this plan is of poor quality, the bank initiates the procedure of bankruptcy or deprives the enterprise of the right to manage its assets.
- The procedure of financial restructuring provides for liberal rules of debt into equity conversion. To do this kind of conversion simple majority of voters who take part in the conciliatory procedure are enough. In this case the rights of other creditors who do not want to sign the peaceful agreement can be restricted. Any creditor or a group of creditors that owns over 50% of debts in value terms can impose its decision on other creditors. Only the creditor who has at least 20% of debts can go to court and try to dispute the decision of the main creditor

Conversion of debt into equity

Swap operations, i. e. turning debt liabilities into equity in the joint stock company can be done independently of conciliatory procedures. If the creditor owns at least 30% of debts of the enterprise he has the right to address the Ministry of Privatization with a request to change debt into equity.

The Ministry of Economy is obliged to automatically launch the procedure of changes of debt into equity in joint stock companies where the state is the owner . it is also obliged to turn state enterprises into joint stock companies within a 30 day period from the time the peaceful agreement is signed by all major participants including Ministry of Finance. It should also do so when creditors ask for it. The state offers all its shares for public sale and gives up the right to own a control or blocking package of stocks.

Selling of debts by creditors

The procedure of financial restructuring ensures liberal rights of selling debts of enterprises on the financial market. This process is designed to accelerate the sale of claims of creditors, compared with the norms of the Civil Code. The bank-creditor which decides not to initiate conciliatory procedures and does not find the decision to force the debtor to pay debts through the court procedure or through bankruptcy procedure is obliged to sell its debt by offering it on the

market or to an interested investor. Potential buyers of debts can be debtors of this debtor or investors who intend to turn this debt into equity. The first group of buyers acquires debt at a discount and then writes it off against its liabilities to the debtor of the bank or it uses this debt to acquire goods from the debtor writing it off in the process of merchandise delivery. Investors will buy debts in order to transform in into equity in this joint stock company.

Financial restructuring and privatization

The restructuring plan can include transfer of debt into equity. This process stimulates quasi-privatization. To complete real privatization it is necessary to simultaneously privatize state owned banks. The program of financial restructuring states the deadline for execution of temporary restrictions. The possibility of liquidation of the debtor should create incentives for it to come to an agreement with creditors. If the peaceful agreement is not signed, the procedure of selling debts in the market or swap operation – debt for equity – is automatically launched.

Automatic initiation of this mechanism is a very strong incentive for bank and enterprise managers to reach peaceful agreement. Indebted enterprises also have incentives to initiate conciliatory procedures, as all decisions on assets of the enterprise are suspended until the end of this procedure.

New owners have the right to elect members of the Supervisory Board of the restructured enterprise and make amendments in its incorporation documents. By doing so they can expand the rights of the Supervisory Board. The creditor who is doing this kind of restructuring can turn from a passive investor who is only interested in increasing the value of its assets into an active investor who is directly involved in management of current activities of the enterprise. Thus conversion of debt into equity in a joint stock company leads in the first stage to financial restructuring and then to change of form of property and legal form of the enterprise (for state unitary enterprises) and finally to organizational restructuring of the privatized enterprise.

Peaceful agreement can provide for additional financing of the debtor aimed at stabilization of its economic and financial status before initiating wide scale restructuring. Additional financing of the debtor during the period of negotiating the peaceful agreement is unacceptable as it might lead to dragging in the procedure of financial restructuring.

Restructuring of insolvent and loss making enterprises

Banks can refuse to initiate the conciliatory procedure with many big industrial and socially important enterprises, which in many cases are insolvent and loss making. Even radical financial and organizational restructuring will not lead to any increase in their effectiveness in the

new economic environment. In such cases mechanism of state intervention should be in place. The availability of such mechanism also protects banks from political pressure. Banks can be pressured to evaluate in a particular way the status of the enterprises and the quality of offers of these enterprises to restructure.

The mechanism of intervention stipulates that budget resources will be provided to support restructuring of these enterprises or their liquidation if they are rejected by banks – creditors. Such enterprises should apply for conversion into a joint stock company and offer a restructuring plans prepared by creditors. The list of enterprises which have failed to do financial restructuring are to be made during one year after completion of the program of financial restructuring of enterprises and banks.

As far as unstructured enterprises are concerned the state can initiate a program of productive employment. Support of such enterprises makes sense until they produce added value that exceeds labor costs or benefits to laid off workers. A specialized agency (fund) manages such enterprises. It is to be set up by the Ministry of Finance, which also conducts training of workers and provides assistance in finding new jobs, places of residence etc. This should decrease the incentives to launch bankruptcy proceedings in the future.

The status of the subsidized enterprise can become extremely unattractive both for the enterprise and for its creditors. Granting the enterprise this status is possible only after commercial creditors give up their financial claims. Management of such enterprise must be changed, employment reduced and wage levels frozen.

Formation of a stock market

The prerequisite for long term, steady economic growth is the development of effective banks and stock markets that provide access for domestic companies to capital. The success of stock market formation in transitional countries has been achieved only in cases where legislation was passed than made the stock market very transparent.

Belarus has legislation that regulates the stock market. There is a Securities Committee and a stock exchange. This legislation that regulates securities market allows the effective protection of small stock holders but it is overburdened by administrative regulations. Its procedures for ensuring transparency of deals are vague. It is necessary to have a professional revision of the existing legislation. Based on this analysis, amendments to the securities legislation will be made.

In order to launch such reform it is necessary to do the following:

- Raise the status and rights of the Securities Committee
- To pass legislation that states that the only exchange where shares can be traded is the Currency and Stock Exchange;
- Raise standards of professional certification of participants of the stock market and to keep the number of issued licenses;

- To formulate strict requirements to listing for the stock exchange;
- Remove restrictions on activities of commercial banks at the stock market;
- Considerably increase authorized capital of brokers that take part in stock exchange trade;
- Introduce tax breaks for 5 years on income from stock exchange operations;
- List on the stock exchange the most attractive stocks for financial market enterprises.

Restructuring of the agricultural sector

It is obvious that Belarusian agriculture needs reforms. The fundamental point in this reform is private ownership of land. *The main elements of the agrarian policy include the following:*

- Full restoration of private property in land. The law “On Land” will be amended. This law is one of the most important prerequisites for attracting investment in agriculture and for dynamic development of this sector and its social support.
- Creation of a market in land, granting the right to change the function of land (not just agricultural) especially in regions that suffered from the Chernobyl disaster. At the first stage owners of land lots, local bodies of power are given the right to lease land for 99 years. This law passed this land automatically becomes the property of the leaseholder if it is envisaged in the lease agreement.
- Creation of conditions for concentration of agricultural land under management and in ownership of the most effective owners. Collective farms will not be liquidated by law. Big agricultural producers have a future only if the property rights of participants in joint stock companies are clearly defined. It is necessary to work out a mechanism of buying out loss-making collective farms by means of paying off their debts to the state and creditors.
- Creation of a stabilization fund that will accumulate means for modernization of fixed assets and purchase of equipment for further leasing for producers. Lease of land and water payments, privatization revenues from selling agricultural enterprises and local fees will be directed into this fund;
- State support of households in the sphere of production, processing and sales of agricultural products. Households will have guaranteed right of equipment lease, access to finance on equal terms with other agricultural producers. Schemes such as Gramen bank will be developed in the agricultural sector (giving loans under collective collateral). Each household will have an opportunity to receive a minimal loan if 4–5 other households guarantee. These households should live in the same village or town.
- Refusal to credit agriculture by loans of the National Bank, creation of effective system of management of financial flows in agricultural

sector. Financial institutions that work with agriculture should attract resources on market terms. It is unacceptable to continue support of agriculture just because it is an important sector, absent any economic justification.

- Transformation of collective and state farms into market structures. The mechanism of distribution of land and assets among members of these collective enterprises should be worked out. Members of the collective farms should have the right of free exit from the collective farm. The procedures for leaving the collective farm, evaluation of assets and land, the contribution of each participant will be described in the law “On structural reforms of collective farms”. Unification of citizens into collective farms will be done on a voluntary basis. It will be done in the legal forms defined by Civil Code.
- Passing the law on mortgage that will provide for mortgage of land for securing a loan. Land should be free for commercial operations.
- Support of farmers and entrepreneurs in the agrarian sector. Private producers should become the basis for development of Belarusian agriculture;
- Fostering vertical integration in the agricultural sector for creating competitive producers;
- Taking measures to prevent the formation of monopolies, setting barriers to market entry in agriculture, restrictions on the movement of agricultural goods, abolition of state monopoly on crediting agriculture and leasing operations.
- Reduction of state purchase and liberalization of prices.
- Legal and organizational support for setting up and development of such institutions as forward and future contracts, wholesale exchanges and auctions, use of storage facilities and use of invoices as tools to guarantee short-term loans in agriculture;
- Fostering the formation of dealerships and distribution networks, leasing companies, machine and equipment facilities and other institutions that help carry out restructuring of agriculture.
- Creation of a system of state support for training agrarian sector specialists and experts, setting up an information system, a system of retraining in order to meet the demand of the sector for high-skilled well-informed specialist;
- Reform of the state system of administration of agriculture.

In the process of reform of agriculture, a class of effective owners of land will be formed. An infrastructure of land market will be created, a land register, institute of land evaluation, mortgage and land lease will be set up. Land reform will be gradual based on elaborate and concrete legislation designed to take into account regional peculiarities and the opinions of ordinary people.

5.6.3. The possible forms of private sector support provided by international organizations

As was mentioned above, donor assistance of measures to stimulate the development of a private sector is needed.

1. The most important step that creates positive conditions for private sector formation and helps to successfully carry out privatization is the introduction of international accounting practices in Belarus. It will make business more transparent and it will stimulate investment. During the process of systemic transformations it is important to obtain the assistance of international organizations in working out the necessary documents, training both accountants and tax service employees.

2. Another important step is to lower administrative barriers to enter and exit the market. The support of international organizations could take the form of working out new legislation and training a group of state employees. Apart from that technical and financial assistance to prepare necessary infrastructure would be appreciated.

3. Another important aspect of SME development is the completion of small-scale privatization. In this sphere there is positive experience of cooperation between Belarus and international organizations that should be used and developed in the future.

4. Lack of access to financial resources is another problem for SME development. To solve this problem it is necessary to continue the existing programs of micro crediting. They should be enhanced by setting up a bank for micro crediting and a state insurance company. They would aim at risk reduction of SME for commercial banks. Support to form investment institutions is also needed. This set of measures should foster creation of effective investment infrastructure for SME support.

5. Another important task for Belarus is to create infrastructure for SME support. Local authorities should be instrumental in fulfilling this task. Local resource centers that would ensure access to information and training of entrepreneurs will be a part of such program.

6. Successful development both of new and privatized companies will be possible if managers and entrepreneurs are well trained and prepared. In order to achieve this it is necessary to develop business education in Belarus. It is possible only with the participation of international organizations.

7. Restructuring and privatization of big enterprises is one of the tools of lowering entry barriers for SME. In the process of privatization, the supply of investment resources increases which leads to a lowering of their price. Thus financial resources become more easily accessible for SMEs.

8. In order to carry out privatization it is necessary to change legislation. Amendments should be aimed at simplification of

privatization procedure and at introduction of new forms of privatizing enterprises. Corporate law is another important piece of legislation that is necessary to ensure effective privatization and restructuring. It is necessary to work out and pass the legislation that regulates the rights of owners and ensures transparency of operations of companies. Support of international organizations is needed in this sphere. They have rich experience in working out such legislation in transitional countries.

9. Another important aspect of successful privatization is the creation of an effective stock exchange. This process also requires the support of international organizations both in drafting legislation and in training personnel. Employees of the State Securities Commission and stock exchange brokers should also be trained.

10. Mass privatization and restructuring of big enterprises will also require expert support of international organizations. Privatization of so called city – companies (when one enterprise is a major and sometimes the only employer in a town) will require special attention and expertise.

11. To stimulate the development of the private sector it is necessary to change the structure of state administration. An agency to attract foreign investment and develop SMEs will be set up. Assistance of international organizations in creation of new institutions is also needed.

5.7. UTILITY REFORM

5.7.1. Current state

From the very beginning of liberalization process utility payments were considered socially important and thus they were tightly controlled by the state. Prices for these services are changed by resolutions of the Council of Ministers or Ministry of Economy.

Low subsidized tariffs for utility services lead to so called cross subsidization. It means that production costs of enterprises include not only taxes and other fees but also contributions for compensation for low tariffs for utility services consumed by households. In addition utilities enterprises receive subsidies to cover losses from the budget

Subsidizing utility companies compared with direct subsidizing of low income families can not ensure target form of support of the most needed. Out of 687,193 bln. BYB that is transferred to utilities enterprises to compensate for subsidization of households subsidies to low income families amounted to just 0,72 bln. BYB. Thus targeted assistance is mere 0,1% of the means transferred to the enterprises for this purpose.

First of all industrial enterprises carry the burden of compensation for losses of subsidized utility services supplied for household consumption. In 2000 and in 2002 the government decided to drastically raise utilities tariffs for the population (in 2001 the year of presidential elections the tariffs did not grow). This growth was particularly rapid in 2002. Prices for household services increased by 150,1%, and utilities services grew by 292,6%. In 2002 rent went up by 5.45 times, water supply – 2.32 times, electric energy – 2.46, gas supply – 3.2 times and heating – 2.79 times. This increase brought the compensation level to 60% of production costs. The Concept of termination of cross subsidization stipulated that heating tariff should be increased by 1.82 times, electric energy – 1.32 times, gas – 2.07 times and rent – 1.15 times (compensation level of production costs was to be 40%).

In spite of the tariff rise the fuel and energy sectors of the economy and housing and utilities sector are in deep crisis. Imported energy resources are used very ineffectively. As energy reform is considered to be the reform of the second order (restructuring and privatization) and it requires meticulous preparation utilities reform can be implemented faster. According to some estimates about 500 mln. USD can be saved annually if the reform takes place.

The peculiarity of the utilities sector is that there is no competition. As a result the quality of services provided is quite low. But instead of promoting competition and ensuring free access to the market as means of fighting monopolistic practices and high prices the

government chose the policy of retail price and profitability regulation. There is much evidence to suggest that the existing level of tariffs is too high.

At present economic organization and interaction in housing and utilities sectors have some systemic drawbacks. Quality and sustainability of these sectors and price stability can not be ensured without removing these problems. These are the problems that became the main reasons for the systemic crisis of the housing and utilities sector. Thus there is strong demand for a consistent pragmatic concept of reform of these sectors.

The basis of economic relations in the sector is the system of budget subsidization of enterprises in the utility sector. It fits well the concept of planned economy, centralization of decision making in the utilities sector and lack of competition. Users of services do not have any chance to influence the quality and quantity of services provided.

The main causes of existing problems in the utility sector are:

- Chronic lack of financing;
- High costs and absence of economic incentives to reduce them;
- Ineffective and loss making operations of enterprises in the utility sector;
- Waste of resources.

Budgetary restrictions are due to lack of funds for modernization and restructuring of the housing and utilities sector. Besides which, a certain share of costs are not covered by payments of households (considerable part of cross subsidization was eliminated in 2002) but are compensated by industrial enterprises which in turn leads to increase of their costs and loss of competitiveness.

The system of subsidization of enterprises that exists in the housing and utilities sectors, unlike the system of targeted social assistance cannot ensure that low income families receive the needed funds. First of all it leads to the situation in which the final recipients of subsidies (by compensating the difference between prices and costs of production) are not just low income families but middle and high income households. In the fourth quarter of 2002 each family, including high income ones, received from the state a utilities services subsidy in the amount of about 1002 BYB a month. Low income households received 587 BYB whereas high income families got 1580 BYB.

Secondly the existing system does not guarantee that households as recipients of the budget assistance will receive subsidies. Local budgets should carry the heaviest burden of subsidization of utility services. Thirdly, calculation of the size of a subsidy in the absence of market prices is pretty subjective and lacks transparency. The subsidy is not a part of the price but a result of the compromise between republican and local authorities.

Combining the functions of the owner of houses and the producers of utility services creates a serious internal conflict of interests and

results in a lack of incentive to effectively manage and maintain houses. The procedure of setting up utilities tariffs is old-fashioned. There is no adequate system of control over production costs. Audit of utilities enterprises is almost non-existent. The process of tariff definition does not reflect objective financial needs and modernization of fixed capital investment of the enterprises. The system of defining the profitability of utilities companies was adopted in the times of the Soviet planned economy. It does not guarantee generation of enough profit to ensure sustainability of production in this sector.

5.7.2. Guidelines for utility reform

The new system of economic relations in utilities sector provides for fundamental changes both of the functions of its participants and mechanisms of their interaction and in the organization of financial flows.

The current system of financing of utilities enterprises will be changed completely. The main idea of the economic model of the utility sector reform (similar to the Russian experience) is to pass the right to manage all budgetary resources that are granted in the form of subsidies directly to households as they are the most highly motivated to effectively use them.

The dividing lines in budgetary financing will be eliminated. Within the system of personified social accounts of citizens, all forms of state support will be united in utility subsidies. Thus the main participants of the reformed utility sector will be the producers of services and their consumers. The sole function of the budget will be to launch the system of targeted social support for the citizens. High income households will not get any support from the state. As a result, consumers of utility services will have the opportunity to control how budgetary means are spent. This will ensure the transparency of the process of subsidization of utility services. The potential of financial institutions (banks) will be used. Banks will open social bank accounts to credit citizens and local budgets in order to ensure steady financial flows. A social accounts system will encourage the self-organization of citizens in the housing sphere. Housing cooperatives will be set up to control utility services delivery, their quantity and quality. There will be a market for professional managers of houses and their maintenance. In this system budgetary funds will be spent more effectively and the budgetary policy will be much more socially oriented. At the same time cross subsidization of population at the expense of industrial enterprises will be eliminated.

The forms of financing of restructuring and modernization of housing and utility sector will also be changed. Investment will be made at the expense of private loans. Budgetary investment

into the utility and housing sectors will be limited. It will only add to private investment in the sector and will not be aimed at crowding out private investment. After 2010, loan financing of housing and utility sector will be the dominant form of financing. More importantly the source of financing of modernization of the utility sector will be regular payments to social accounts of citizens to compensate for utility services payments. During this period tariffs for utility services will be fixed for a certain period of time. It will ensure guaranteed investment in the sector and guaranteed return on investment that was made to the utility and housing sector.

A competitive environment in the housing sector will increase its effectiveness and lead to lower costs of producing utilities services. Additional investment will be attracted to the housing and utilities sectors for restructuring and modernization. Relations between utilities companies and consumers will be based on agreements. The functions of the owner of houses and their manager will be separated. The tariff policy of local monopolies will be revised to make it more transparent. It will enable the achievement of the following:

- a) ensure 100% coverage of production costs by households without increasing the overall (budget plus household payments) payment for utilities within the norms for housing area. High income families will pay the full price of utility services.
- b) consumers of services will have a chance to directly influence the quality of services and quantity consumed. This will increase pressure on enterprises to perform more effectively and will make them cost sensitive.
- c) owners and tenants of houses will have the chance to choose managers of houses leading to an increase of quality of these services.
- d) stimulate energy saving both by utility companies (to reduce production costs) and consumers (to reduce costs of utility services).
- e) stabilize financial flows for organizations that produce utility services and to make them transparent.

Building a new economic model will enable the government to ensure the functioning of a subsidy-free housing and utilities sector. Its effectiveness will rise, conditions for investment into the sector will be created and targeted assistance to low-income families will be ensured. High-income households will be cut off from state support while low-income households will receive social transfers on their social accounts.

5.7.3. Possible spheres and forms of assistance of international organizations in carrying out utility reform

International donor organizations can provide much needed assistance to the housing and utilities sector of Belarus. *Donor assistance to ensure utility sector reform is needed in the following spheres:*

1. To improve heating system insulation of 80% of all buildings (roofs, walls, basements, windows, doors);
2. To install meters for energy and water consumption. This will make it possible to monitor consumption of utility services by each households. 100% of houses that have central heating need these meters;
3. To ensure decentralization of heating of 80% of houses and installation of new heating appliances;
4. To support the creation of condominiums.

Problems in the sphere of energy saving and thermal insulation are particularly acute. Much heating energy is wasted. A small share of these losses can be compensated by means of raising tariffs for households. This will stimulate their saving energy and encourage them to demand better maintenance of heating systems. In any case without large investment into these sectors these problems can not be eliminated.

Up till now most of blocks of flats have not been equipped with heating meters. Most buildings have one-pipe systems with very limited potential for the regulation of temperature inside the buildings. Temperature inside buildings is regulated in a very inefficient way – by means of opening windows. As flats are not properly equipped with appliances to regulate heating it is impossible to know how much heating is used by each flat.

As flats do not have appliances to count and regulate the use of thermal energy, households do not pay for the services they consume but pay based on per capita calculation and the size of the flat. It does not encourage households to save energy. In fact 25–50% of all energy produced can be saved if adequate measures are taken.

As on extremely cold days in winter many buildings are underheated and heating is switched on late in autumn, electric heaters are frequently used. Each year more of them are used as heating norms are often broken. Besides electric energy tariffs for households are lower. This situation brings about increased costs of energy production. From the point of view of electric energy production, generation of thermal energy by using electric energy is highly inefficient and irrational. Thus money is needed not only to ensure investment into fixed capital of companies in the utility sector but to install appliances to count and regulate consumption in flats.

Carrying out the above-mentioned measures will result in a rapid reduction of energy resource consumption due to more effective use

of the resources. They will also bring about a reduction of budget subsidies, increasing their transparency and the targeted character of social assistance.

Another sphere of support for the utilities sector is *to provide financial and organizational assistance to set up condominiums* – associations of flat owners. In spite of the fact that the law on condominiums was passed in 1998, the existing social and economic conditions primarily the tariff policy in housing and utility sector, makes it useless to set them up.

At present flats are privatized by most of residents but houses remain in municipal ownership which brings about problems in providing services for residents of such flats. The existing tax mechanism and other administrative aspects do not encourage residents to form associations that can protect their rights and to influence costs of utility services as services of commercial companies are much more expensive. Economic and organizational support of local authorities by the international community in setting up such associations and developing a competitive environment in the sphere of housing and utilities services is another important sphere of utility sector reform.

5.8. SOCIAL POLICY

The success of reforms in the society depends a great deal on their support by the population, the credit of trust that people grant to the leadership of the country and reformers. Social policy should be based on targeted or address assistance to the least socially protected people. It should be just, effective, transparent and open to the public. It should be pursued in coordination with all structures of the civil society.

5.8.1. Current status of the social security system

State transfers, subsidization of production of a few goods and services, price ceilings on a number of goods, grants of various benefits and transfers constitute the foundation of the social security system in Belarus. This system is universal and can not solve the problem of redistribution of resources in favor of the most needed. Moreover the current policy brings about much harm and damage. The budget is overburdened with liabilities. The population has unrealistically high expectations. The competitiveness of the real the sector is falling. The constitutional principle of ensuring free health care and education is compromised. Numerous benefits and transfers are poorly targeted and the state does not help those who most need this assistance.

There are no effective mechanisms and criteria of targeted social assistance in Belarus. 34 broad categories of the population receive state aid (the old, the poor, single parent families, military officers and ex military officers, youth, people who took part in programs of liquidation in consequence of the Chernobyl disaster etc.) 29 forms of social assistance exist: giving food, providing medical services, information and financial support etc.) Besides there are 300 forms of benefits (privileges) for different groups of the population. For example 250 categories of people have telephone benefits. 2.3 million households receive various forms of assistance. At the same time about half of the population lives below the poverty line.

The average old age pension is about 48 USD, i. e. lower than the official poverty line in the country. The size of the pension of one third of pensioners is not enough to buy enough food based on rational consumption norms.

Wage rates set by the government bodies for enterprises of all forms of property are so low that they can not ensure modernization of production facilities and their development. For example in January 2003 the wage rate of the first category with all additional bonuses was just 33% of the minimal consumption budget (MCB).

The average wage in January 2003 was 109 USD. It is just 40%

higher than the MCB. At this level of wage payments a household with two working people can not feed one child. The low income of most of the population is one of the major factors of birth rate reduction.

At present only 30% of households can buy or build a flat without the assistance of the state. If an average citizen of Belarus spends one third of his wage on building a flat he will be able to pay for it in 90 years. Today there are about 600.000 families in the housing queue. Price regulation aimed at social protection of the people turned out to be highly ineffective. The prices of good that make up the minimal consumption budget of the population grew fastest during the last 5 years, meaning that cost of living for the poorest grew the fastest.

5.8.2. Strategy of social reforms

The strategy of consistent and systemic reforms provides for transition into a system of targeted support of the most needed individuals. Aid is distributed in monetary form. At the same time corporate welfare will be reduced and terminated. The new social security policy will target people – not companies. A considerable amount of direct and indirect subsidies for the real sector will be abolished. High income groups will also be cut off from state social aid. Social services and goods will be provided by the private sector in a competitive environment. The state will be just a customer that orders a certain amount of services. It will control how these services are produced and who benefits from them.

The main tasks of the social security policy are:

- Redistribution of budget means in favor of the most needed who objectively can not independently ensure their own social security during the time of transition;
- Ensuring access to housing, utilities, transport, educational and healthcare services and also to food and some industrial goods for the least socially protected people;
- The creation of an effective system of professional retraining, and creating an environment that stimulate self-employment;
- Setting up a universal information system that has information about job vacancies both inside the country and abroad, training programs, price dynamics, where to find necessary information and consultations.

The main elements of social security reform are:

- Switching to the targeted individual social security and assistance system for the most needy.
- Working out and passing legislation that clearly states the criteria of poverty that qualifies the person to receive state aid. The minimal overall income that qualifies a person to receive state aid is at least 50% above the poverty line as defined by the UN;
- Compiling lists of people who have the right to receive state aid.

This information should be made available to the public through local Housing and Utilities Services and local bodies of power. These lists are modified on a regular basis;

- Setting up a national data base on the state aid system. It should include all related information about criteria and parameters and size of state aid transfers;
- Reduction of cross subsidization by means of making costs of subsidized services equal to their price. Compensation for the people will be targeted based on the poverty criterion.

Labor relations and employment

Under socialism unemployment officially did not exist. Legalizing this phenomenon was like a bolt from the blue for the society. People turned out not to be ready to overcome the negative consequences of unemployment. The backwardness of the Belarusian economy based on state property, low labor productivity, inability to compete with non-socialist producers of similar goods, low quality of goods and inability (or lack of will) to adjust the economy to market conditions – all these factors brought about a reduction of demand for Belarusian goods and services and ultimately a loss of markets when the borders were opened. As a result much labor at many enterprises became excessive. Many jobs were cut; vacation without leave became quite widespread, neither work nor orders for goods were available. Wages plummeted. The natural desire of managers of enterprises to get rid of redundant employees was stifled by administrative measures, which considerably hampered adjustment to new conditions.

Nevertheless the process of laying off workers in Belarus brought to recognition of unemployment. In January 1997 unemployment was at the highest level and reached 185.000 people or about 4% of the labor force. As of March 1, 2003 unemployment level was 143.400 people.

Administrative measures taken by the authorities increased unemployment. For example presidential decree on employment stimulation passed in March 1997 stated that getting unemployment benefit should be contingent on participation in public works. This decree led to the situation in which it did not make any sense to register as unemployed. Unemployment benefit could (no more than 13 USD since December 2002) be granted only when a person worked a certain amount of time at public works (cleaning streets, toilets, work at vegetable storage facilities etc.). The Decree made the Employment Service control strictly how unemployed people were utilized. They had to follow the norms of this decree. The Service began to stop paying unemployment benefits to those who did not meet the requirements of the decree without providing any assistance in finding a job. For example in 2002 Unemployment Service could help find a job for just 38% of persons who addressed it for help.

As research showed, the application of administrative measures did not bring about a reduction of unemployment but lead to the transformation of it from open to informal or officially unrecognized. According to information from the Minsk Scientific Research Institute for Social Economic and Political Problems, by the beginning of 1997 there were four unregistered unemployed for every officially registered one. At the end of October 1998 this ratio got even worse. There were 5.3 unregistered unemployed for every registered one. National Institute for Social Economic Political Research showed that in 2002 hidden unemployment in Belarus was 3–3,5 higher than registered. Which means that actual unemployment was about 400–450 thousand people or about 9–10% of the labor force.

Another factor that suppresses unemployment is the increase in gray sphere employment. Today this kind of employment is about 300–400 thousand people. Unemployment is also restrained by the order of the executive power to managers of state enterprises not to lay off redundant workforce, estimated at about 1 mln. people.

In 2002 the situation in the labor market became worse due to deterioration of the overall economic situation. Only 85% of jobs were renewed after people were laid off, increasing official unemployment. Most of the people left their jobs voluntarily due to low wages and wage arrears. In 2002 the number of part-time jobs also increased by 24.7% compared to 2001. The number of unpaid furloughs was increased by 10.7%. As a result since August 2002 we have been observing a steady rise of official unemployment. At the same time the number of vacancies dropped. It is especially difficult for women and youth to get a job. More than 60% of unemployed are women and youth in the 20–21 age group. Unemployment is a more acute problem in towns and cities with one big employer and where military units are located. The Brest and Gomel regions are most vulnerable in this respect. Minsk oblast and the city of Minsk are the least effected regions.

As for rural areas, in spite of the wide scale crisis of state collective farming unemployment is not a big problem there. The thing is that for many years a naturalization of agricultural production has been taking place. Rural residents earn income by selling the produce of their household production. They support themselves on their individual lots. Those who have horses and equipment earn income by providing different services for dacha owners and pensioners. Income from kolkhozes and sovkhoses is very low and wages are paid with delays of up to half a year. In fact, employment in the “public production sector” has become secondary employment and a place where pensioners can get some additional income. When budget financing is cut off there will not be a large increase of unemployment in the rural area.

The consequences of tight monetary policy can be expected in other

sectors where 38% of enterprises are loss making. There are even worse cases in branch ministries. Under the supervision of the Ministry of Communication, 62.3% of all enterprises are loss making, Ministry of food and agriculture – 50.7%, Ministry of trade – 40.4%. Unfortunately official statistics do not show how many people work at these loss-making enterprises. Experts believe that most of them are big enterprises where 1.0–1.2 mln. people are employed. Restructuring these enterprises and quick initiation of bankruptcy procedure could lead to soaring unemployment.

There is quite a large potential for unemployment growth among the economically inactive population which amounts to about 700.000 people. Quite a few of these people in new economic conditions (for example if unemployment benefit are raised) will decide to register as unemployed. As a result the budget will have additional liabilities.

Thus the analysis allows us to estimate that the maximum potential unemployment is about 30% of the labor force. That it why it is rational and effective for the economy to bankrupt loss making enterprises especially in small towns during 8–12 months so that the unemployment level does not exceed 16–20% of the labor force.

The experience of transitional countries shows that the transformation of the real sector of the economy leads to considerable changes in the labor market. Administrative regulations and definition of the structure of labor makes things worse and add to social instability. Instead a stimulating environment for small and medium business development and for self-employment should be promoted.

To soften the consequences of economic reforms it is necessary:

- To accelerate the development of infrastructure for SMEs (business incubators, techno-parks);
- Set up a computer system for job search both in Belarus and abroad;
- Liquidate the institute of *propiska* (residence permit) and other administrative restrictions on movement and employment of labor and acquiring real estate;
- Foster the development of private centers for retraining and modification of training programs of specialized technical schools according to the existing demand.

Labor legislation should be reformed along the following guidelines:

- Effective allocation and use of labor resources and strict observation of the rights of both the employee and the employers;
- Increasing the role of individual labor agreements;
- Improvement of court mechanisms to ensure protection of the employee's rights;
- Increasing the role of the wage not just as a reproductive tool but also a stimulating development payment;
- Fostering the development of market mechanisms of labor payment regulation.

Income policy

Alongside with the creation of a system of targeted social aid the state ensures economic freedom for economic entities to stimulate the creation and accumulation of capital. To do that it is necessary to reduce administrative barriers, simplify the tax system, reduce tax rates, stabilize the national currency, create equal economic and administrative conditions for everybody and to foster the development of a system of savings and investment.

Adequate social security policy in this sphere should include:

- Increase of taxes for consumption of low quality hard drinks and cigarettes. It will improve the demographic situation and lowering the burden on state social funds;
- Investment in housing, training and education, job creation by SMEs and contributions into charity funds are freed from income tax payment;
- Free access to the services of foreign charity foundations, humanitarian organizations, no taxes on Chernobyl humanitarian programs and activities that are health-protection oriented.
- Amnesty for income of the population earned 1991–2003 ;
- Reform of the healthcare system.

Today while medical care is declared free the population pays more for medical services than it would spend if there were a market for medical services and if a system of targeted social aid existed. The critical state of the Belarusian health care system requires the creation of a fundamentally different system of medical aid and health protection.

Reform of the health care system will allow the following:

- Make access to health care system much easier for the poor;
- Balance state liabilities with financial possibilities of the budget;
- Ensure transparency and sustainable development of modern medical technologies by means of creating competitive environment in the sphere of medical services;
- Lower costs of administration of the health care system;
- Create conditions for supplying the population with necessary drugs and medicine.

Development of a system of private polyclinics and hospitals, creating competitive environment in the market for health services will help stabilize prices for the population on a level that makes these services more easily accessible. There will be a considerable boost in the motivation of the people to use modern technologies in the healthcare system.

Financing of healthcare system should be done primarily by medical insurance fees. When a deficit occurs, a minimal amount of medical services is still guaranteed by the state.

The healthcare system should ensure an adequate supply of free medical services for the people with low incomes, take preventive

measures against various diseases, lower the child mortality rate and undertake measures that ensure increase life span. The health system should target the protection of maternity and childhood.

To that end the following should be done:

- Provide free consulting services for pregnant women and mothers with small children at home
- Provide free emergency services;
- Create a system of discounts and free drugs for certain individuals who have heart diseases and diabetes etc.;
- Set up a well-functioning system for preventing contagious diseases;
- Ensure financial support of donors,
- Undertake the retraining of doctors and specialists;
- Develop the institution of home doctors.

Policy in the sphere of education and science

The National education system should be competitive and labor market demand oriented. Today the effectiveness of budget investment in education is extremely low. On the high school level and at higher education institutions, corruption and bribery flourish. Parents are made to pay for free education and pay for school repairs. The prestige of teachers is very low and still falling. Belarusian higher educational institutions (HEI) including private ones prepare specialists that are not in demand on the market. Education is human capital investment, an investment in the future.

Revision of the contents of the educational process should accomplish the following tasks:

- Make the curricula of educational institutions less stressful
- Change the methodology of teaching by developing communication skills and ability to independently analyze information;
- Increase the importance of independent work of the students;
- Expand teaching subjects and topics that ensure rapid social adjustment (economics, law, foundations of the political system, management, sociology);
- Ensure good command of at least one foreign language;
- Switch on to international standards of education at all levels, to ensure international recognition of Belarusian documents on graduation from educational institutions.

State investment in education should be done in two ways:

- Creation of a data base of educational institutions, modernization of equipment based on number of students and pupils;
- Support of students from low income families and assistance to gifted children and youth (in the form of targeted subsidies from local and national bodies of power).
- Higher educational institutions and schools should be more independent. Which means

- No discrimination against form of property in budget funds distribution;
- Transparency of money flows in educational institutions via setting up supervisory boards, organizations that control state educational institutions etc
- Contractual relations between the state and private clients and with contractors;
- Tax breaks for charities and educational system investors;
- State accreditation and independent system of quality control of education;
- Expanding the rights of educational institutions to manage their financial resources with the participation of supervisory boards.

To ensure access to elite education, children from low income families and orphans should be guaranteed up to 20% of the places in educational institutions, provided they finish high school with all As. In addition the universal character of education means the following

- A rise of student scholarships to the level of the minimal consumption budget;
- Raising standards of transparency of entrance exams to higher educational institutions (setting up an independent testing service, reduction the number of oral exams, national educational institutions monitoring and control over procedures of entering HEIs.

The modern model of national education should meet the following criteria:

- Optimal combination of various forms and kinds of educational institutions;
- Continuity of education, integral interconnection of various levels of educations;
- Development of national cultural and regional peculiarities of education while keeping state standards and the achievements of the world culture;
- Separation of school from church (the bible is a subject studied according to the decision of parents). Different religions have the right to set up their own schools;
- Existence of a system of self government in higher educational institutions and broad autonomy of universities. Elements of self-government at the high school level are parent supervisory committees that have the right to control the activities of the school administration;
- Development of cooperation with foreign educational institutions.

One of the priorities of the state policy in the sphere of education should be creation of opportunities and conditions for citizens to improve their skills and to educate themselves. It will accelerate the process of adjustment to changes in life. The state should stimulate efforts of non-government and professional associations, companies, enterprises and individuals in carrying out educational and training programs.

In the sphere of science the state policy should be aimed at support of leading scientific schools that work in competitive environment. While science is getting more and more commercial the priority of the state should not just be support of applied research that is a private consumer oriented, but fundamental research and research connected with the cultural heritage of the nation.

Scientific research financing should be done through three channels:

- Budget financing of state orders for fundamental and applied research;
- Budget grants for the National Academy of Science that are received in open transparent tenders;
- Orders and grants of economic entities, NGOs and foundations of individuals. The contributions of enterprises, culture and education are freed from taxes and other fees.

Keeping a national identity in multiethnic Europe requires the particular attention of the state in the sphere of development of the Belarusian culture. These measures also provide for expanding the use of the Belarusian language, which will make Belarusian society more stable in an environment of globalizing world cultural and information processes. The task of policy in the sphere of culture is to understand the historical differences in the context of European and world cultural development and adjustment of Belarusian cultural achievements to European values.

Pension reform

Carrying out pension reform is an obligatory element of the social policy. As the demographic situation in Belarus is getting worse, people are getting poorer and expenditures of the pension fund are rising, carrying out pension reform is an economic and social necessity. The pension system should encourage people to earn more and to save.

Goals of the pension reform are

- Ensuring current financial stability of the pension system in the deteriorating demographic situation and negative trends in the labor market;
- Increasing the size of real pensions;
- Restoration of links between the size of the pension and income;
- Raising the credit of trust of the population in the national pension system.

The pension system reform provides for transition to a three tier system. The first tier is an obligatory minimal state old age pension which is paid to every citizen who reaches the age of 62. Revenues from privatization, tax revenues and the obligatory 10 per cent pension tax on all workers are used to pay these pensions. Disability pensions are also a part of this tier.

The second tier is the obligatory pension that is paid from an individual pension account. The size of the monthly payment is 10% of the wage. Transition to the private pension fund and opening of the individual pension account is voluntary for people in the age group from 18 to 55.

The third tier is the pension paid by the system of voluntary pension insurance. Payments of citizens into this system in the amount of up to 10% of income are also tax exempt. Employers are also granted the right to maintain corporate pension insurance for their employees.

The old pension system and its obligations for pensioners and people over 55 years old remain valid. People in the age group of 18–55 get state pension bonds. The fiscal amount of these bonds depends on the size of contribution into the State social security fund. People who enter the labor market are obliged to open an individual pension account in one of the private pension funds.

5.8.3. Possible spheres and forms of assistance of international organizations in carrying out social security reforms

For the last 12 years countries of Central and Eastern Europe (CEE) and EBRD, IMF and the World Bank along with dozens of think tanks all over the world have accumulated a great deal of experience on how to move from a centrally planned economy to a free market. All countries have made some serious mistakes, the consequences of which have been lasting. There is not a single country in the world whose experience could be mechanically applied to Belarus if we want a positive outcome of reforms. Moreover policymakers of Poland, Estonia and Russia cannot advise copying their way to a free market. Many policymakers of these countries evaluate their own experience as not quite successful.

Almost all countries noted that social security reform is a reform of the second order which should be started after liberalization, privatization and formation of new institutions. As a result of this methodological mistake, the social sphere was viewed by politicians as secondary, one that required just partial financing and attention. At the same time many countries in different periods of their history had quite a few positive results in their social security reforms, Chile, New Zealand, Estonia, Hungary and other countries among them. International organizations that work practically in all transitional countries have a unique opportunity to evaluate the quality of concepts and programs of reforms and the practical experience of their implementation. IMF, World Bank could invite to Belarus experts who worked with similar reforms in other countries. Their knowledge and participation in the social security reform in Belarus will help build up trust in Belarusian policy makers among foreign investors and will ensure the formation of a positive image of the government of

reformers in Belarus, which is important for the sustainability of reforms.

Donor support of social security reforms will be provided in the following major areas and projects:

1. Concepts and programs of various reforms will be expanded and completed. Intellectual potential will be concentrated to complete the drafting of the following:

- Pension reform,
- Healthcare system reform,
- Labor market reform, youth and the unemployed integration into labor and modern society,
- Educational system reform.

To draft the above-mentioned reforms four working groups will be financed. Each group will consist of 5 experts. As a result draft laws in the framework of the four reforms in the social sphere will be prepared and presented.

In the pension sphere

- a) Law “On state pension system”,
- б) Law “On individual pension accounts system”
- в) Law “On investment of funds of the private pension system”

In the healthcare sphere

- a) Law “On state healthcare system”
- б) Law “On private health insurance system”
- в) Law “On development of competition in the healthcare system;

In the sphere of labor market development

- a) Law “On status, rights and obligations of the unemployed”;
- б) Law “On public works”;
- в) Law “On registration and liquidation of commercial and public organizations”;

In the sphere of education system reform

- a) Law “On primary education”
- б) Law “On secondary and professional specialized education”
- в) Law “On higher education”.

These laws should clearly define the rights and obligations of founders of educational institutions, teachers and the state. They should free the teacher from bureaucracy and enable him or her to concentrate rather on creative work than on making reports and filling out forms.

On the other hand it is necessary to clearly define the mechanisms of financing schools and to grant teachers more authority over the teaching process. Laws should establish rights of parents and Supervisory Parent Boards and also modify the role of district and regional state structures that supervise activities of educational institutions.

2. Formation of a group of international experts to carry out analysis of concepts and programs. This group will work out recommendations

for the final version of the concepts. Each draft concept will be given for analysis to two experts. Later they will take part in working out the final versions of these concepts. This work should last 6 months.

3. Publication of four concepts in the social sphere. 2000 copies of each book will be published. They will include articles and materials that can be used for promotion of ideas of the four reforms in the social sphere.

4. Four conferences in Minsk and one conference in each regional city will be held. Representatives of the authorities, experts, political parties, interested organizations and donors will be held.

5. Carrying out of a campaign in the press to discuss the concepts in mass media. One seminar in each city will be held in order to enable authors of the reforms and international experts to explain to local powers, trade unions and influential NGOs the essence of reforms.

6. Making programs of concrete measures to be taken within the framework of each reform. Sources of finance, time and other logistical and administrative issues will be defined and described.

7. Working out and passing the normative act on the structure that will license and monitor both state and private higher educational institutions.

8. Providing technical assistance to set up private pension funds, assistance in opening individual pension accounts. 2–3 international experts will be employed in Belarus during a period of two years. Western partners will make regular visits to Belarus to monitor and fine tune the reforms under way.

9. Technical assistance will be provided to set up an Agency for Private Pension Funds Supervision which will monitor activities of private pension funds. This body is to control how pension funds perform and meet standards and criteria of the law on investment of pension assets.

10. Loans to make current pension payments will be given in case there are temporary problems with cash flows to the State Pension Fund.

11. Training employees of state bodies and private pension funds.

12. Software for the pension system that meets its requirements (registration of pension accounts, contributions and interest etc.);

14. Providing technical assistance for opening individual medical insurance accounts. 2–3 foreign experts will work in Belarus for 2 years. Foreign partners in Belarus will make regular visits to monitor development of the situation and make possible corrections into the program of reform.

15. Technical assistance to arrange activities of private insurance companies will be provided. Special attention will be paid to interaction between suppliers of medical services and state bodies in terms of compensation for the services to citizens within the state guaranteed minimum. The size of the contribution to the individual medical

account by the individual and the state will be defined. Legislation that will create competition in the sphere of medical sphere will be drafted.

16. Loans to life and health insurance companies will be provided.

17. Training employees of state bodies and insurance companies will be arranged.

18. Working out and installation of the software that is the basis of the database for the new medical insurance system.

19. Technical equipment for regional branches of the state medical insurance fund.

20. Drafting and passing the legislation on the body which will issue licenses to the organizations that will provide services in the healthcare system. It should be independent of the state. This body will also monitor activities of both state and private structures of the healthcare system

21. Technical assistance will be provided to set up and to organize activities of the Public Works Fund. The scope of activities of this structure, mechanisms of interaction both with state and private structures will be defined. 2–3 foreign experts will work in Belarus during the period of 2 years. Representatives of donor organization and experts will visit Belarus to monitor the progress of the labor market reform.

23. Belarus will receive a bigger quota for temporary and seasonal employment abroad. This will be achieved in the process of negotiation with EU, CIS countries and the USA.

24. Setting up and equipping training centers in each district city where city – companies operate (where one company is the major employer in the city). These centers will train workers and get them ready for a flexible labor market. These centers will also employ teachers in demographically problematic areas.

25. A web site of the employment center will be set up. Regular information on the state of the labor market will be published there. International donors will support its activities for 2 years.

26. Providing loans to the government to pay unemployment benefit and social programs financing in case of temporary cash flow problems to the budget or budget deficit.

27. Providing loans to build blocks of flats (condominiums) that will serve as temporary residential facilities to ensure real flexibility of labor when workers that were laid off in one place can move to another and get a cheap place to stay. This measure will help solve the problem of employment in cities with one major employer. These blocks of flats will be built by private companies in regional cities and in Minsk and cities where private companies set up businesses that require the employment of a lot of labor. These blocks of flats will be managed by private companies, which will have individual contracts with all employers. 20 houses are to be built all over the country.

28. Regional centers for specialized training of high school children and school graduates will be supported by international organizations. These centers will also provide psychological support for youth in the region.

29. Technical and intellectual assistance for preparation of modern high quality textbooks for primary, secondary schools and higher educational institutions will be granted. Textbooks on the following subjects will be prepared: "Environment and Human Beings", "Basis of Economics", "Introduction to Political Science", "World Literature", "Modern Art", etc. The task of this particular project is to lay the foundations of a democratic, market perception of the modern world from the primary school. Another task is to inform children about real history, allow them understand cause and effect relations of the modern world. These textbooks should help school children to navigate easily in complex modern life.

30. Opening a computer class in every high school and equipping it with modern computers that will have free Internet access.

31. Setting up a school network Intranet which will be an information source both for teachers and children. This network will also be used for distance learning, consultations and implementation of modern didactic methods.

32. Buying school buses to bring children to school from distant villages. These buses will be leased by individual entrepreneurs. Transportation services will be delivered in a competitive environment.

33. Financing programs (in private training centers) to train teachers of primary and secondary schools (in regional cities and in Minsk). Regular seminars, summer schools during school vacation will be carried out with the assistance of international organizations.

34. Scholarships for gifted children to study at universities will be granted. Criteria for giving scholarships will be worked out by a joint group of Belarusian and foreign experts.

35. Scholarships to study at the best international universities will also be provided. In this way high skilled professional will be trained to work in Belarus in the sphere of state administration, law enforcement, education and healthcare.

36. Modern courses on various subjects will be prepared (textbooks, didactic and methodological materials) for higher educational institutions (political science, sociology, economics, history of economic science, foundations of market economy, marketing, applied psychology, jurisprudence and international law).

37. In case of cash flow problems loans will be given to repair schools and install energy and fuel saving heating systems.

38. Modernization of village and town libraries, buying new books for them.

39. Grants will be given to ensure information support of reforms in the social sphere. This money is given to private national and local

newspapers. Special attention should be paid to interaction between people and government officials.

40. Preparation and publication of information brochures. They should explain in plain language the essence of pension, healthcare, education and job market reforms. The following handouts will be prepared and published: (2–4 pages each): “Your pension. Pension reform – guarantee for a well-off old age”, “Your health. How to get medical services after the reform of the healthcare system”, “Your education. School reform – enlightened way to the future”, “What you should know about the labor market”, “What you should do to find a new job”, “Citizen and state: partnership in the social sphere”.

41. Preparation and launching TV projects (analytical programs, talk shows, interviews with reformers etc.) to explain the essence of social reforms. The task is have trust to a) ideology of reforms, b) people who make programs and carry out reforms and c) to structures that are intellectual centers where concepts and programs of reforms are drafted.

42. Preparation of detailed plans which describe all stages of reforms. They will state why they are launched, who benefits from them, who pays for them and what the outcome of the reforms will be. These materials will be prepared for state employees who will work on the reforms in practice and monitor their progress. Another important task is to get the nomenclature to support social reforms.

43. Legislation on the administration of social infrastructure (kindergartens, spas, summer camps, hospitals and cultural establishments), which should be the responsibility of local bodies of power and not of industrial enterprises.

44. Technical support to administer the process of property transformation on the local level (object of social infrastructure). 7 experts will be invited to Belarus (one in each region and in Minsk) for one year. They will arrange training courses for employees of district and regional executive councils and committees. State officials will be taught how to transfer property from enterprises to municipalities.

45. To audit and analyze the state of social infrastructure. Each social object will have its own set of technical documentation to determine the amount of technical and financial assistance and what personnel are required to manage these objects in the new market environment. Social policy will be effective and efficient if a competitive environment in the social sphere (creation of private institutions in the sphere of education, healthcare, pension and job market) is supported by the state and international organizations.

