



REPUBLIC OF BELARUS

SELECTED ISSUES

December 2017

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SELECTED ISSUES

November 29, 2017

Approved By
European Department

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EXPORT DIVERSIFICATION AND TRADE BARRIERS¹

International experience suggests that greater export diversification² is associated with higher incomes and resilience to shocks. The paper considers the relatively low level of diversification of Belarusian exports relative to peers, and barriers to higher export potential. Belarus faces different trade regimes vis-à-vis its largest trading partner, Russia, in the framework of the Eurasian Economic Union (EEU); and its second-largest, the European Union (EU). The paper discusses tariff and nontariff barriers within the EEU; the more restrictive trade relations with the EU; and other potential barriers to trade, including logistics and limited trade facilitation. WTO accession would help improve export competitiveness. Further EEU integration could also boost trade potential, but with the attendant risk that trading links become more concentrated rather than diversified.

A. Introduction

- 1. Export diversification is associated with higher living standards and greater resilience to shocks.** A large cross-country empirical literature has found positive relationships between diversification and both income levels and the likelihood of export accelerations, and between export concentration and growth volatility.
- 2. Belarus's economy is relatively undiversified, especially relative to its current income level.** Belarus is an upper-middle income country, and since independence has experienced periods of strong growth, notably in the mid-2000s. But it remains dependent on a relatively narrow set of exports and trading partners. This leaves Belarus vulnerable to shocks affecting these markets and partners—as evidenced by the recent combination of shocks to fuel and potash prices, and to its largest trading partner, Russia. The Belarusian authorities have for some years publicly sought to promote greater diversification, targeting more even shares of exports to Russia, to the EU, and to the rest of the world; the ongoing challenge is the consistency of other policies with the diversification goal.
- 3. This paper is set out as follows:** Section B reviews the pattern of Belarusian exports and key metrics of export diversification, as well as international evidence on the implications of export diversification. Section C discusses barriers to trade, and other barriers to firm entry and to participation in global value chains (GVCs). Section D outlines the authorities' strategy to promote export diversification. Section E considers policy implications.

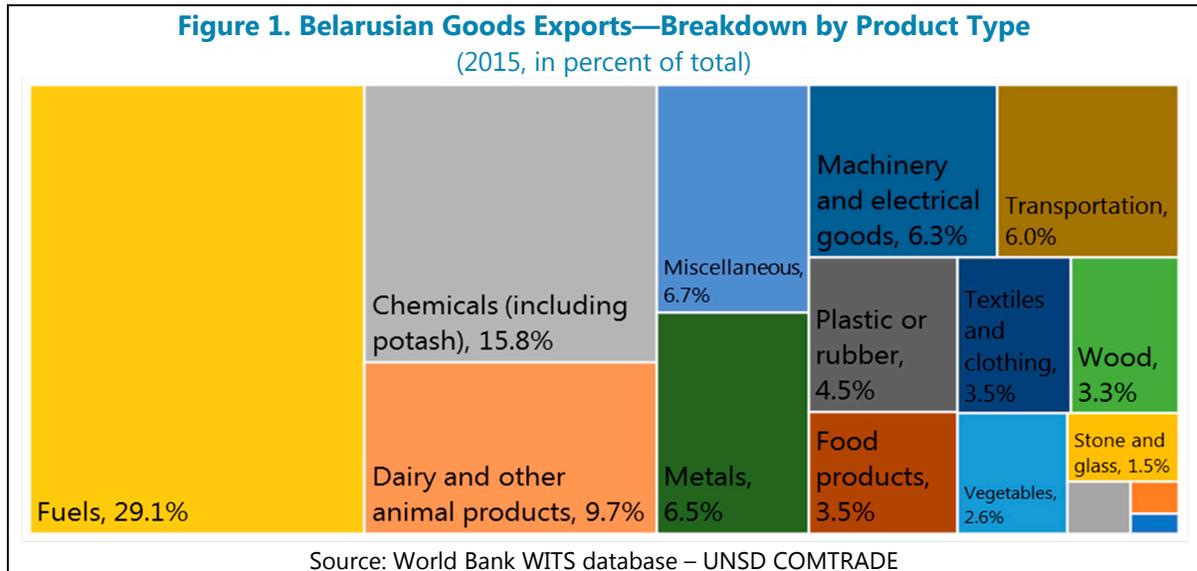
B. Belarusian Exports: Assessing Concentration

- 4. By product type, Belarusian goods exports are relatively concentrated in petroleum products and potash** (Figure 1). In 2015, nearly half of exports were accounted for by petroleum

¹ Prepared by David Moore.

² Export diversification—and its inverse, market concentration—relate to the structure of a country's exports, and can be defined in terms of export *products* or export *destinations*.

products (around 30 percent of the total), and chemicals (15 percent, mainly potash). Diversified agricultural and manufacturing products account for the remainder of goods exports.



5. Belarus’s largest revealed comparative advantages are in areas where it is difficult to move into new products. Figure 2 indicates significant comparative advantages in fertilizers (potash), a long-standing area of strength; mineral fuels; and dairy products, where exports grew substantially between 2005 and 2015. These specializations are in peripheral areas of the “product space” (Figure 3), a map between sectors based on the Hidalgo-Hausmann concept of how knowledge and techniques can be transmitted from one sector to another. Economies specializing in products that are tightly connected in the core of the product space find it relatively easy to shift from one product to another.

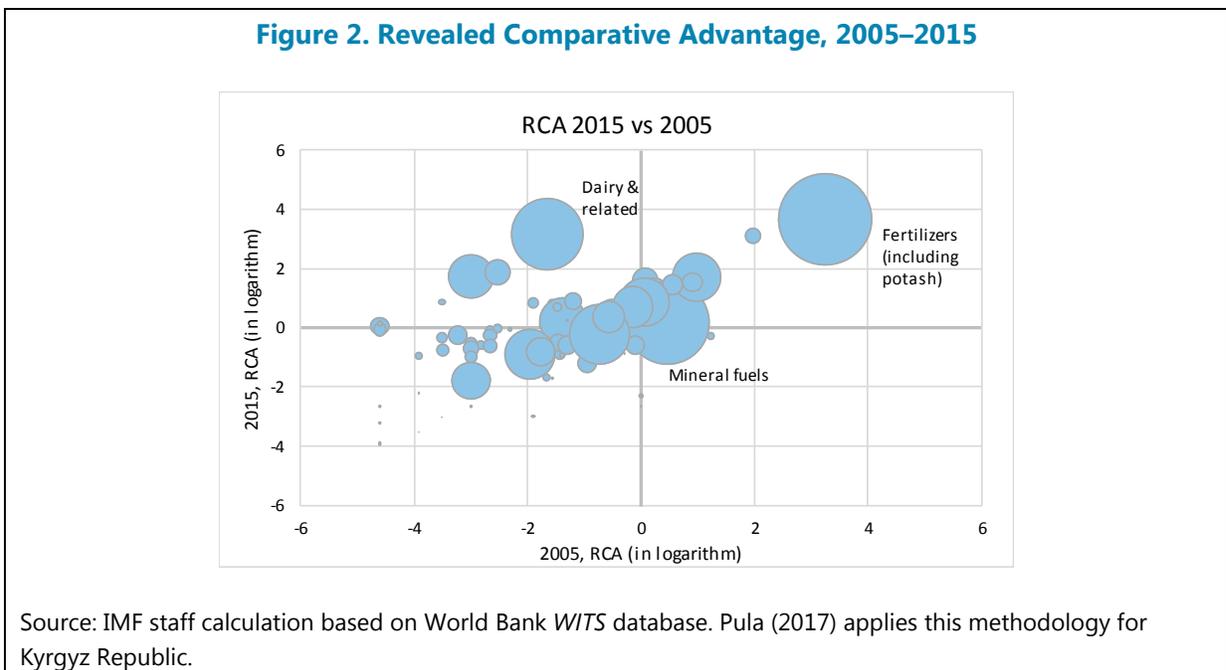
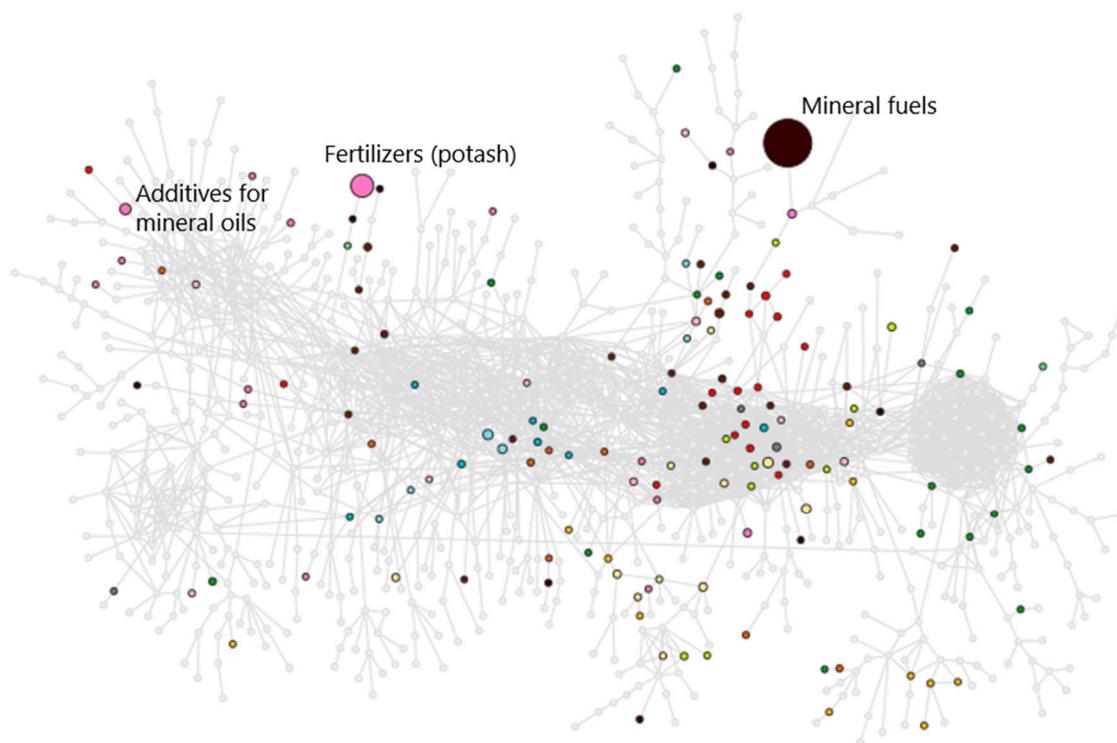


Figure 3. Product Space, 2015

Source: Atlas of Economic Complexity, <http://atlas.cid.harvard.edu/about>

Colored dots indicate export products where Belarus has a revealed comparative advantage

6. Yet export quality has been high. The IMF's index of export quality³ (available to 2010) indicates Belarusian export quality in line with central and eastern European comparators, and substantially above EEU peer countries (Figure 4). Similarly, estimates of "complexity"⁴ by Hausmann, Hidalgo et al. (2011) indicate that Belarus produces a relatively sophisticated (complex) set of exports given its income level (Figure 5)—but also, conversely, underperforming income relative to export complexity.

7. Belarusian exports are also concentrated by destination market.

- Belarus's main export market is Russia, which accounts for around 40 percent of total exports—and a dominant share of diversified-product exports (excluding petroleum products and potash).

³ Henn, Papageorgiou, and Spatafora (2013) derive export quality from observed unit values (average trade prices for each product category), adjusted by gravity equations specified for each of the 851 distinct products in their large dataset.

⁴ Hausmann, Hidalgo et al (2011) define their Economic Complexity Index as "a measure of how diversified and complex a country's export basket is. It is calculated as the mathematical limit (eigenvector) of a measure based on how many products a country exports and how many other exporters each product has."

- The EU is Belarus’s second-largest regional partner, and accounts for around a third of overall trade. The EU is a market for refined petroleum products and other exports.
- Ukraine has also been a significant partner, accounting for 10 percent of Belarusian exports—mainly of petroleum products.

Figure 4. Belarus and Selected Countries: Export Quality, 2010

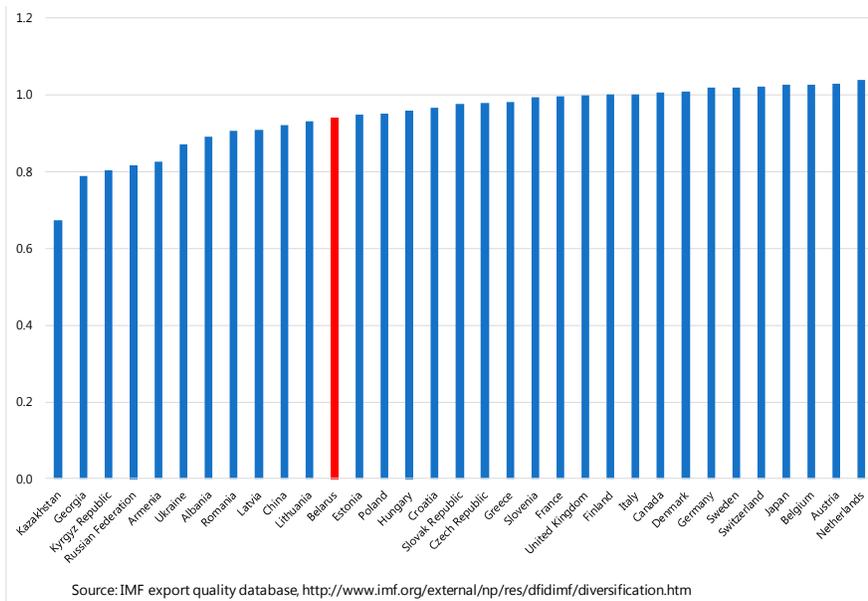
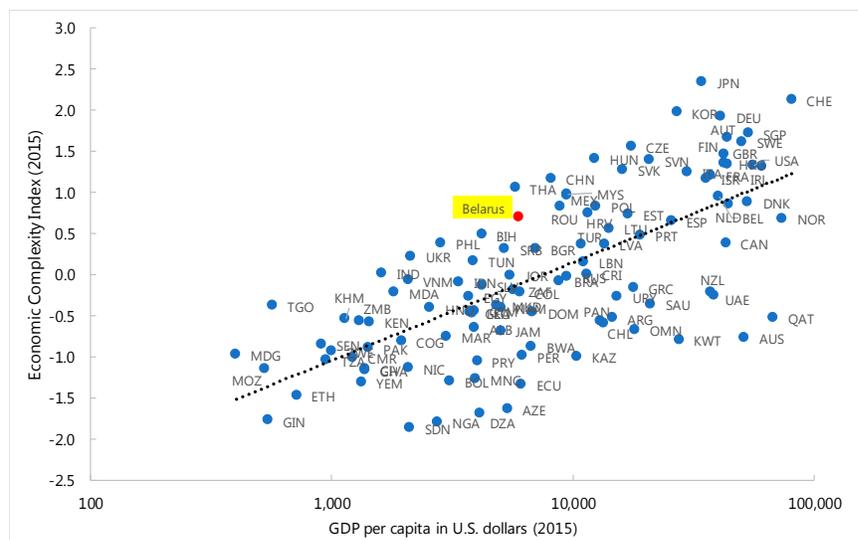
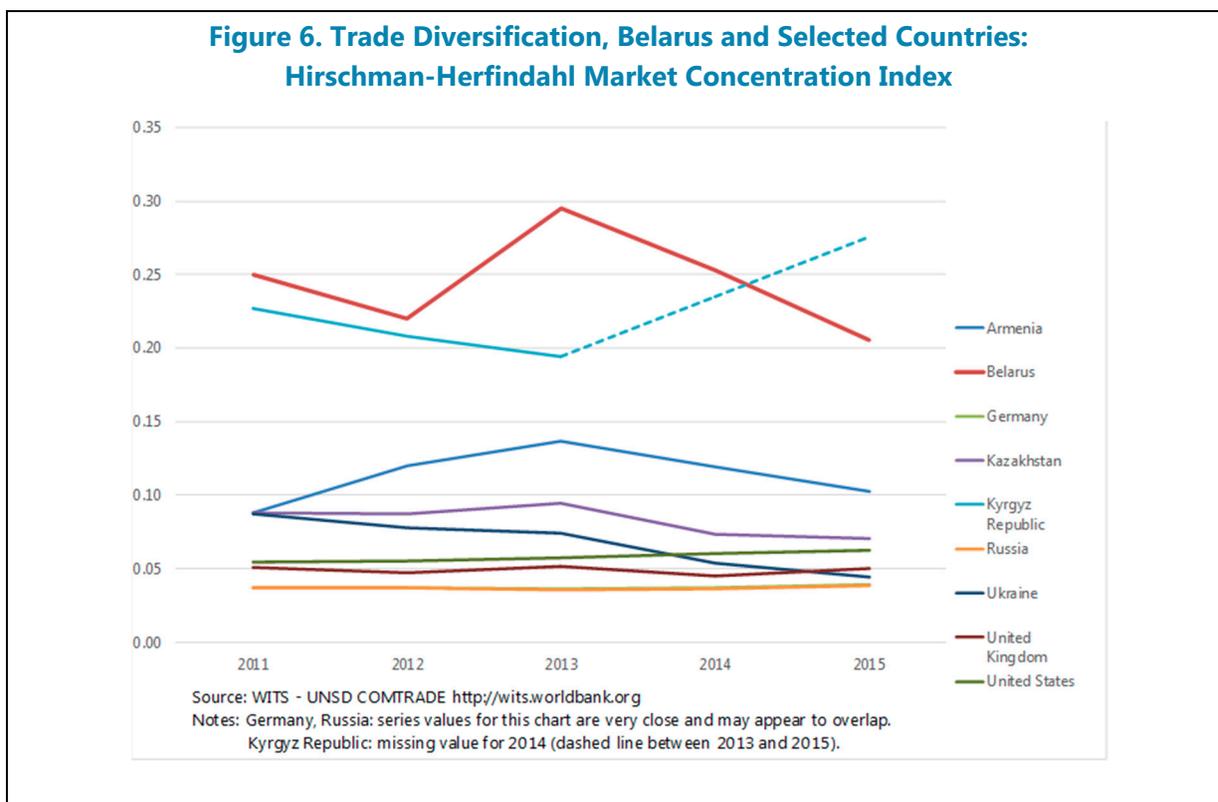


Figure 5. Economic Complexity and GDP Per Capita



8. Belarus's trade patterns are significantly more concentrated than those of peer countries. The Hirschman-Herfindahl market concentration index (Figure 6) indicates that Belarusian trade has been significantly more concentrated over time than trade in large-country comparators including Russia and Kazakhstan—which, like Belarus, are members of the Eurasian Economic Union (EEU)⁵—as well as Ukraine. Market concentration indices are lower for more advanced economies. However, market concentration for Belarus is comparable to that of the Kyrgyz Republic, another EEU member.



At first glance, limited export diversification, and high complexity relative to income (when complexity is itself a function of export diversification), may seem contradictory. But this reflects a situation where, for export products that are diversified, the destination market is not (i.e., the diverse export products go mostly to one destination, Russia); while at the same time, where export destinations are diversified, the exported products are not.

⁵ EEU members include Belarus, Russia, Kazakhstan, Kyrgyz Republic, and Armenia.

Box 1. 2017 Energy Financing Agreement with Russia

The integration agenda of the Eurasian Economic Union (EEU) includes energy markets. EEU countries have announced their intention to create a common electricity market by 2019, and staged integration of the oil and gas markets by 2024 and 2025 respectively.¹

In spring 2017, Belarus and Russia reached agreement on the following core elements of a short-to medium-term energy and financing deal:

- Russia will continue to make available to Belarus discounted crude oil, in an amount of 24 million tons, contracted annually through 2024.
- Belarus is in the process of modernizing its oil refineries and, according to the Belarusian authorities, its efficient refining capacity is temporarily reduced. On this basis, Belarus will import 18 million tons annually from 2017 until around 2020, which it will refine for export; instead of importing the remaining 6 million, Belarus will receive a transfer from Russia in the form of crude oil customs duties, to compensate for the foregone value added on the refined product. This transfer is expected to be around \$450-\$500 million annually, depending on oil prices.²

Belarus's measured goods exports will thus be lower than otherwise during the period of below-contract volumes of crude oil imports, which implies reduced value-added from refining and exporting. This is distinct from the net impact on the balance of payments, which is offset by the customs duty transfer (secondary income).

- Belarus will continue to import gas at discounted prices from Russia, at a price of \$144 per thousand m³ in 2017 and \$132 per thousand m³ in 2018. In April 2017, clearing a previously disputed debt, Belarus made a lump sum payment of \$726 million to Gazprom Belarus (subsidiary of the Russian-owned parent Gazprom).
- Russia has also supported continuation of financial support through the Eurasian Fund for Stabilization and Development (a \$2 billion package over 2016–18), and in September 2017 directly provided to Belarus a \$700 million refinancing loan.

¹ Pastukhova and Westphal (2016) provide an overview of EEU energy market integration plans.

² Belarus also collects customs duties on exports of petroleum products refined and exported from Belarus using Russian-source crude oil, based on export duty rates applying jointly in Belarus and Russia. Belarus faces a decline in this revenue source as Russia's "tax maneuver"—shifting from oil export duties to a mineral extraction tax—progresses. However, the pace of the tax maneuver remains

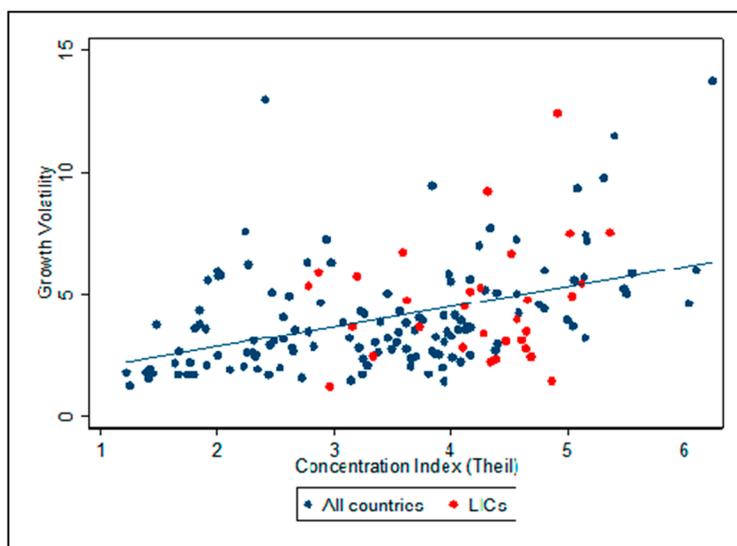
Box 2. Diversification and Growth: International Evidence

International evidence on policies to sustainably boost exports offers lessons for policy design. These studies, including large-sample panel data set studies, consider a variety of structural factors beyond traditional macro and trade policies. Some key results include:

Export accelerations: Cerra and Woldemichael (2017) study the Latin American experience to explore factors behind export accelerations. Diversification and lower average applied tariffs are both associated with higher probabilities of export accelerations. They find strong evidence that participation in global value chains (GVCs) is a critical trigger for export accelerations, driven by growth in foreign value-added content of exports. This highlights the importance of FDI in underpinning higher exports. Cerra and Woldemichael also find a stronger role for real exchange rate depreciations in Latin America relative to a worldwide sample.

Diversification and resilience: IMF (2014), in a LIC-focused analysis but with broader lessons, finds that higher export diversification is associated with lower growth volatility. The link emerges more clearly in the context of diversification “spurts,” which occurred most frequently in the 1960s and 1990s and were evenly distributed across regions, albeit longer lasting in the Asia-Pacific region.

Export Diversification and Growth Volatility, 1962-2010



Source: IMF (2014).

Barriers to trade: IMF (2017) finds several structural factors inhibiting Latin American trade: quality of infrastructure and transport services, availability of ICT, and customs procedures that are more burdensome (as measured by the World Bank’s Logistics Performance Index) in Latin America than in other emerging market regions.

Reforms and growth: Prati, Onerato, and Papageorgiou (PAP, 2013) analyze a 90-country data set over 1973-2005. They find evidence that real and financial sector reforms are positively associated with higher growth, though this relationship weakens for countries far away from the technological frontier. PAP note that the data are heterogeneous and caution against focusing only on average results, which may mask the impact of “botched” reforms that led to growth disasters.

9. The degree of export market concentration implies several sources of vulnerability.

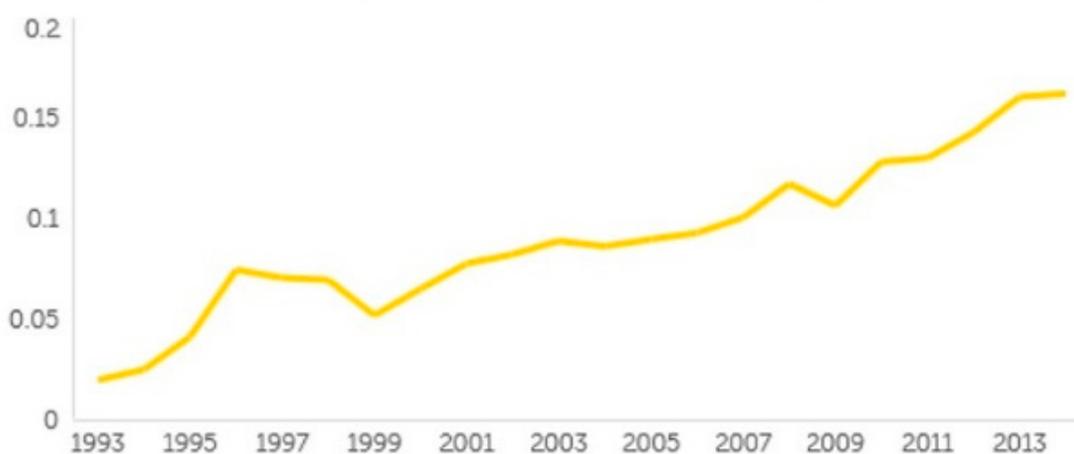
While lower degrees of concentration (and higher diversification) are associated with lower growth volatility (Box 2), Belarus instead is vulnerable to a number of risks, several of which materialized in the past three years:

- a growth slowdown or recession in Russia through the trade channel;⁶
- disruptions to the energy market, including volatility in pricing (Box 1); and
- falls in the price of other key exports—potash prices fell by 36 percent in 2016, leading to a loss of more than 1 percent of GDP in export earnings.

10. The services sector, which has a larger private share of ownership, is increasingly important.

The sector developed from a minimal base in the 1990s, and has since expanded steadily, despite a setback in the recent recession. Services credits (in the balance of payments) increased from 8 percent of GDP in 2010 to 14 percent in 2016, and have also increased in terms of world market share (Figure 7). The IT sector has grown especially rapidly: its share of services credits increased from 8 percent in 2010 to 17 percent in 2016. Central bank data indicate differences in trading partners for services compared with goods: around 41 percent of services exports in 2016 were to the EU, and 24 percent to Russia.

Figure 7. Services Exports
(In percent of world service exports)



Source: IMF *International Trade in Services* database

11. Belarusian enterprises so far are limited participants in GVCs. The available data have important limitations: the most comprehensive available source that includes Belarus, the EORA database, runs to 2013 and covers goods but not services. With that caveat, Belarus is largely unintegrated in forward GVCs, i.e. where Belarusian enterprises supply intermediate goods and services used in other countries' exports. An OECD (2015) study measures much higher backward

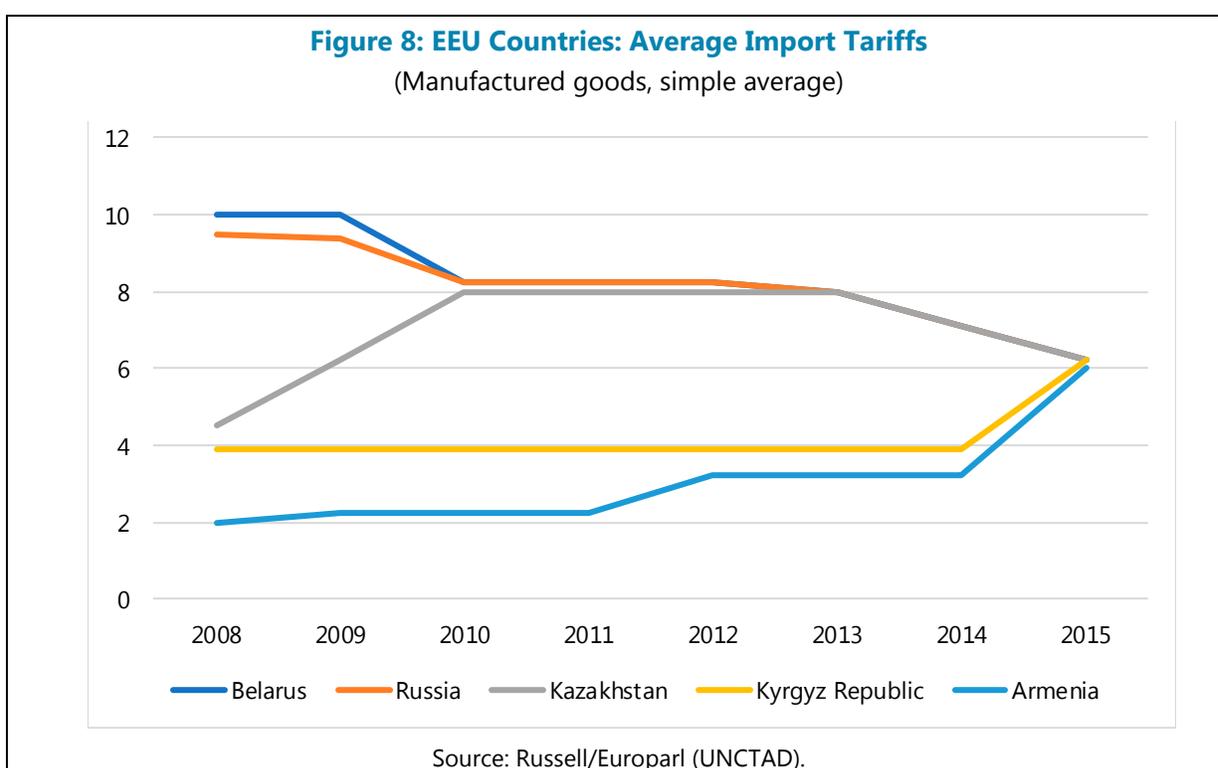
⁶ Stepanyan et al. (2015) analyze the trade, remittance, and financial spillover channels from the Russian growth slowdown to CIS and other countries.

participation—where foreign goods and services are used as inputs into the country’s own exports—but reflecting the dominant role of energy exports (consistent with relative lack of diversification).

C. Barriers to Trade

Tariff and Nontariff Policy Barriers

12. Belarus has lowered tariffs in recent years, including in the framework of the Eurasian Economic Union (EEU). The 5-member EEU has applied in principle a common external tariff since 2015.⁷ Belarus has progressively reduced its average tariffs on manufactured goods, consistent with convergence to the common tariff (Figure 8). The EEU tariff currently remains significantly above EU tariffs but further reductions are pending by end-2019, in line with World Trade Organization (WTO) accession commitments of Russia and Kazakhstan.⁸



13. Within the EEU, nontariff barriers (NTBs) nonetheless remain significant. NTBs include a mix of safety and hygiene measures, technical barriers to trade, and other policy interventions including price controls, marketing restrictions, and subsidies.⁹ Based on a large survey of enterprises, the Eurasian Development Bank (2015) estimated moderate NTBs between

⁷ In addition, an EEU-level customs code is scheduled to take effect from 2018.

⁸ See for example https://www.wto.org/english/news_e/news11_e/acc_rus_10nov11_e.htm

⁹ Russell (2017) notes a tightening of restrictions in 2016-17 on Belarus’s meat and dairy exports to Russia.

Belarus and Russia, equivalent to around 6 percent of export value; but higher NTBs between Belarus and Kazakhstan (around 16 percent). Vinokurov (2017) finds that Belarus would benefit the most from a reduction in NTBs, since the largest beneficiaries of NTB reduction would be manufacturers of machines and equipment—where Belarus has a comparative advantage—but for which NTB-related costs are highest. Subject to EEU consensus, NTBs could be reduced over time though would be hard to eliminate.

14. Belarus is not yet a WTO member. All other EEU countries are now members, leaving Belarus at a competitive disadvantage for exporting to non-EEU countries (see SM/16/244). Belarus has reactivated its efforts to join the WTO (see below). The World Bank (2015) estimates net welfare gains to Belarus from WTO accession of 8.2 percent of Belarusian consumption, or 4 percent of GDP, in the medium term; it projects expansions in the business services and most manufacturing sectors, albeit with declines in the transport equipment, leather and footwear, and pulp and paper sectors.

15. Trade relations with the EU—Belarus’s second main trade partner—are still covered by a pre-independence framework. In the absence of a subsequent bilateral agreement, trade relations remain subject to the 1989 Trade and Cooperation Agreement between the then European Community and the former Soviet Union.

- Under this agreement, most-favored-nation treatment is the default for trade relations.
- However, the EU can impose country-specific measures on Belarus, which is *not* a WTO member. The EU recently removed quota limits on textile exports; but has also recently imposed duties on steel bars (at 12.5 percent).¹⁰

16. Belarus has bilateral trade agreements with several other regional partners. Besides EEU countries, Belarus has bilateral agreements with Azerbaijan, Tajikistan, Moldova, Uzbekistan, Turkmenistan, Ukraine, and Serbia.¹¹ In addition, the EEU has a free-trade agreement with Vietnam.

Logistical Barriers

17. Indicators of Belarus’s logistics performance show mixed evidence of possible barriers to internal and external trade.

- The World Bank’s *Logistics Performance Index* for 2016 ranks Belarus at 120 out of 160 countries, below Ukraine (80th) and Russia (99th). Belarus scores relatively well on

¹⁰ In addition, in 2007, the EU suspended trade preferences to Belarus under the Generalized Scheme of Preferences (GSP)—available for low and lower-middle income countries—violations by Belarus of International Labour Organisation core principles). However, Belarus is now above the income threshold for which the GSP remains available.

¹¹ Source: http://mfa.gov.by/en/foreign_trade/trade_regime/

timeliness and international shipments. It scores worse on customs, infrastructure, and tracking and tracing.

- Belarus performs significantly better in the Bank's 2018 *Doing Business* survey, ranking overall 38th out of 190 countries (Russia is ranked 35th). The survey reports strong performance on trading across borders, including in terms of time and costs of border compliance. A caveat is that survey results may disproportionately reflect the views of existing, undiversified exporters,¹² which would be consistent with higher barriers for newer market entrants.
- The OECD publishes [trade facilitation indicators](#) for OECD and selected non-OECD countries. Indicators for Belarus are poor by regional standards (Europe and Central Asia).

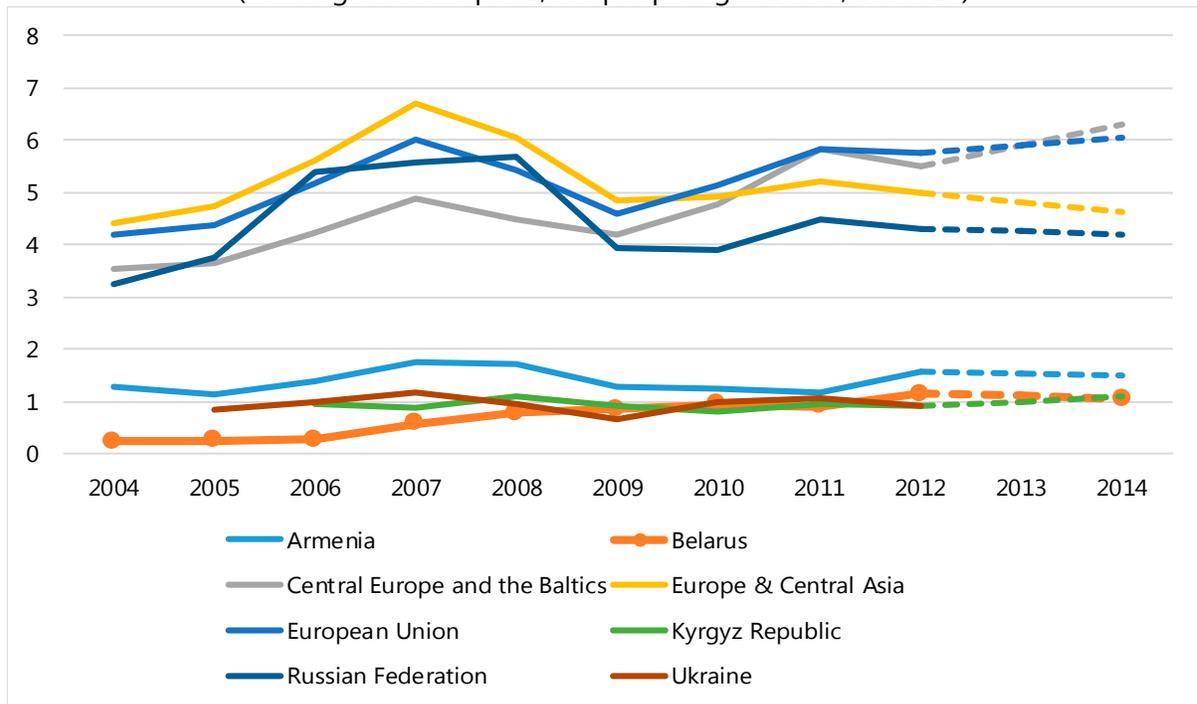
Barriers to Market Entrants

18. Diversification depends on new market entrants. Higher diversification is associated with higher levels of foreign direct investment, which can promote integration into GVCs. So far, new entry of domestic and foreign businesses has been limited:

- The World Bank's Entrepreneurship Survey indicates persistently low levels of new businesses, by both regional and peer country standards (Figure 9).
- Inward FDI has been modest at 39 percent of GDP at end-2016. While this is higher than in some advanced economies, it is low relative to emerging market peers (Figure 10). Moreover, inward FDI is low relative to countries with similarly large and negative net international positions (Figure 11).
- Sources of FDI largely reflect traditional investors (Figure 12). The stock of inward FDI as at end-2015 is predominantly from Russia, which accounts for nearly three quarters of the total (including capital routed through Cyprus), and largely reflects reinvested profits. FDI from China, which is an important lender to Belarus and is currently financing the Great Stone industrial park project, has so far been low.

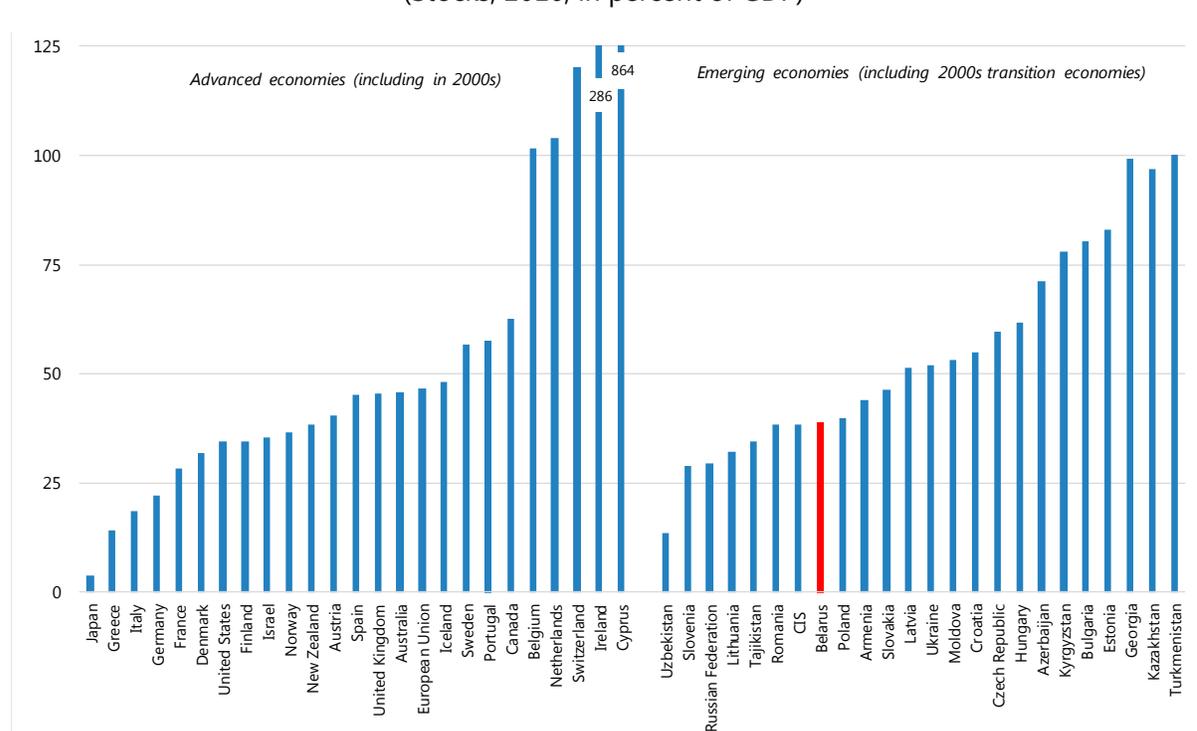
¹² Findings are based on reports from exporters of fertilizers to Brazil, and importers of motor vehicle parts from Russia.

Figure 9. Belarus and Selected Countries: New Business Density
(new registrations per 1,000 people ages 15-64, 2004-14)



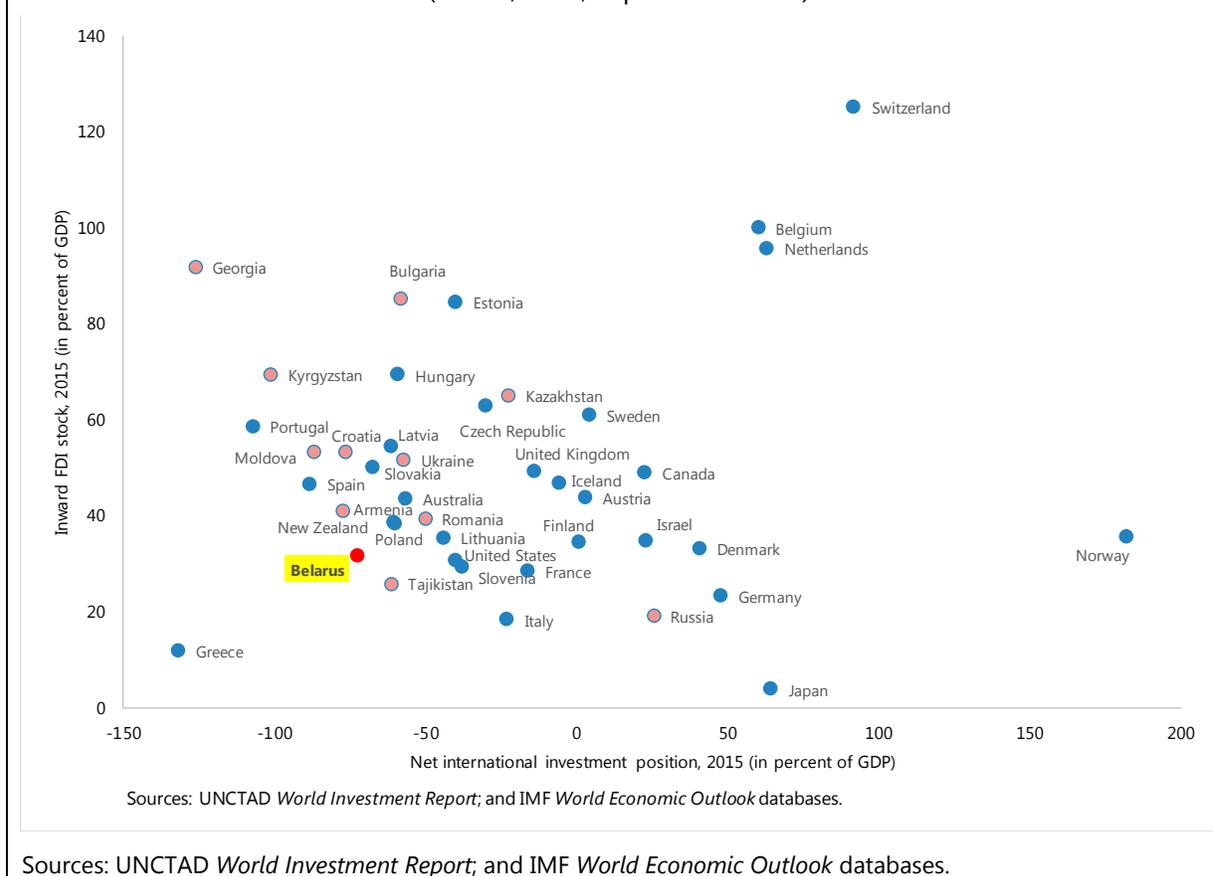
Source: World Bank Entrepreneurship Survey and database. Note: missing values for 2013.

Figure 10. Belarus and Selected Countries: Inward Foreign Direct Investment
(Stocks, 2016, in percent of GDP)



Source: UNCTAD.

**Figure 11. Belarus and Selected Countries:
Inward FDI and Net International Investment Position**
(Stocks, 2015, in percent of GDP)



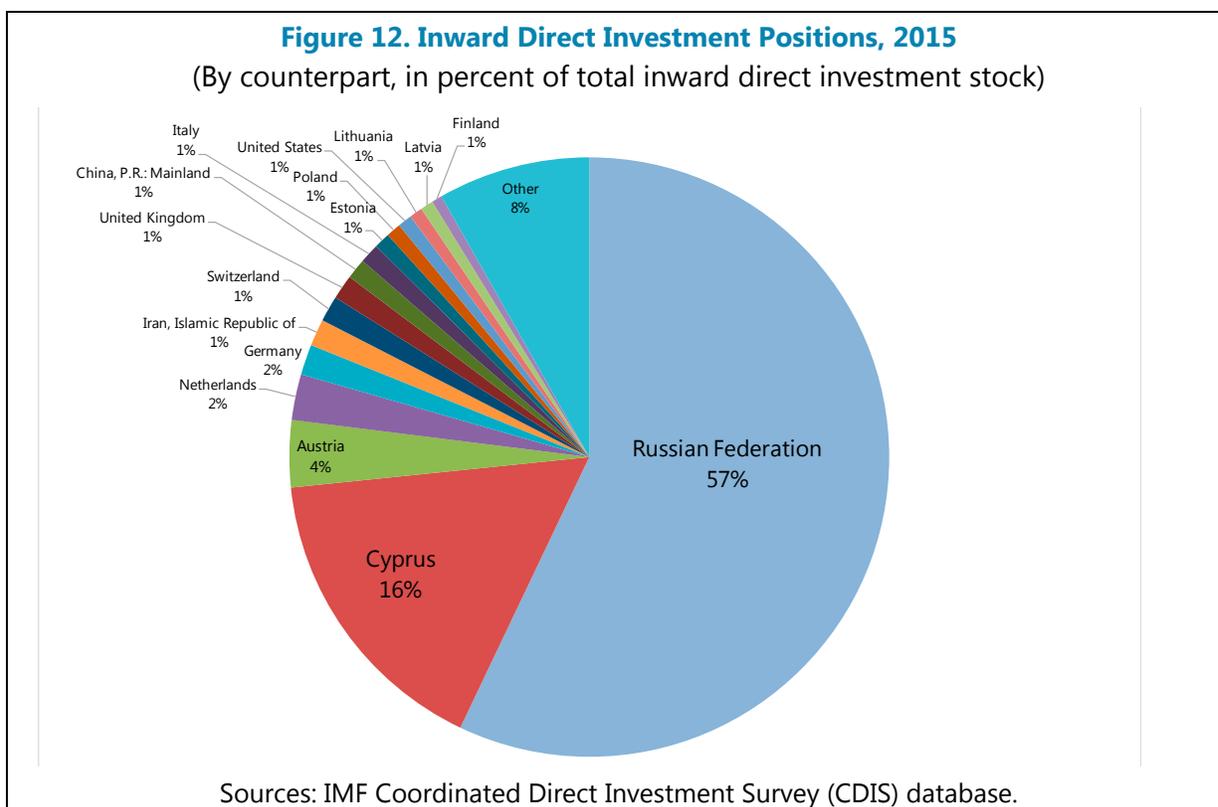
D. Authorities' Strategy

19. The authorities recognize the benefits of increased export diversification. The senior leadership has announced a "one third - one third - one third" target for exports, in which a third of Belarusian exports go to Russia and the EEU, another third to the EU, and the remaining third to other countries. This would entail a significant expansion of exports to the latter two groupings.

20. Belarus, through the EEU framework, is pursuing bilateral trade agreements with third countries.¹³ The EEU and Vietnam concluded a free trade agreement (FTA) in 2015, which took effect in 2016. FTA negotiations are currently in progress between EEU members and Egypt, India, Iran, Israel, and Serbia on goods; and between EEU members and Singapore on goods and services.

¹³ See http://mfa.gov.by/en/foreign_trade/export/diverse/

21. Belarus has renewed its efforts to join the WTO. Two discussions between Belarus and a working party of WTO members took place in 2017. Technical discussions will continue into 2018, with working party members encouraging Belarus to continue pursuing bilateral market access negotiations with interested members.



22. The authorities are seeking to attract new companies at the Great Stone business park now under construction.¹⁴ Great Stone is a predominantly Chinese-financed special economic zone located just outside Minsk. Under the business plan, the park aims to attract 200 high-tech companies and employ over 120,000 people. The park enjoys large tax and customs exemptions.

E. Policy Implications

23. The benefits of export diversification are clear, but will need sustained policy efforts in a number of areas if they are to be realized. While no single element of the following is a panacea, policy priorities that could maximize prospects over time of higher diversification could include:

¹⁴ See <http://www.industrialpark.by/en>

- Continue to pursue WTO accession as a high priority. Potentially difficult discussions with current WTO members may lie ahead on subsidies (including to agriculture) and the role of the state. But an accession deal will be essential to secure long-term competitiveness.
- Seek potential benefits from further EEU integration, including pursuing an agenda to reduce nontariff barriers. But, to guard against the associated risk that this concentrates rather than diversifies exports, this should be part of a wider strategy.
- Continue dialogue with the EU with a view to a more level playing field, creating conditions for a phase-out of quotas and related instruments.
- Proactively address logistical and infrastructural obstacles to new businesses, even if these bottlenecks are manageable for existing businesses.
- Prioritize business environment reforms that bring in new market entrants and promote inward FDI, and ultimately prospects for greater participation in GVCs.

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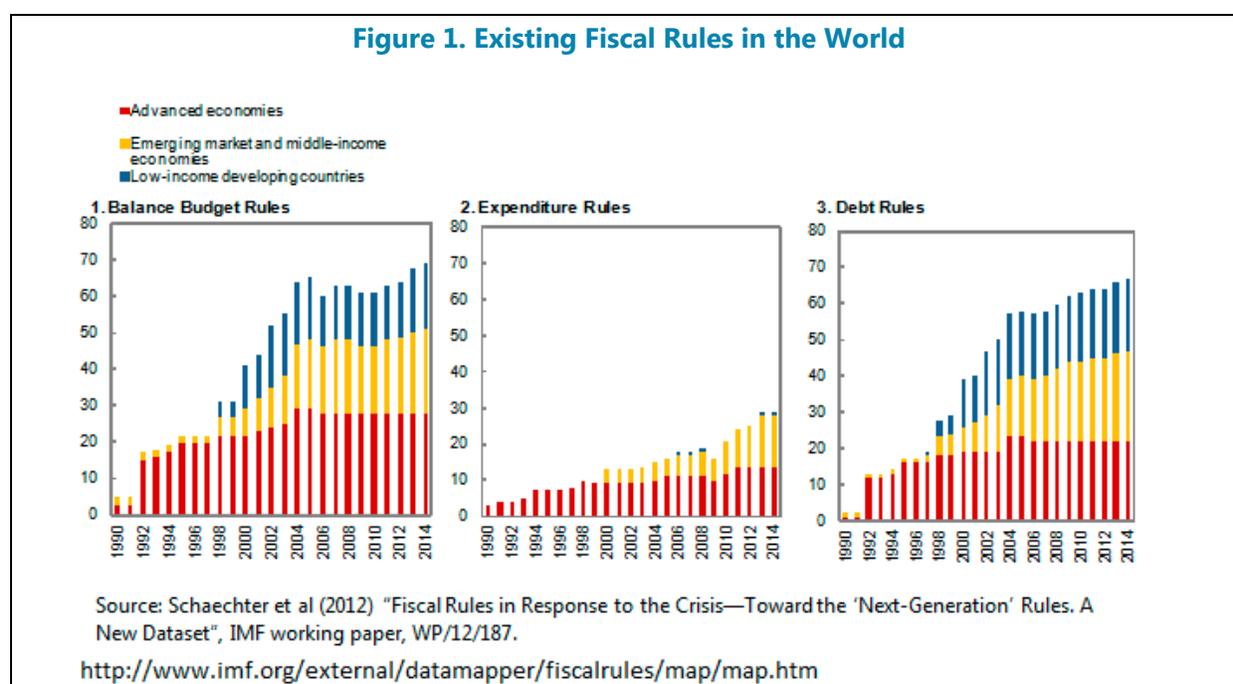
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SUSTAINABLE AND RESILIENT FISCAL RULE¹

A. Introduction and International Experiences of Fiscal Rules

1. A fiscal rule is often in the form of a permanent constraint on fiscal policy through simple numerical limits. The numerical limits are often imposed on budget or debt aggregates over a long-lasting time period with a view to guide fiscal policy. While fiscal rules can serve different objectives, the focus is primarily on promoting fiscal sustainability. Empirical studies suggest that national fiscal rules have been generally associated with improved fiscal performance.²

2. Many countries have adopted fiscal rules, recognizing important beneficial effects. As of end 2015, 96 countries had at least one national or supranational fiscal rule, of which more than half were emerging market and developing economies.³ Countries tend to adopt either deficit, debt, expenditure rules or a combination (Figure 1) to anchor expectations and enhance governments' commitment to fiscal discipline and sustainability. Fiscal rules are particularly beneficial when supportive fiscal institutions operate effectively, and there is the political will for successful implementation.



¹ Prepared by Estelle Xue Liu and Dora Benedek.

² Some references include Debrun, X., D. Hauner, and M.S. Kumar (2008), "Tied to the Mast? National Fiscal Rules in the European Union", *Economic Policy*, April 2008, pp. 299-362.

³ Information from IMF database on fiscal rules. Reference: Schaechter et al. (2012) "Fiscal Rules in Response to the Crisis—Toward the 'Next-Generation' Rules. A new Database", IMF WP/12/187.

3. The choice of fiscal rules depends on each country's circumstances; but some common elements are present.

The first is the need to set a clear objective. Traditionally, rules are introduced to ensure long-term debt sustainability. Second, it should contribute to economic stability by smoothing economic cycles. Third, it should be comprehensive yet simple to ensure broad support and compliance verification by all (politicians, public, and markets). Importantly, it should be resilient to shocks to allow for some flexibility.

4. Existing fiscal rules can be grouped into three main categories, each of which has its benefits and drawbacks.

- Rules targeting budget balances are the most common rules in advanced economies. These rules (targeting overall balances, primary balances, structural balances, etc.) can support debt sustainability, and help with economic stabilization. In addition, they are relatively simple and easy to communicate, and are easy to monitor and implement. However, these rules can lead to procyclical fiscal policies.⁴ Structural balance rules enhance the simple budget balance rule, by accounting for economic cycles.⁵ Yet, inherent uncertainties in estimating potential output and exclusion of commodity and asset price cycles make structural balance rules inadequate to assess the actual underlying fiscal policy stance and difficult to communicate.⁶
- Debt rules are the second most common rules. These rules are theoretically the most effective in ensuring convergence to a debt target and they are easy to communicate. However, debt rules do not provide short-term guidance for fiscal policy because policy slippages, exchange rate and interest rate fluctuation, and budgetary measures impact debt ratios with a lag. An additional operational challenge with debt rules is the difficulty of setting the appropriate debt target.
- Expenditure rules impose caps to nominal spending or real expenditure growth. Relatively easy to monitor and communicate, these rules enhance the stabilization role of fiscal policy by constraining spending during booms, when windfall revenues, particularly commodity-related revenues, are temporarily high, but allowing tax revenues to adjust to cyclical or discretionary changes during downturns. While most cyclically sensitive items are on the revenue side, expenditure rules could potentially constraint automatic stabilizers on the spending side (e.g. unemployment benefits) during downturns. Excluding cyclically-sensitive expenditures from target variables is often discussed as a solution but this may complicate monitoring. By setting spending levels, expenditure rules can also provide operational guidance in choosing fiscal targets. However, expenditure rules alone do not provide a direct anchor for debt sustainability.

⁴ For example, higher revenues during boom years tend to result in higher expenditures under the balanced budget rule, and vice versa.

⁵ Structural balance rule has been adopted in various countries (e.g. Euro area, Chile, Colombia among others).

⁶ Liu, Mattina and Poghosyan (2015) "Correcting 'Beyond the Cycle': Accounting for Asset Prices in Structural Fiscal Balances", IMF Working Paper No. 15/109.

5. The next sections discuss how key elements of the fiscal rules in Belarus could be strengthened, leveraging on international experiences. Rationales are developed for the need of a fiscal anchor and supporting operational rules. The focus is to help make Belarus' fiscal framework more robust to economic cycles and large shocks. This means improving the medium-term fiscal framework, by establishing comprehensive debt anchor and budget balance measures and management of risks.

B. Existing Fiscal Rules in Belarus

6. To improve fiscal management and ensure fiscal sustainability, Belarus established a complex set of fiscal rules: (i) a balanced-budget rule for the state budget⁷—which excludes an ongoing nuclear power plant (NPP) project, extra-budgetary funds, and quasi-fiscal operations (recaps and guarantees); (ii) a medium-term central (general) government debt ceiling of 45 (50) percent of GDP (which includes the NPP and project loans from China,⁸ but excludes guarantees); (iii) at least 50 percent of annual public debt repayments should be covered by non-debt creating sources; (iv) a commitment to use all proceeds from export custom duties on crude oil and petroleum products for foreign currency public debt principal and interest payments; (v) a prohibition on net new issuance of government guarantees on domestic corporate domestic debt. Meanwhile, additional targets are set to facilitate growth, including a five-year moratorium on new taxes until 2020 and a medium-term objective to maintain state tax revenues below 26 percent of GDP.

7. Recent fiscal pressures highlight weaknesses in the existing rules.

- There is no clear relationship among the rules. It is not established whether a balanced budget would help to maintain the debt ceilings. A tax revenue ceiling at 26 percent of GDP could potentially be inconsistent with the budget balance rule and debt ceilings. Public debt management is fragmented, with separate ceilings for debt at the central and local levels and on guarantees.⁹ In addition, different policies are adopted on debt issuance at the central and local level.¹⁰
- Important exclusions in budget balance measures have weakened the rules significantly. Headline state budget balance measures exclude balances from extra-budgetary funds including the social protection fund (SPF),¹¹ NPP expenditures and quasi-fiscal operations

⁷ The state budget includes republican (central) and local government budgets.

⁸ These loans represent significant fiscal risks and should be included in the target. The NPP project, financed by Russia, is estimated to cost \$6-7 billion over 2012-2020.

⁹ Public debt in this paper refers to general government debt and guarantees, including Russian loans for NPP projects, Chinese loans for private business development, and SDR.

¹⁰ For example, local government debt issuance should link to local revenues.

¹¹ Central budget transfer to SPF is included in state budget expenditures, so state budget reflects SPF balance. However, revenues and expenditures of SPF are not presented in the state budget.

such as recapitalization and guarantee payments.¹² In consequence, public debt dynamics have worsened despite continuous headline budget surplus (Figure 2, left panel), partly due to quasi-fiscal activities.¹³ A more comprehensive budget balance measure calculated by staff improves its linkages with debt dynamics (Figure 2, right panel). Tables 1 and 2 and Figure 3 explain the differences between the two-budget balance and public debt measures.

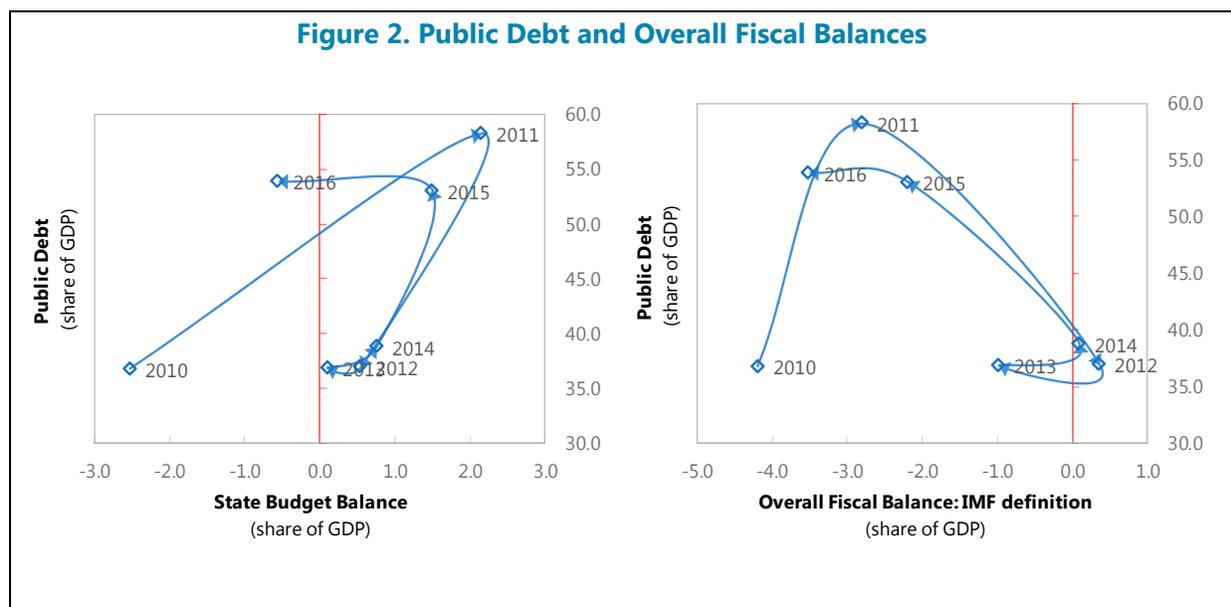


Table 1. Belarus: Public Debt, 2010-16
(Percent of GDP)

	2010	2011	2012	2013	2014	2015	2016
Public debt (staff definition)	36.8	58.2	36.9	36.9	38.8	53.0	53.9
Republican government (authorities' definition)	17.9	37.8	23.5	23.0	24.6	36.6	39.2
of which: NPP	0.0	0.0	0.4	0.7	1.0	2.1	3.3
SDR allocations	1.0	1.5	0.9	0.8	0.8	1.1	1.0
Guarantees	14.9	16.3	11.2	11.9	12.1	14.0	11.3
Local government (authorities' definition)	3.0	2.5	1.4	1.2	1.3	1.4	2.3

Sources: Belarusian authorities and IMF staff calculations.

¹² Box 1 explains the treatment of two major project loans in debt and budget balance measures.

¹³ The average off-balance sheet expenditure was 2 ½ percent of GDP over 2010-16.

Table 2. Belarus: Fiscal Balances, 2010-16
(Percent of GDP)

	2010	2011	2012	2013	2014	2015	2016
State (authorities' definition) 1/	-2.5	2.0	0.5	0.2	1.3	1.8	0.5
State (staff definition) 2/	-2.5	2.1	0.5	0.1	0.8	1.5	-0.6
General government (staff definition) 3/	-1.8	2.8	0.7	0.0	0.8	1.1	-0.3
Overall balance (staff definition) 4/	-4.2	-2.8	0.4	-1.0	0.1	-2.2	-3.5

Sources: Belarusian authorities; and IMF staff estimates.

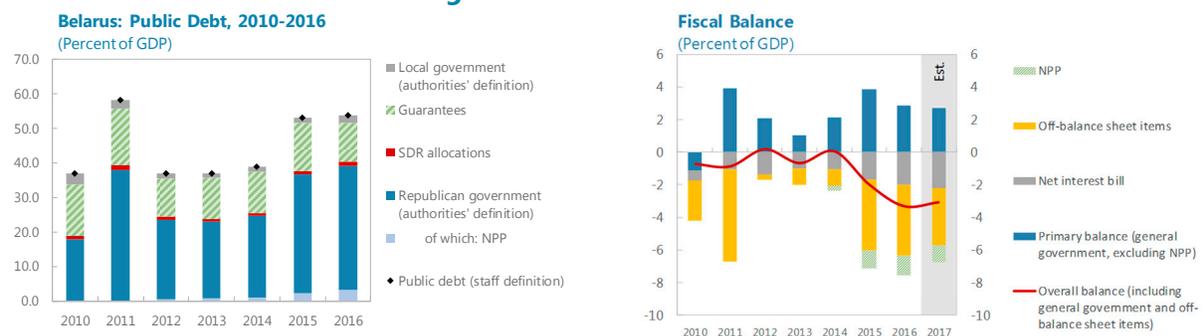
1/ Republican and local governments (authorities' definition).

2/ Republican (incl. NPP) and local governments; excludes budget loans through 2016.

3/ Includes SPF (consolidated).

4/ Includes debt-creating off balance sheet operations.

Figure 3. Debt and Balances



Sources: Belarusian authorities and IMF staff calculations.

Box 1. Debt and Balance Measures: Major Project Loans

Two major sets of project loans contracted under bilateral inter-governmental agreements are included in public external debt.

Nuclear Power Plant (NPP). A 2-reactor nuclear power plant under construction in northwestern Belarus is financed under a Russia-Belarus intergovernmental agreement. Borrowings under this arrangement are sovereign debt of Belarus, and on lent to the Belarusian NPP company, a subsidiary of the state-owned energy company Belenergo. Available financing is up to US\$10 billion, based on 90 percent Russian financing and 10 percent Belarusian co-financing. The first reactor is on track for completion in 2019, with the second scheduled for 2020. The authorities currently project cost of the NPP project around US\$6-7 billion over 2012-2020.

Chinese project loans. China has provided several credit lines to Belarus to finance investment in priority sectors. These priority sectors include transport, energy, industry, infrastructure, projects of small and medium-sized enterprises as well as the projects implemented by tenants of the Chinese-Belarusian industrial park. Those loans, with maturities up to 18 years and contracted in US dollars, euros, and Chinese yuan, are distributed by the Export-Import Bank of China and China Development Bank. The Belarusian government is the legal borrower of record, and on lends the funds to state-owned and privately owned companies. The outstanding loan stock was US\$3.1 billion at end-2016. The loans are at a mix preferential (fixed) and commercial (fixed and floating) interest rates.

In May 2015, China announced credit lines to Belarus of up to US\$7 billion. These credit lines are available for the Belarusian government in the framework of credit and investment cooperation between Belarus and China.

NPP related loans are treated as budget expenditures. Repayments of the NPP loans will start in 2021, in principle from resources generated by the Belenergo-owned NPP company. Since the second reactor will only come online from 2020, it might take some time for the NPP to generate profits. In view of the significant risks that the government may have to provide resources for servicing the NPP debt, at least for the first few years of repayments, The IMF staff's fiscal framework explicitly treats the NPP project as a government project, and includes its expenditure as part of central government expenditure.

China project loans are treated as on-lending. Chinese project loans are distributed over different sectors, and are expected to be serviced by the operation of these projects. While these loans are sovereign debt, they also correspond to government assets where the government is the creditor to domestic corporate borrowers for these loans. Available information does not indicate obvious signs of difficulties for the corporate borrowers to repay their debt. However, in the event that the corporate borrowers would be unable to service the project loans and the repayment burden were to fall on the government, then the relevant amounts would need to be reclassified as government expenditure.

- Medium-term fiscal planning is a key weakness. The government's focus on annual budgeting without a medium-term macro-fiscal outlook hindered strategic planning, leading to inadequate fiscal buffers during the economic downturn. There have been efforts to strengthen the medium-term planning, such as three-year budgeting. However, key elements of sound medium-term fiscal planning are missing: (i) there is no clear single medium-term fiscal anchor to ensure fiscal sustainability (e.g. size of public debt); (ii) the capacity of medium-term forecasts

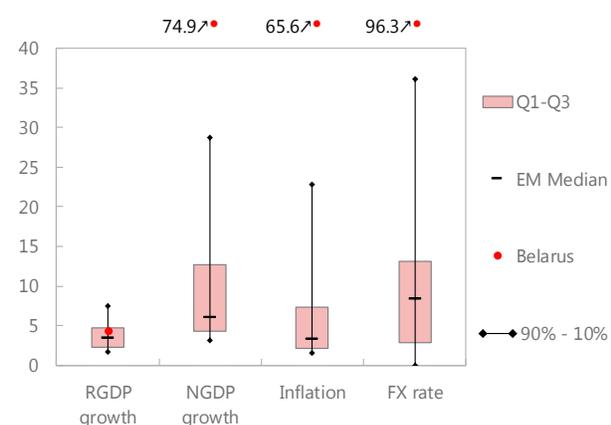
needs to be enhanced;¹⁴ and (iii) insufficient attention has been paid to monitoring the government's overall exposure to fiscal risks.¹⁵

- Weakness in medium-term fiscal planning and the balanced budget rule have contributed to procyclical bias. A balanced budget defined on non-cyclical basis does not allow for saving in good years and extra spending in bad years. When crisis hits, countries adopting a balanced budget rule would have to conduct procyclical policies owing to lack of fiscal buffers. Since the economic slowdown in 2009, Belarus has experienced sharp and continuous revenue contractions. With limited fiscal buffer, the government avoided a substantial deterioration of fiscal position through expenditure consolidation. Overall government expenditures, including SPF expenditures, reduced from 55 percent of GDP in 2008 to 38.3 percent in 2016.¹⁶ This has been mainly achieved through a significant reduction in capital expenditure reduction. The large expenditure reduction could partly reflect a shift to off-budget spending. Staff calculated annual off-balance expenditure, mainly for SOE and bank recapitalization, went up from around 1 percent of GDP in 2006 to around 3 percent of GDP in 2015 and 2016.

8. Based on international experiences, the existing fiscal rules in Belarus could be updated in several aspects.

- A debt anchor targeting a safe debt level, based on a comprehensive measure, will help anchor medium-term fiscal policy in Belarus, and allow greater ability to manage shocks. The related debt measure should be comprehensive, including obligations of all levels of government. This debt measures should also include government guarantees, given the large stock of guarantees (11 percent of GDP in 2016) and continuous payments by the government. Gross debt should be used to ensure transparency in debt calculation and easy communication to the public, while net debt could be used as a

Figure 4. Macro Volatility: EM vs Belarus¹
(Standard deviation of indicator over 1996-2016)



Sources: WEO, IMF staff.

1/ For each variable, the inter-quartile range is illustrated by the bar, and the range between the 10th and 90th percentile is plotted by the vertical line. The outcome for Belarus is marked by the red dot.

¹⁴ The Ministry of Economy in Belarus conducts forecasts on macroeconomic variables, while the Ministry of Finance conducts revenue forecasts and allocate expenditures based on forecasts from the Ministry of Economy.

¹⁵ For instance, exclusion of recapitalization operations from the budget has caused headline fiscal balance measures to lose relevance as a guide to the government's fiscal performance.

¹⁶ This measure excludes off-balance sheet expenditures.

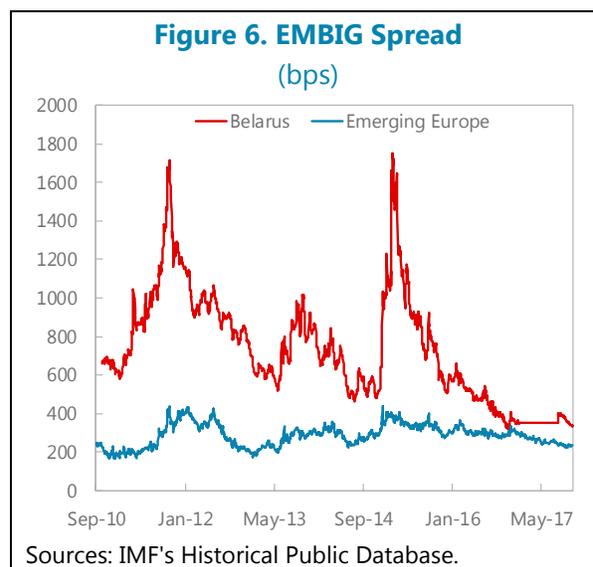
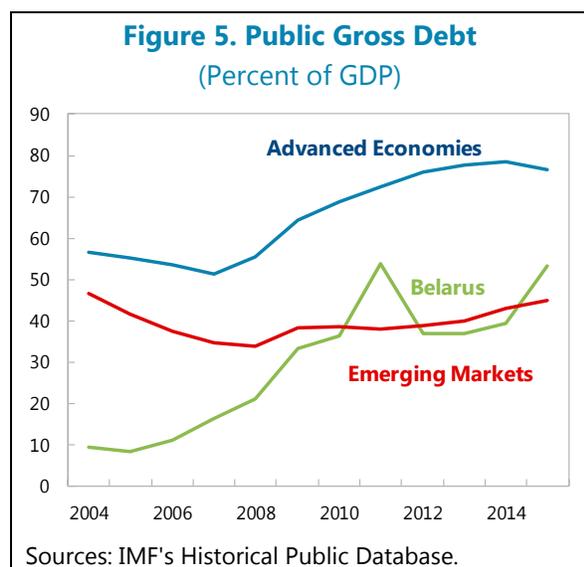
reference.¹⁷ Given future uncertainties, it is prudent to set a lower “safe” debt target to prevent, with high likelihood, losing control of debt dynamics under severe adverse conditions. This is especially crucial for Belarus, given its history of large macroeconomic shocks (Figure 4).

- Adopt an operational fiscal target, linked to the safe debt target in the medium term. The operational targets could be budget balance or expenditure ceilings, supported by sound medium-term macro-fiscal forecasting and planning. The measure for the target should be comprehensive, including all levels of the government and quasi fiscal activities, allowing better linkages with debt dynamics. The operational targets should be resilient to shocks and contribute to macroeconomic stability.
- Strengthen supportive institutions and secure broad-based support from the government. Supportive institution, including medium-term planning and fiscal risk assessment, would enhance credibility and successful implementation of the rules. Policy makers, at different levels, should be committed to comply with the rules, and avoid formulating policies that could potentially undermine efforts to maintain the fiscal anchor.

C. Calibrating Public Debt Anchor for Belarus¹⁸

9. To calibrate a debt anchor at a safe debt level requires identification of the debt limit.

The debt limit could be roughly calibrated at the level beyond which a debt distress episode will occur with heightened probability (e.g. default, restructuring or large increases in sovereign spreads). Adopting a single debt limit would strengthen the fiscal framework as it is a simple rule and linked with debt sustainability objectives.



¹⁷ Net debt is equal to gross debt minus financial assets. It is often difficult to determine which government assets are truly liquid, particularly in financial stress.

¹⁸ Debt anchor and rule calibrations in this paper are guided by IMF (2016) “How to Calibrate Fiscal Rules? A Primer”.

10. A medium-term gross debt limit of 60 percent of GDP is recommended for Belarus. For emerging-market economic, the IMF Debt Sustainability Analysis (DSA) framework for Market Access Countries uses benchmarks of 70 percent of GDP.¹⁹ However, in the case of Belarus, given the high foreign currency share of the public debt and larger macroeconomic volatilities than EM peer, a more conservative gross debt limit can be considered. Indeed, in 2011 and 2015 when the public debt was rapidly approaching 60 percent of GDP (see Figure 6 and Table 3), the sovereign spread increased rapidly. Meanwhile, the country was downgraded continuously. Therefore, 60 percent of GDP could be considered as the conservative debt limit for Belarus.

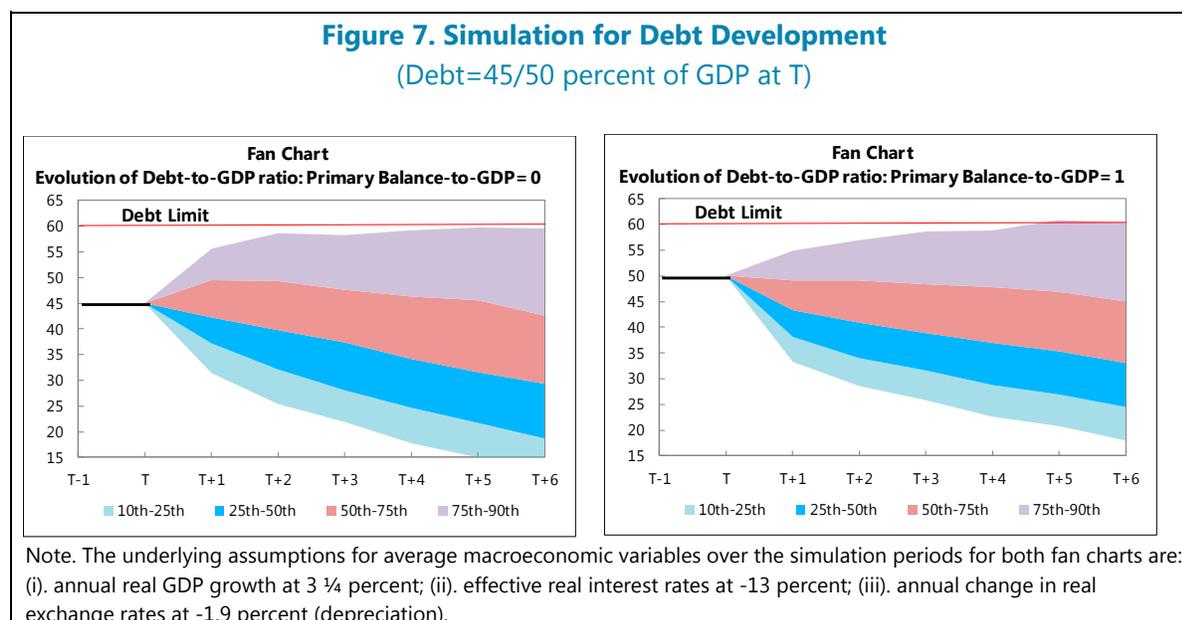
2010		2011		
Moody's	B1 (stable)=>	B2 (negative)=>	B3 (negative watch)=>	B3 (negative)=>
S&P	B+ (negative)=>	B (negative)=>	B (negative watch)=>	B- (negative)=>
2012		2013	2013	2014
Moody's	B3 (negative)=>			
S&P	B- (stable)=>	B- (positive)=>	B- (stable)	
2015		2015	2016	2017
Moody's	B3 (negative watch)=>	Caa1 (negative)=>	Caa1 (stable)	
S&P	B- (stable) =>			

11. A debt anchor, at a safe debt level, is calibrated to ensure public debt below the debt limit of 60 percent of GDP. Simulations are conducted by choosing the initial level of debt such that debt remain below the debt ceiling with a chosen probability over the medium term, given negative historical macroeconomic shocks. This initial debt level is then the safe debt target over the medium term.²⁰ In other words, the safe debt level should provide sufficient buffer to cope with negative shocks, by allowing the debt level to go up without exceeding the debt limit with a high probability. The medium-term debt path also depends on government's willingness and capacity to general budget surpluses in to contain debt within the limit. A historical record of fiscal discipline and high primary balance could result in a lower initial debt level to stabilize the debt.

¹⁹ International Monetary Fund (2013), "Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries".

²⁰ The IMF DSA framework is used for the stochastic simulations, which are based on symmetric laws and draw both positive and negative shocks. The joint distribution of macroeconomic variables for our simulation are drawn directly from calibrated joint normal distribution of historical values for real GDP growth, effective real interest rate, primary balance and change in real exchange rate over 2006-2016.

12. Simulation results propose safe debt level for Belarus at about 45 percent of GDP. The safe debt level is calculated by assuming the gross debt limit at 60 percent of GDP and government's willingness to maintain a balanced primary budget (fan chart, left panel). This allows a fiscal buffer of around 15 percent of GDP. Historical experience suggests this buffer is necessary. Amidst large negative shocks, public debt increased by 22 percent of GDP in 2011, and by 16 percent of GDP over 2013-15. However, Belarus has been able to maintain high primary balances over several years, that would allow a smaller buffer below the debt limit. Overall, the single debt target in the range of 45-50 percent of GDP is recommended.



13. Comprehensive fiscal risk assessment is needed to better calibrate safe debt target. The presented simulations only take into consideration shocks from a few macroeconomic variables. It would be important to have a more detailed assessment of risks (e.g. contingent liabilities from SOEs) before deciding on a safe debt level.

D. Operational Rules

14. In the short term, Belarus could continue to use the rule to target budget balance, but based on a more comprehensive measure and linked to a debt path. This may be easier to adopt as it preserves the role of the overall balance as operational target. However, it should be linked to a normative debt path towards the safe debt level over time. A drawback, however, is that this rule tends to be procyclical. This may be unavoidable over the next years given the adverse debt dynamics in recent years.

15. A structural balance rule, linked to a debt path, could be an option to foster countercyclical policy, but subject to technical difficulties. This rule tries to explicitly include a countercyclical component by allowing revenues (and some expenditure items) to respond to the

cycle. However, it would require fiscal buffer for its implementation, thus making it difficult to implement at the current juncture. In addition, the rule is highly sensitive to measures of potential GDP growth, which is difficult to estimate given the high volatility of GDP growth. As such, it is complex to implement such a target and verify compliance given the dependence on an unobservable variable (output gap).

16. A multi-year expenditure ceiling rule (linked to debt target) could be a more practical and desirable option in the medium-term. For example, setting a stable path for expenditure growth ceiling over 3 to five years, consistent with debt target, would help preserve debt sustainability and add a stabilizing component to fiscal policy. An advantage over the structural balance rule is that it does not necessarily rely on estimates of potential output, therefore it is a simpler rule, and easier to monitor.²¹ There would be a smooth and predictable path for expenditures, as they would not need to adjust to yearly shocks. However, to be effective and credible such a rule will require strengthening medium-term fiscal management and rebuild fiscal buffers.

17. To increase the enforcement of the fiscal rules, an error-correction mechanism could be considered. Some countries have adopted automatic corrections to deviations from target to strengthen enforcement. For example, the Slovak Republic and Poland added triggers as debt approaches the debt limit. In Slovak Republic, once debt breaches 50 percent of GDP, the government needs to take corrective measures to prevent debt from reaching the 60 percent limit.²² Belarus could also consider automatic correction mechanism to support a debt ceiling, for example adding automatic spending freeze (or cuts).

18. The new rule should also include escape clauses. Revisions to planned path should be allowed under well-motivated conditions, including national emergencies or significant errors in the underlying assumptions (e.g. long-run growth, interest rates). This also requires supportive fiscal surveillance mechanisms to avoid damaging the credibility of the rule.

E. Concluding Remarks

19. Recent fiscal pressure in Belarus reflects weakness in the framework, despite great effort to maintain a balance budget. Inconsistent fiscal rules, fragmented fiscal accounting and monitoring, lack of medium-term planning all contributed to fiscal vulnerability.

20. The ongoing PFM reforms provide a good opportunity to address the weaknesses. The government's PFM reform strategy, prepared in 2015, aims to introduce a medium-term budget framework. To ensure the success of this reform, we suggest the following:

²¹ In the EU framework, the expenditure benchmark is linked to a 10-year average of potential output growth, so expenditure as a share of GDP will remain unchanged over the cycle.

²² The corrective measures depend on the size of the breach. They include presenting plans to Parliament to correct deviation, freezing expenditures, or even a vote of confidence on the government.

- A medium-term fiscal anchor, targeting a safe debt level in the range of 45–50 percent, should be established and communicated to the public immediately. The debt measure should be comprehensive, including all levels of government and guarantees. At the same time, for its own policy guidance, the government could maintain existing different debt ceilings for central, local government debt and guarantees.
- An operational annual fiscal target should be linked to the debt anchor. In the short term, the budget balance could be used as the operations target, but it needs to be linked to a medium-term debt path to target the debt anchor. It is crucial to make sure that the balance measures are comprehensive, including all levels of the government, quasi-fiscal operations and extra budgetary funds. A multi-year expenditure ceiling rule (linked to the debt objective) could be a more practical and desirable option in the medium-term.
- Additional mechanisms should be adopted to ensure credibility. These could include an error-correction adjustment mechanism to ensure that corrective measures are taken to prevent debt from breaching the debt target (e.g. automatic spending freeze), and an escape clauses allowing revisions to the planned path under certain conditions, e.g. national emergencies or significant changes in underlying assumptions.
- Medium-term fiscal planning should be established, with the enhanced capacity of medium-term macro-fiscal forecasts, based on realistic assumptions.²³

21. Fiscal risks should be identified, monitored and incorporated in the budget process.

Some of these changes will not be feasible to adopt immediately. Yet some steps can be implemented now, including adopting a credible single medium-term safe debt target and improve budget and debt measures as the first step. The establishment of proper operational targets might require technical assistance.

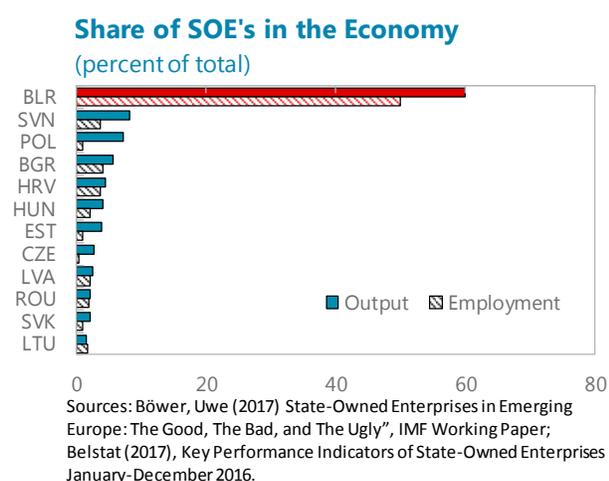
22. It is key to secure broad based support from all levels of the government. In recent years, various policies to support SOE sector and social benefits have resulted in deteriorating fiscal stance, despite strong fiscal discipline to maintain a balanced budget. These ad-hoc policies are not incorporated in the overall fiscal target, and has weakened fiscal sustainability. Therefore, it is crucial to ensure commitment from all levels of the government to the fiscal rules.

²³ Ministry of Finance has already requested assistance to enhance their revenue forecasting.

STATE-OWNED ENTERPRISES IN BELARUS¹

1. Belarus relies heavily on state-owned enterprises (SOEs)² as a driving force of its economic growth and development. However, SOEs' financial performance, as well as institutional flaws and rigidities pose questions about their ability to effectively fulfill this function. These also invoke questions about efficiency of using public resources in supporting the SOE sector and the associated fiscal risks. The note aims at assessing SOEs' abilities to be the engine of the economic growth by analyzing SOEs' performance in Belarus, including relative to that of private companies³. It also draws on other countries' experiences related to SOEs' roles in the economy, SOEs' performance and SOE sector reforms.

2. The SOE sector in Belarus is large relative to other European countries. In 2016 on average almost 50 percent of employed in Belarus worked in the SOE sector. SOEs generated over 60 percent of total output⁴ and over 77 percent of the industrial production. The size of the SOE sector and its importance for the economy make Belarus stand out from other European countries. It is specifically visible, when Belarus is compared with countries which transformed their economy from largely state-owned to more market-oriented (text chart).⁵



A. Background

3. SOEs play a dominant role in the Belarusian economy. As of end-March 2017, there were 4,734 SOEs (out of the total of 7,356 medium and big non-financial companies), grouped into 3,549 legal entities. A majority of these were either fully owned by the state (1,800 legal entities) or had a

¹ Prepared by Beata Jajko.

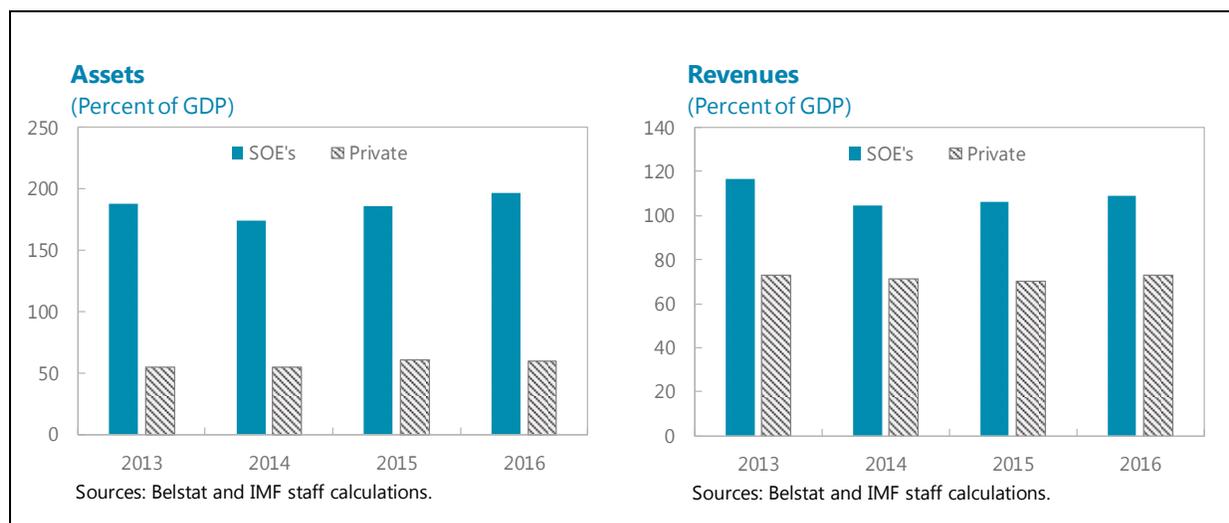
² SOEs are defined as fully owned by the state (republican and local levels) or with any state's share in the ownership.

³ The analysis is based on data on medium and big non-financial companies (i.e., SOEs and private companies with the average number of employees above 251 in a calendar year), aggregated by economic sectors. In addition, a dataset including individual data of about 560 SOEs (39 indicators), including 100 highly indebted in foreign currency SOEs (additional indicators on foreign currency revenues and long-term liabilities) was used. The unavailability of data on individual private companies (due to confidentiality reasons) prevented any in-depth comparison of performance of private companies and SOEs. *Data source:* Belstat and the NBRB.

⁴ Output defined as revenues from sales of products, goods, works and services. Belstat (2017), Key Performance Indicators of State-Owned Enterprises January-December 2016.

⁵ Cross-country comparison is difficult and should be treated as illustrative, given the limited publicly available consistent data across countries.

dominant, i.e., over 50 percent, state ownership (1,384 legal entities). The SOEs employed about 1.4 million workers (about 66 percent of the corporate sector⁶ workforce), and generated about 60 percent of total revenues (turnover) of the corporate sector. SOEs managed 76 percent of the corporate sector's assets and were responsible for more than 70 percent of corporate sector's liabilities (text charts). SOEs differ across sectors of the economy, including in terms of their size, concentration in specific sectors and percent of sectoral revenues they generate.



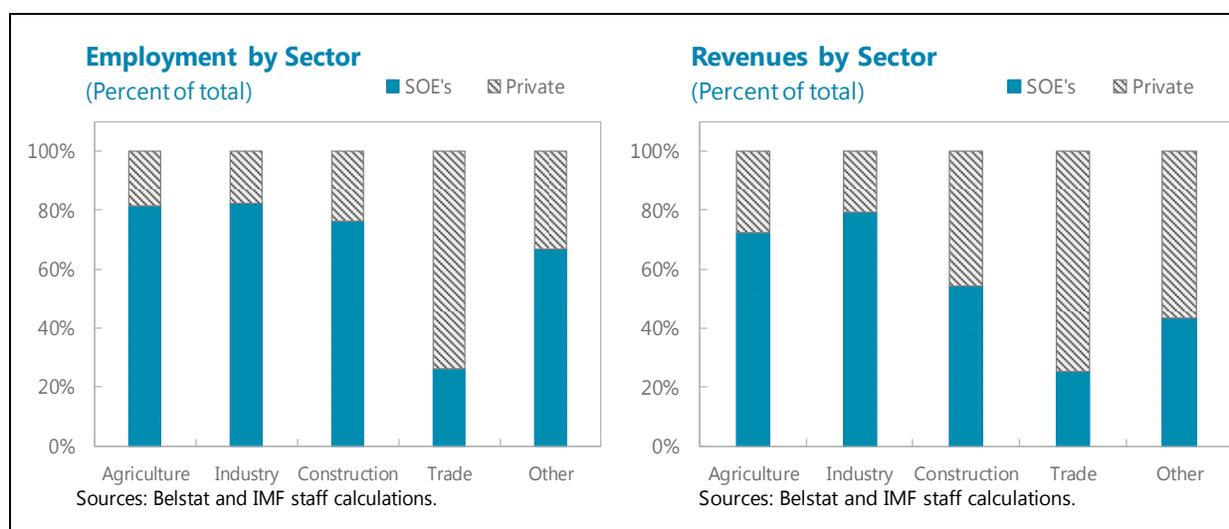
4. SOEs are central to the country's growth strategy (text chart). They serve as important instruments in implementing the authorities' broad socio-economic policy (including meeting exports and production targets and maintaining high level of employment and wages) and ad hoc sectoral objectives.⁷ These overarching objectives, amid the flaws in SOEs' institutional arrangements, determine performance behaviors and strategic investment decisions of individual SOEs. Moreover, the distinction between commercial and non-commercial functions of SOEs is often blurred, with some entities performing significant non-commercial functions that in other countries would typically be considered general government functions. The state footprint in the economy not only heavily impacts business behavior of SOEs, but also leads to concerns about a level playing field for private companies.⁸

⁶ Corporate sector in this note refers to 7,356 medium and big non-financial companies. Specifically, it does not include companies with the average number of employees of 250 and lower.

⁷ Despite some efforts made by the authorities to limit SOEs' volume performance targets, SOEs' objectives remain driven by a socio-economic development plan (see: 'Republic of Belarus Government Action Program for 2016-2020' of May 2016) and more detailed authorities' socio-economic objectives, including exports volumes, employment, wages and investment in the economy.

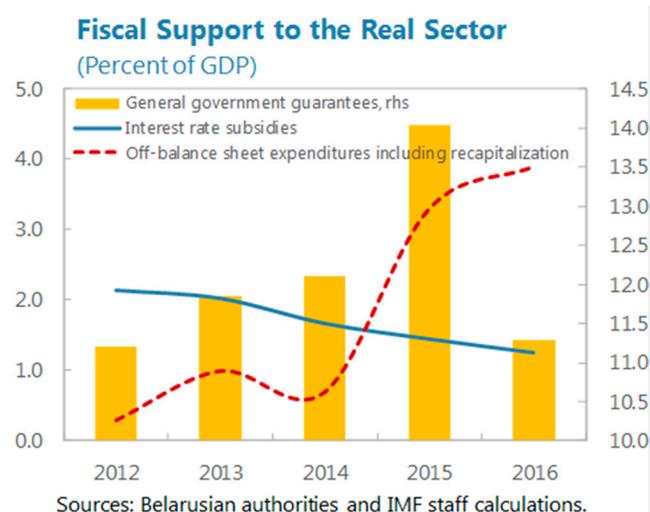
⁸ Based on a business survey, main areas where private companies are perceived as being treated differently from public companies include: treatment by the controlling bodies (47.4 percent of respondents), prices of raw materials (35.2 percent), conditions for obtaining permits and licenses (35.1 percent), rental rates (32.0 percent), access to credit (25.8 percent), and public procurement (20.1 percent). Source: Research Center of the Institute of Privatization and Management, 'Development of small and medium-sized enterprises in Belarus, 2017'

<http://www.research.by/publications/surveys-of-business/1701/>



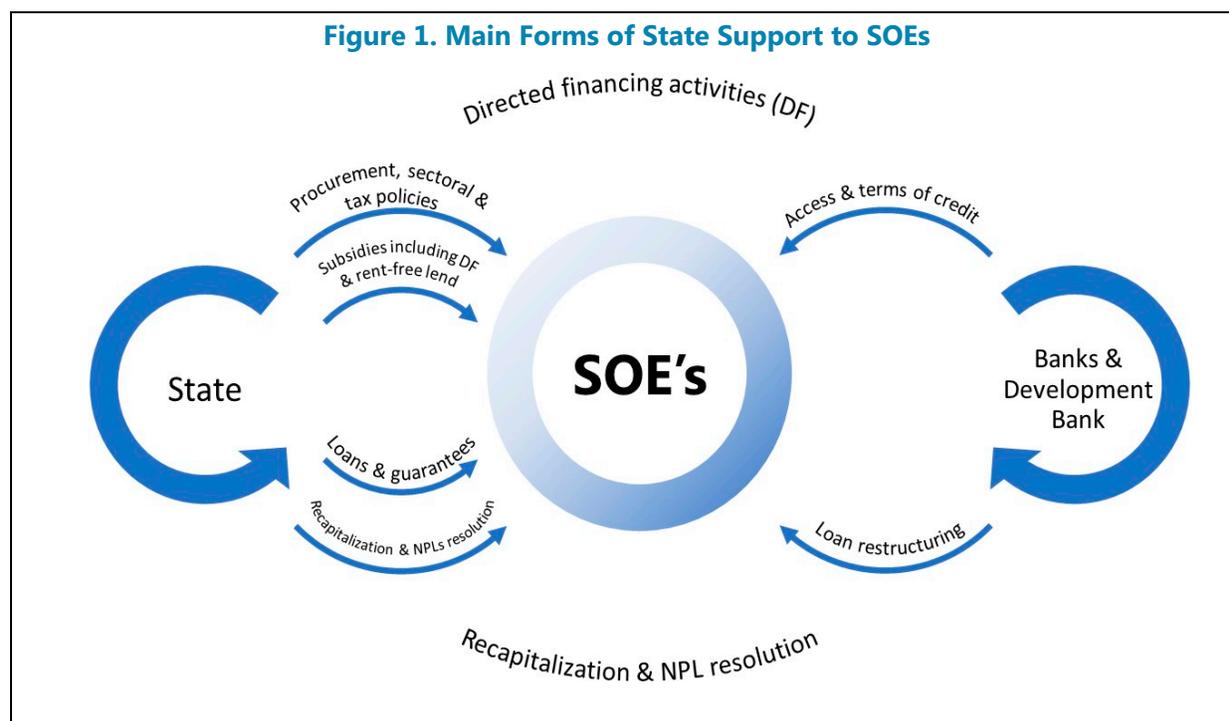
5. SOEs' institutional framework suffers from structural weaknesses. SOEs' ownership, policy and regulatory functions are often concentrated in one entity (a line ministry). This concentration risks conflicting value maximization for owners with strategic socio-economic objectives and weakens accountability. Moreover, corporate governance and reporting of SOEs are well short of international best practices. For example, SOEs are also often shielded from competition with private companies, given the state support and preferential treatment they enjoy. Overall, the existing arrangements distort the system of incentives, do not favor efficiency, adversely impact business and managerial behaviors, and thus SOEs' performance.

6. SOEs rely heavily on direct and indirect state support and protection.⁹ They benefit from government subsidies and on average, easier access to credit on better terms than private companies (including due to directed lending programs, government guarantees, and access to state banks). With the government as an owner, SOEs can also tap public resources in a form of recapitalization funds or benefit from arrangements under government sectoral restructuring programs. These forms of the government support to SOEs have been persistent over years and intensified during the recent crisis (text chart). In addition, SOEs in practice can benefit from the preferential treatment under public



⁹ In 2016 a Presidential Decree (No. 106) financial support of the state to the real sector: (i) should be limited to priority state programs (with a competitive selection mechanism), (ii) direct subsidization from the budget should be limited to reimbursement of expenditures on production equipment and spare parts for investment projects under state programs, and (iii) loans should be limited to those granted, based on a tender, by the Development Bank for investment projects under state programs (consisting of 20 programs).

procurement and take advantage of government economic development programs oriented towards specific economic sectors or branches.



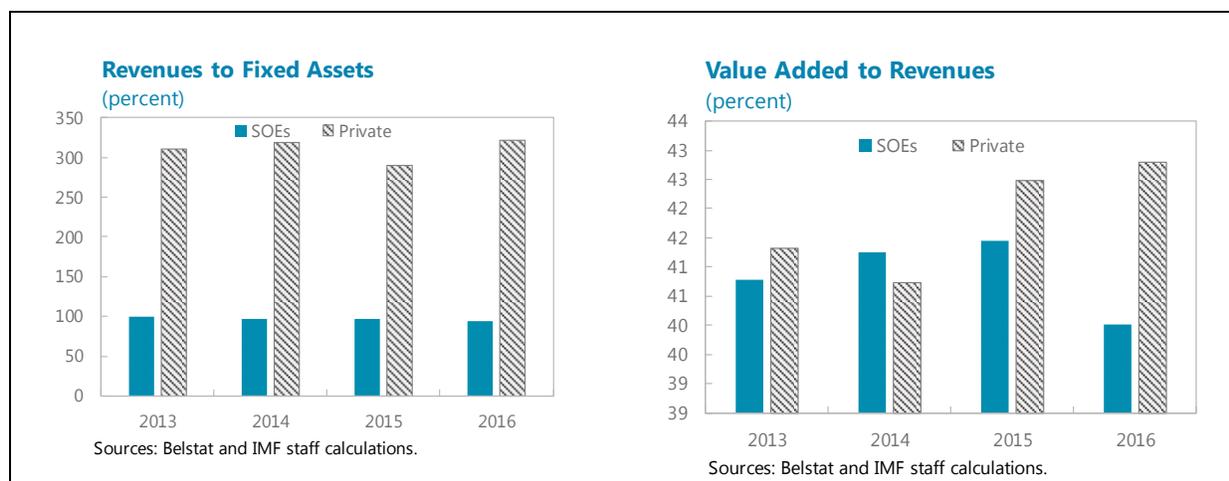
7. The state plays an active role in addressing SOEs in distress, but there is no comprehensive SOE restructuring or NPL resolution framework. In addition to supporting individual companies in difficulties, state policies are also oriented towards specific economic sectors. A sectoral approach has recently been applied towards cement, glass, other manufacturing and wood working SOEs (2015) and agricultural (2016/2017) SOEs. In both cases, the state intervened to break or at least weaken the negative feedback loop between SOEs and financial institutions, addressing problems of non-performing loans through the recapitalization and removal of bad assets from the balance sheets of financial institutions.¹⁰ Heavily indebted wood working companies were acquired by the Ministry of Finance and transferred into the management of the Development Bank, responsible for their debt restructuring. Problematic agriculture companies and their debts were moved into a specially created asset management company (AMC) or transferred from the republican to local governments. However, little visible progress has been made in restructuring of operations of these SOEs. Besides the lack of a comprehensive systemic approach to SOEs' restructuring and NPLs' resolution, the corporate insolvency framework remains relatively weak, with lengthy rehabilitation procedures.

¹⁰ The basic mechanism of recapitalization includes the government issuing bonds purchased by commercial banks to substitute loans which SOEs are unable to repay (usually the nominal value of government bonds is equal to the value of loans they replace).

B. Financial Performance: SOEs and Private Companies

Overview

8. The overall SOE financial performance lags that of private companies (text charts).¹¹ On the macro level, SOEs are less profitable than private companies, even though the latter face overall higher costs. In 2013–16, SOEs' return on equity (ROE) and return on assets (ROA) were on average respectively around four and three times lower than those of private companies, and SOE average net profit was about twice lower. The difference would be even more prominent if the data were



corrected for specific government subsidies.¹² Even though the share of loss making companies in total companies looks more favorable for SOEs, the data are distorted by the direct and indirect state support. SOEs are also less effective than private companies in creating revenue and generating profits from revenue (text chart). It should be noted that financial results of both SOEs and private companies in 2013-17 are influenced by temporary changes to the national accounting rules, which overall had positive impact on their profit indicators.¹³ In addition, in some sectors there are significant differences between SOEs and private companies in terms of their size, concentration and the share of revenues they generate in total sectoral revenues. The averages for the whole economy should be therefore interpreted with caution.

¹¹ SOEs overall performance indicators are likely influenced by their non-commercial (social) activities.

¹² These subsidies include funds received from the budget to cover losses due to the state regulation of prices and tariffs used for compensation of current expenses. However, detailed data on this government support are not available.

¹³ There were three main regulatory acts which had an impact on profitability indicators of companies between 2013 and 2016: (i) Ministry of Finance Resolution No. 16 of March 11, 2013 'On Certain Accounting Issues' (in force January 2013-January 2017); (ii) Presidential Decree No. 103 of February 27, 2015 'On Recalculation of the Value of Assets and Liabilities' (in force January 2015-December 2017), and (iii) Presidential Decree No. 345 of August 7, 2015 'On Disposal of Property' (in force January 2015-January 2017). No detailed data are available to assess the actual impact of these regulations on profitability indicators of companies nor to support the hypothesis that SOEs benefited more than private companies from these changes.

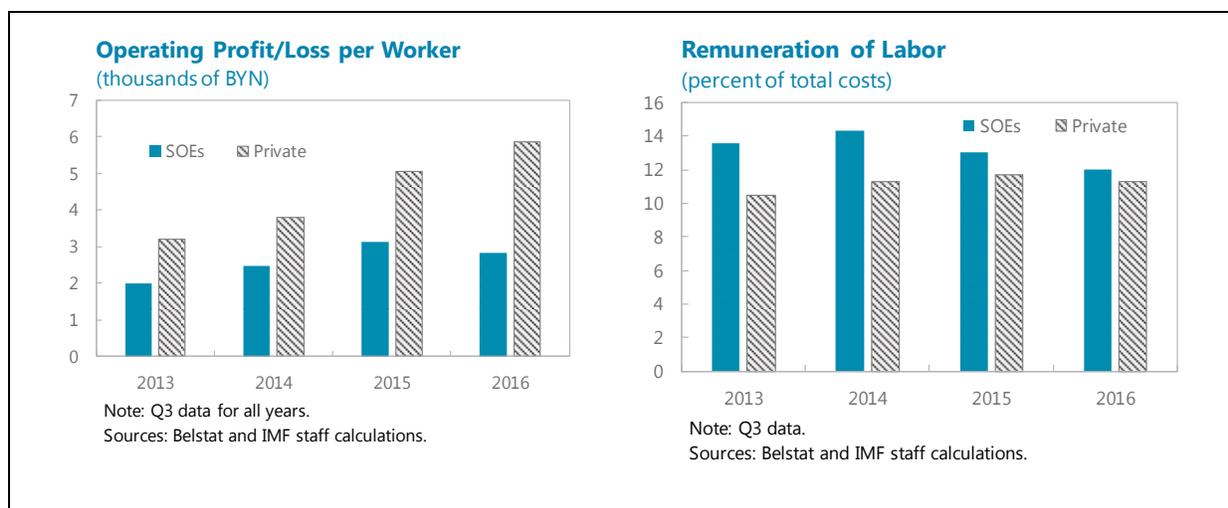
9. SOEs are on average less liquid than private companies, as evidenced by current liquidity ratios and the share of overdue payables in total payables. They are also running higher arrears on credit and loans than private companies. In terms of wage arrears per worker, the overall picture is less clear, as the SOEs seem to finance (with bank loans) a larger share of their wage bill than private companies.¹⁴ The data suggest that SOEs might be doing slightly better than private companies in managing their payables versus receivables. However, without more detailed information, this hypothesis cannot be verified. There is also no detailed information available to analyze cross-payments between SOEs, between private companies themselves, and between SOEs and private companies.

10. SOEs compare unfavorably with private companies in terms of productivity and efficiency in employing labor. On average, SOEs generate much lower value added per employee than private companies (text chart). In 2013-16 their operating profit per worker was on average almost half of private companies, despite lower overall costs of production¹⁵ per worker. As the margin on sales was also on average lower in SOEs than in private companies, this might imply that selling prices of SOEs' products were, on the economy-wide level, on average lower than that of private companies.¹⁶ Moreover, despite the costs of remuneration being lower in SOEs in per worker terms, the share of costs of remuneration in total costs of production was on average higher in SOEs than in private companies (text chart). This may suggest overemployment in SOEs on the economy-wide level relative to private companies.

¹⁴ On April 30, 2017 bank loans of the corporate sector incurred for payment of wages amounted to BYN156.7 million, i.e., 7.1 percent of the wage bill accrued for the month (in March, 2017 this figure was BYN165.8 million, i.e., 7.6 percent). The highest share of debt issued to pay wages was held by SOEs under the supervision of the Ministry of Architecture and Construction (i.e., 76.9 percent of the total accrued wage bill), and Ministry of Industry (10.5 percent), and SOE holdings: the Belarusian State Light Industry Goods and Production and Sales Concern (Bellegroprom - 39.1 percent) and the Trade Concern of Forestry, Woodworking and Pulp and Paper Industry (Bellesbumprom -15 percent). NBRB analytical reports.

¹⁵ Costs of production include costs of products, goods, work and services.

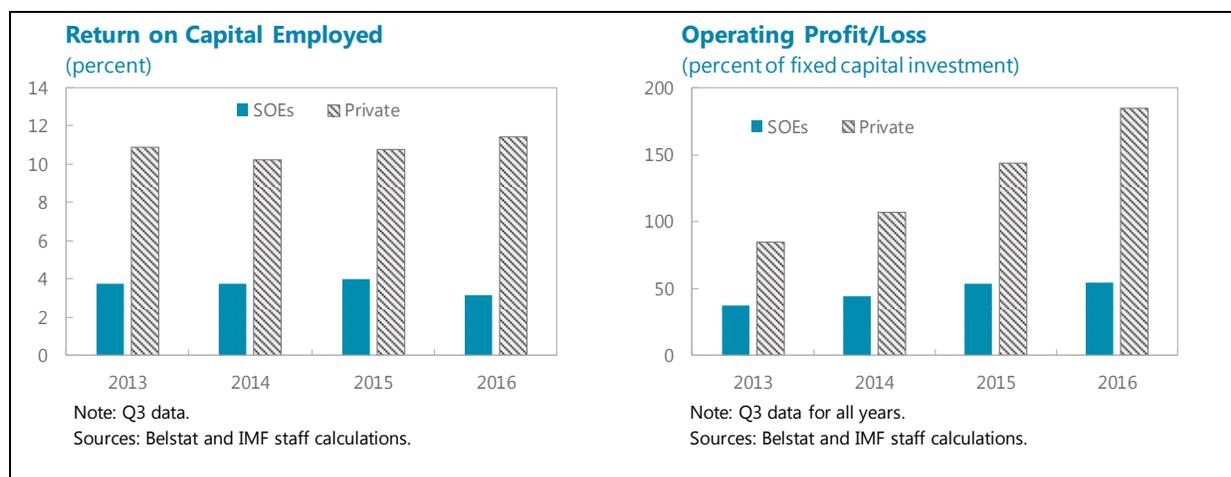
¹⁶ Several factors may come here into play: (i) economy-wide averages do not distinguish among different products offered by SOEs and private companies, including products related to non-commercial functions of SOEs; (ii) quality of some products offered by SOEs may not be at par with that of private companies; (iii) prices charged by SOEs may be heavily influenced by the authorities' policies oriented towards containing inflation and price regulations and (iv) differences in the share of foreign currency liabilities in total liabilities and the extent to which SOEs and private companies were hit by the currency depreciation.



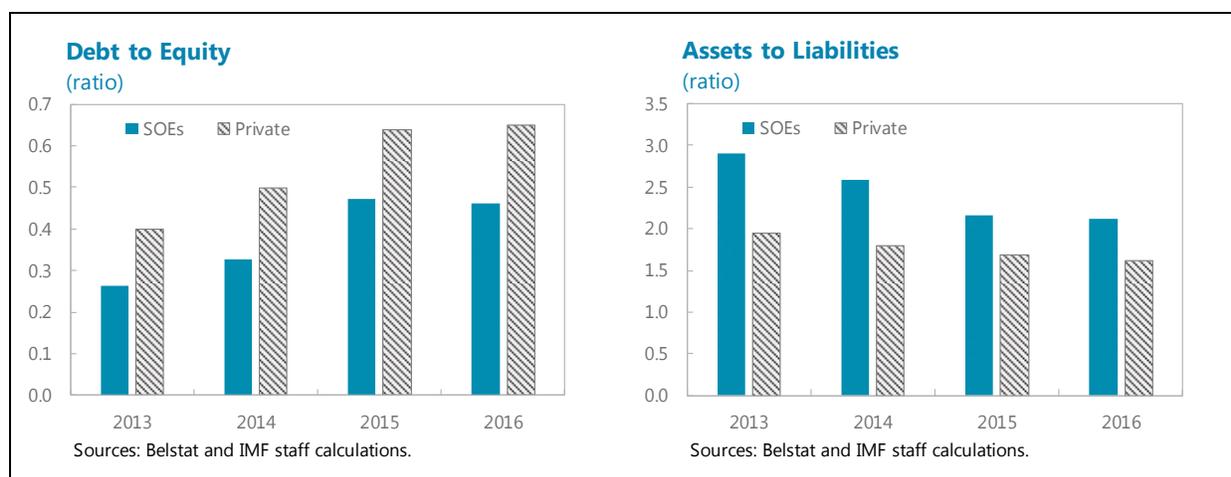
11. There seems to be also a large gap between SOEs and private companies in terms of efficiency of using capital. The return on capital employed¹⁷ was on average three times lower in SOEs than in private companies. In addition, SOEs' net operating profit as a ratio of fixed capital investment was on average 2.5-3 times lower, whereas their costs of credit were on average lower¹⁸ (text chart). The efficiency of investment in fixed capital could be an important factor. It likely reflects investment decisions of SOEs made on a macro level, including overarching sectoral policy objectives, which may not always be the best option from the point of view of an individual SOE. Verification of this hypothesis, however, would require more in-depth analyses based on detailed data. In addition, large SOEs in Belarus were created in the Soviet Union times. Despite SOEs having been upgraded technologically, the use of capital in SOEs is likely insufficient, due to the poor system of incentives and lack of relevant managerial skills. The inferior productivity and efficiency indicators relative to private companies is also likely related to flaws in SOEs' institutional framework, including the presence of the non-core assets and activities and the design of the holding structures, which tend to protect non-efficient or hardly viable companies at the expense of good performers.

¹⁷ Measured as operating profit/loss to capital employed (proxied by assets minus short-term liabilities).

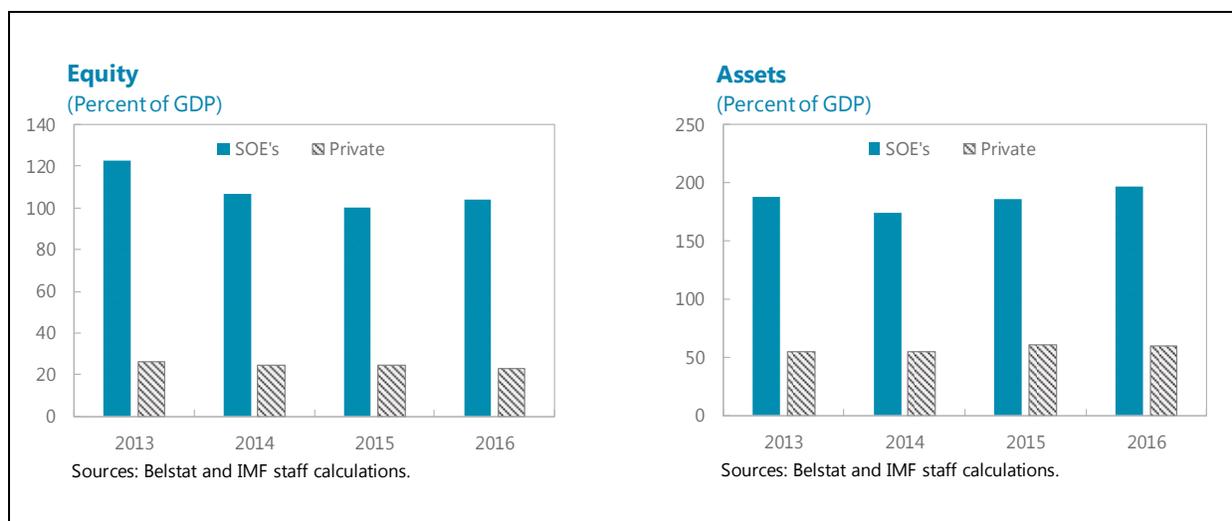
¹⁸ Based on very short time series (3 quarters), the calculated effective interest rate on credit and loans for private companies is on average some 1.3 times higher than for SOEs, consistent with differential access to credit. In addition, some other measures of profitability also point towards private companies' advantage over the SOEs, e.g., revenues from sales per worker or per fixed assets.



12. Although basic sustainability indicators seem to favor SOEs versus private companies, any definite conclusions based on them can be misleading. SOEs on average have more assets per worker and rely more heavily on equity than debt financing (text chart). But there seems to be a substantial difference in asset quality (and productivity) which justifies cautious interpretation of the data.¹⁹ SOEs’ dominant reliance on equity financing is also not surprising, given the state presence and state interventions, including recapitalization of troubled SOEs. However, contrary to SOEs, the cost of debt financing for private companies is on average lower than their return on equity. This can suggest that private companies may generate more earnings by acquiring debt that they would otherwise.

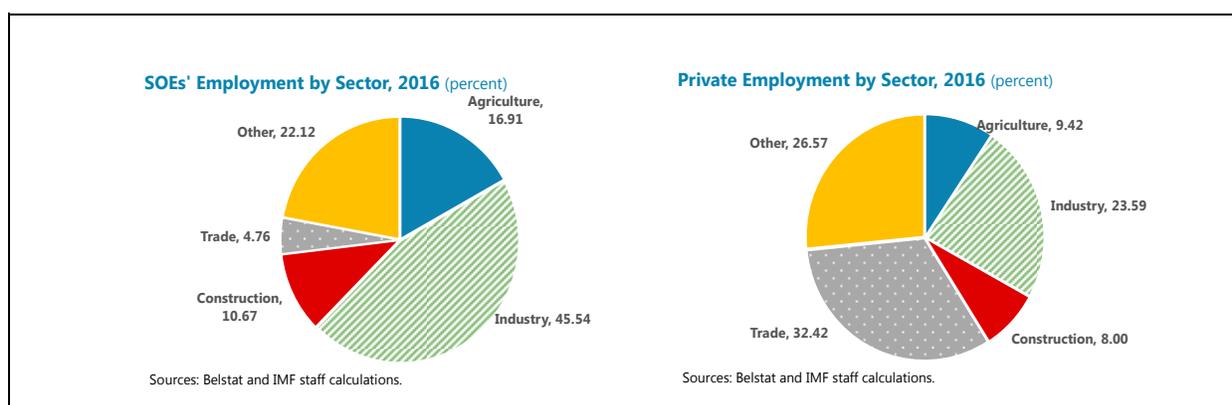


¹⁹ This can be at least partially explained by the non-core assets in SOEs. In addition, based on the findings of a IMF TA mission, SOEs may not have the ownership rights to all of assets (e.g., some of the assets are in fact leased, not owned by SOEs). In addition, the valuation effect has likely a big impact, given that assets are reported based on their book value (and not market value). This way of reporting might be a likely reason why during the recession SOEs’ assets grew faster than nominal GDP.



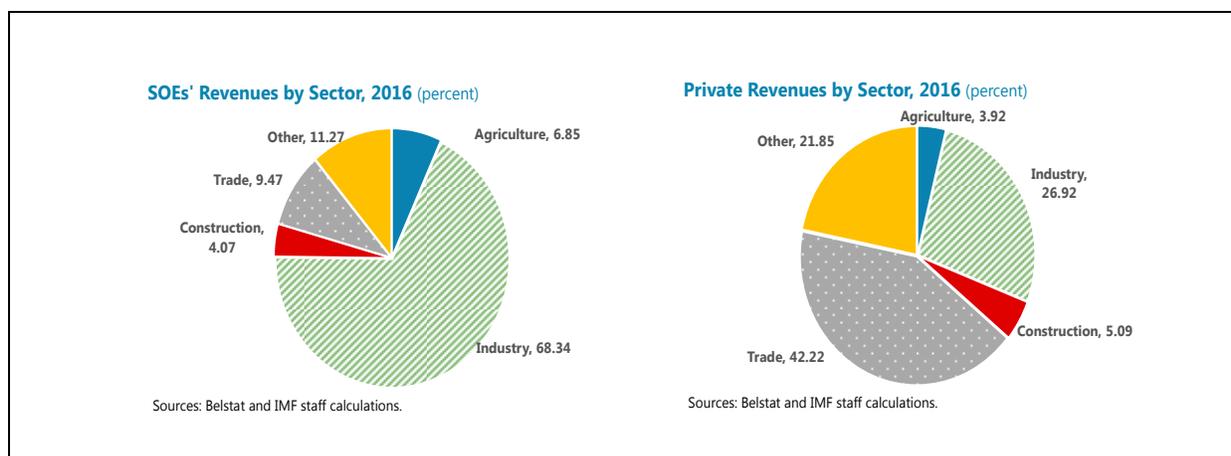
Sectoral Level²⁰

13. General conclusions about the economy-wide underperformance of SOEs versus private companies largely hold on sectoral level, however, noticeable sector-specific differences exist. These are, among others, visible in sectors with the relatively largest share of companies in terms of revenues, assets and employment, like manufacturing, agriculture and construction²¹ (text chart). These sectors play an important role in generating value added to the economy, with a share of 19.6 percent, 6.8 percent and 6.3 percent in 2016 GDP respectively.



²⁰ Changes to the classification of economic sectors implemented by Belstat in 2016 (switching from SNA2001 to 2008) distort comparability of sectoral time series data. Therefore, any conclusions based on sectoral data time series need to be made with caution.

²¹ The transportation sector, not shown here, also plays an important role, in terms of the number of companies and its share in assets and employment of the corporate sector. However, changes in the economic sectoral classification limit the available time series for analytical purposes.



Manufacturing Sector

14. On average, SOEs' financial performance in the manufacturing sector lags that of private companies, despite the presence of flagship state companies.²² SOEs are less profitable, less liquid and less efficient in employing the available resources. This may seem at odds with the arguably expected more commercial-like behavior of SOEs in this sector and the sector's prominence in the economy (including potash- and oil refinery-related activities). A plausible explanation might be that the relatively high weight assigned to the manufacturing sector in fulfilling broad socio-economic objectives seems to alter SOEs' managerial behaviors and adversely impact their competitiveness.²³

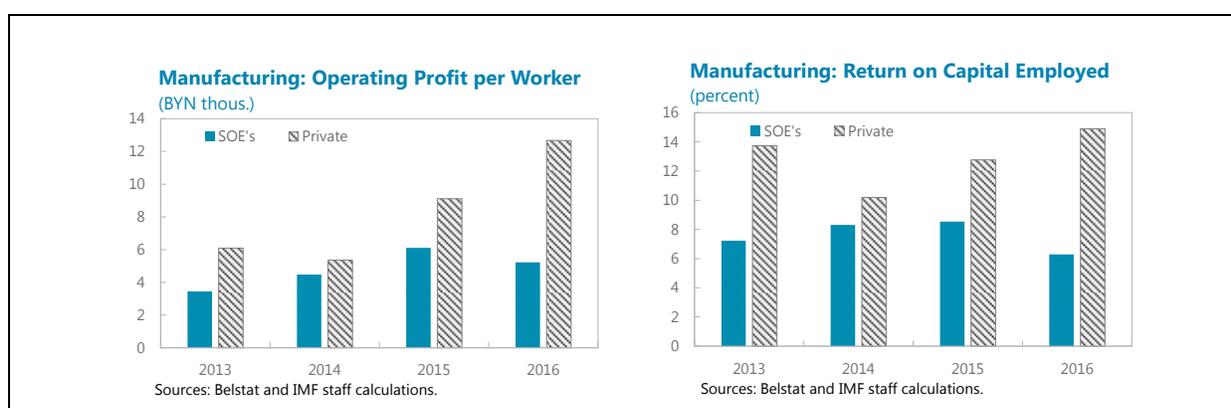
15. In 2013–16, SOEs involved in manufacturing activities were not only less profitable than private companies, but also faced more significant liquidity constraints. SOE's margin on sales was on average substantially lower, while the share of total costs of production to revenues exceeded that of private companies. The latter was driven by non-labor costs, as costs of remuneration of workers were lower (including, contrary to the average for SOEs in the whole economy, as a share in total costs of production). Higher non-labor production costs may indicate existing differences in types and import intensity of inputs and signal differences in the production and delivery chains, but these are also related to SOE's lower than that of private companies' efficiency in using the available resources (see paragraph 16). On average, SOEs were not only less liquid than private companies, but were also facing problems with fulfilling their current obligations, including the timely service of debt. This is showed by their current assets falling short of current liabilities in 2015–16.²⁴

²² These include Belaruskali (a potash company) and oil refineries.

²³ The available data do not allow in-depth sub-sectoral analysis, nor analysis of performance of flagship companies versus potential private or international competitors.

²⁴ This should also be seen in conjunction with the BoP crisis 2014/2015 and related devaluation of the Belarusian Rubel.

16. SOEs' productivity and efficiency in using resources was below those in private companies. Despite lower remuneration costs per worker, the SOE's operating profit per worker was on average some 1.5 times lower than that in private companies (text chart). Interestingly, the average nominal wages and salaries for SOEs in the manufacturing sector were higher than the average for SOEs in the whole economy, but still lower than in private companies. In addition to differences in the required skills, available labor supply, and the presence of the flagship SOEs, this is also likely a confirmation of the importance of the manufacturing sector for the authorities' socio-economic policy and, arguably, of the relative comparative advantage of private companies in other sectors. SOEs' return on capital was also lower than that in private companies (on average some 1.7 times), so was the operating profit per unit of fixed capital investment (text chart). Unlike for the whole economy, costs of credit for SOEs (proxied by the calculated effective interest rate) seem not to be very different from the cost of credit to the private sector.²⁵



17. Although there appear to be no major visible differences between SOEs and private companies in common sustainability indicators, some signs of tensions in the former exist. In terms of leverage, SOEs and private companies shared similar pattern, with both relying more on debt financing.²⁶ Despite the coverage of liabilities with assets being marginally higher in SOEs than in private companies, in 2013–2016 total assets per worker in SOEs were on average lower (unlike averages for the whole economy). This can be explained by lower current assets (in line with the findings about SOEs' liquidity), as fixed assets per worker in SOEs were higher than in private companies.

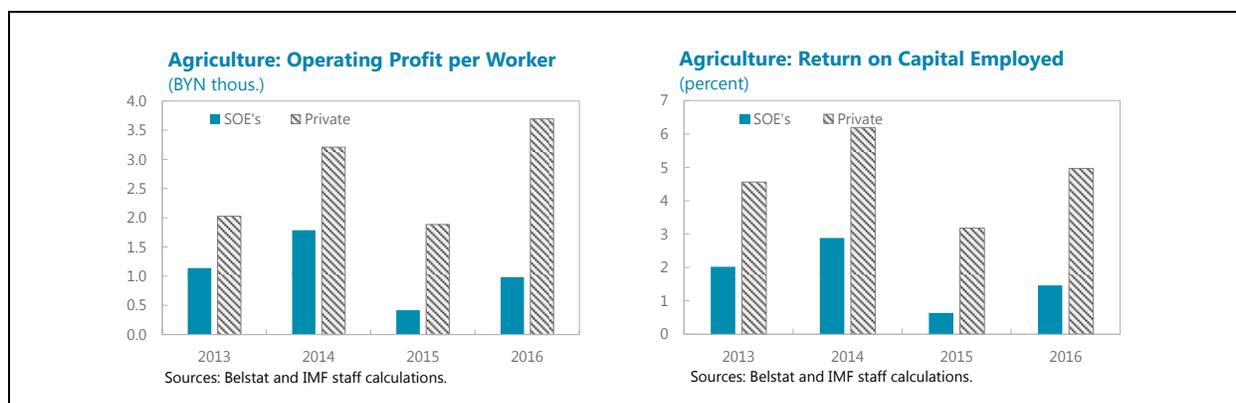
²⁵ It might be explained by the limited reliance on directed lending in this sector comparing to other sectors or the share of foreign currency credit in total credit, including differences in this respect with private companies. However, differences between SOEs and private companies likely exist in other terms of credit (including maturity and grace periods), as well as credit availability (e.g., in case of export companies). The conclusions are highly influenced by a very short time series (only 3 quarters).

²⁶ Higher leverage is usually common in more capital-intensive sectors.

Agricultural Sector

18. SOEs significantly underperformed private companies in the agricultural sector. If it was not for the state support, including in the form of directed lending²⁷ and subsidies, or the arguably preferential treatment under the public procurement, the discrepancies would be even more prominent. This is the implication of the existing differences in the structure of the market (large public conglomerates and smaller private companies), but also the authorities' policies towards the agriculture sector, including price and market regulations. In addition, the share of private companies in the agriculture sector is small. Without the specific state subsidies, SOEs would on average have permanently run net losses.²⁸ In addition, both SOEs' margin on sales and costs of production, driven by lower non-labor costs amid favorable state policies, were significantly below those of private companies. SOEs were also less liquid and faced more severe problems with meeting debt obligations than private companies.

19. SOEs underperformance, when comparing to private companies, is sharply visible in terms of productivity and efficiency of using labor and capital. The operating profit per worker was in SOEs some 2.5 times lower than that in private companies. While the average monthly wages and salaries of agricultural SOEs were below those in private agricultural companies, the share of labor costs in total production costs in SOEs was higher. This may suggest that SOEs' labor resources are not used efficiently, and that there are technological gaps between SOEs and private companies. In SOEs, return on capital employed was almost three times lower, and operating profit per unit of fixed capital investment about twice below that in private companies (text chart).



20. The weak performance of SOEs in the agriculture sector is in sharp contrast to the substantial increase in their number and number of employed over 2013-16. At the same time, both the number and the role of private companies (including employment and revenues) have

²⁷ SOEs benefit substantially from directed lending used for current activities (including fertilizers) and investment. Based on the Resolution No. 1102 of December 29, 2016 of the Council of Ministers, in 2017 57.5 percent of all disbursements under directed financing is directed towards the agriculture, 78.5 percent of which towards the current agricultural activities.

²⁸ Even after including subsidies, one in four of SOEs in the agriculture sector was loss making in 2016.

been steadily declining. Although those figures may be partially influenced by statistical changes to the classification of the economic sectors, or mergers or divisions of companies, the increasing reliance on poorly performing SOEs may raise questions about the sustainability of the agricultural sector in the foreseeable future (absent changes to state policies). Given these trends and the strong negative macro financial loops, lessened to some extent by state support, including by the creation of the AMC, the agricultural sector still poses fiscal and financial stability risks.

Construction Sector

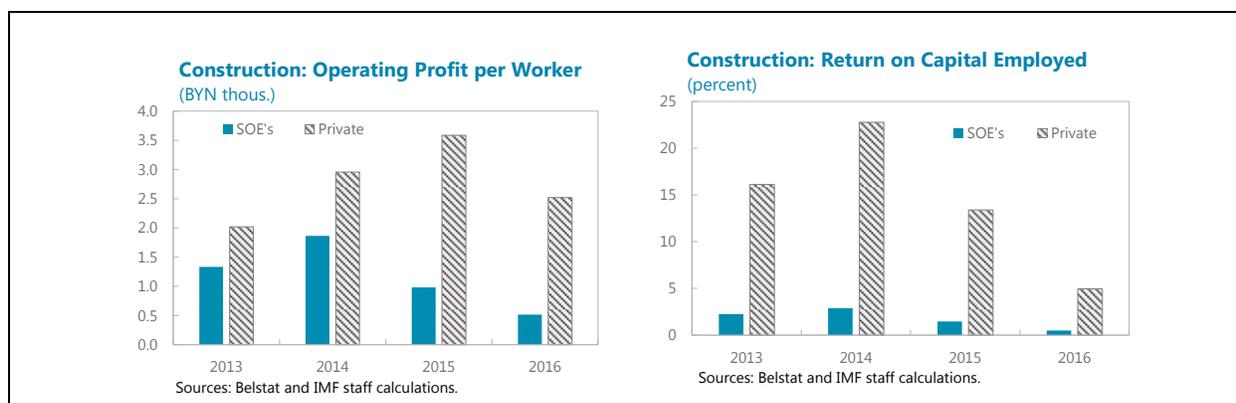
21. On average, SOEs underperform private companies in the construction sector.

Significant discrepancies exist, specifically in ROE and ROA. The latter may imply relatively low productivity of SOEs' fixed assets, which have a dominant (on average 74 percent versus 27 percent in private companies) share in the SOEs total assets. In addition, the valuation of assets (book value) is likely playing a role. The difference may also be partially related to the type of construction work and thus equipment needs (including ownership versus leasing) of both groups of companies. Despite the on average lower average monthly wages and salaries, the share of remuneration costs in total SOEs' costs of production remained similar to that in private companies. In addition, their average costs of production to revenues were slightly higher, whereas the margin on sales somewhat lower. Also in terms of liquidity, SOEs performed on average worse than private companies and had visible problems in timely servicing their debt. However, largely owing to the state support, SOEs experienced on average slightly lower increase in the share of loss making companies during the recession of 2015-16.

22. Both labor and capital productivity in SOEs in the construction sector is below those in private companies, with a particularly sharp difference visible in the latter.

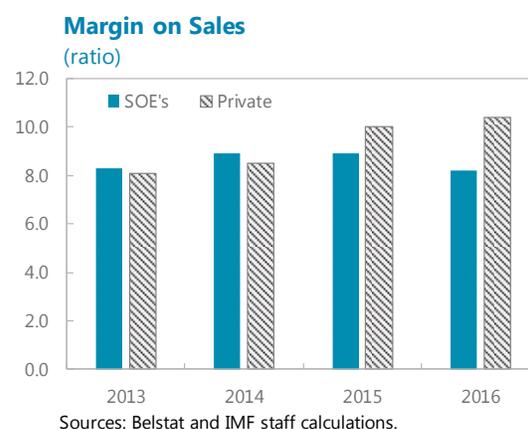
In 2013-16, SOEs' return on capital employed was on average some eight times lower. On the other hand, in terms of profitability of investment in fixed capital (proxied by the operating profit to fixed capital investment), SOEs lagged private companies on average by some 30 percent. These, together with the dominance of fixed assets in total assets, may suggest the excess of fixed assets in SOEs (and possibly pointing to underutilization, subpar quality, and/or overvaluation effect)²⁹. Lower labor productivity but relatively similar remuneration costs, despite lower average wages and salaries, may on the other hand point towards a possible problem of overemployment in SOEs. The potential overemployment may also be partially inferred from the 2013-2016 developments in SOEs' labor force relative to those in private companies. The 22 percent drop in the number of SOEs (while total assets grew by 47 percent in real terms) was accompanied by a 15 percent reduction in employment, whereas the 17 percent increase in the number of private companies (when their assets almost doubled in real terms), was accompanied by a 11 percent reduction in employment.

²⁹ It may also imply more flexibility of private companies in securing equipment, including through leasing.



2015–16 Recession Responses

23. Financial performance of the corporate sector was adversely hit by the 2014/2015 crisis and the following recession. The impact came partially through the exchange rate effect, following a sharp depreciation and fluctuations of the Belarusian Rubel, the weakening demand and, at least in some cases, a worsening spread between input and output prices. The crisis exposed the underlying problems with the corporate balance sheets, including currency and asset-liability mismatches (see paragraph 29). Profitability of SOEs and private companies suffered, substantially impacted by losses on investing and financing activities, and in case of SOEs in 2016 also losses on current operations. Contrary to SOEs, however, private companies on average managed to increase their margin on sales by keeping the increase in costs below that of revenues (text chart). On average, liquidity and sustainability of both groups of companies deteriorated.



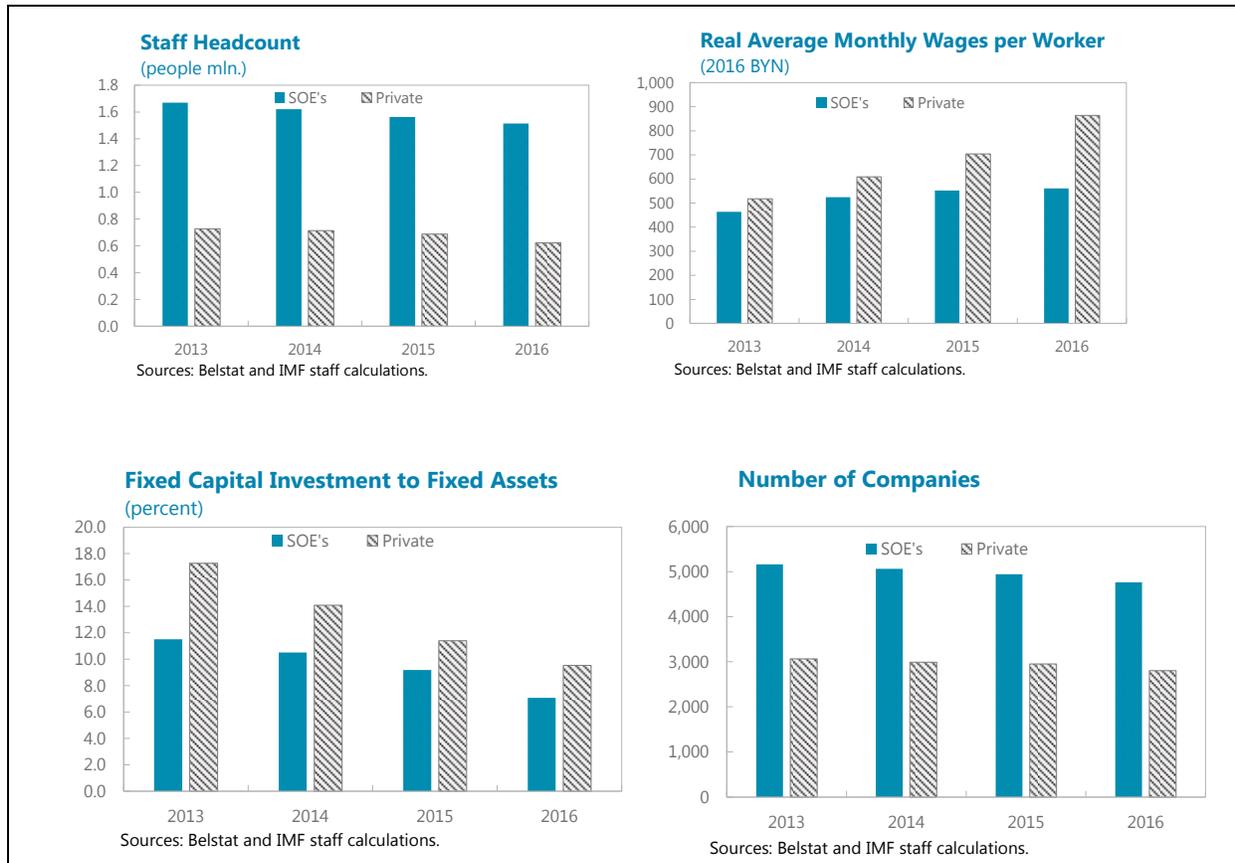
24. On average, SOEs' response to the crisis was less radical than that of private companies.³⁰ In 2015–16 the reduction in employment in private companies was almost twice the size of that in SOEs (12.7 percent versus 6.6 percent), although from a lower base. Lack of detailed data, however, prevents from drawing definitive conclusions about the reasons behind the staff downsizing.³¹ While both groups reduced their fixed capital investment³² as a share in fixed assets by

³⁰ Numbers are distorted by the state support and changes to the number of companies. The latter is partially addressed by using assets as a reference point.

³¹ Specifically, to what extent the reduction in labor was driven by the objective of improving SOEs' performance.

³² The cuts in fixed capital investment in SOEs were 13.8 percent in 2015 and 21.2 percent in 2016 and in private companies 17.5 percent and 22.7 percent for the same years, respectively.

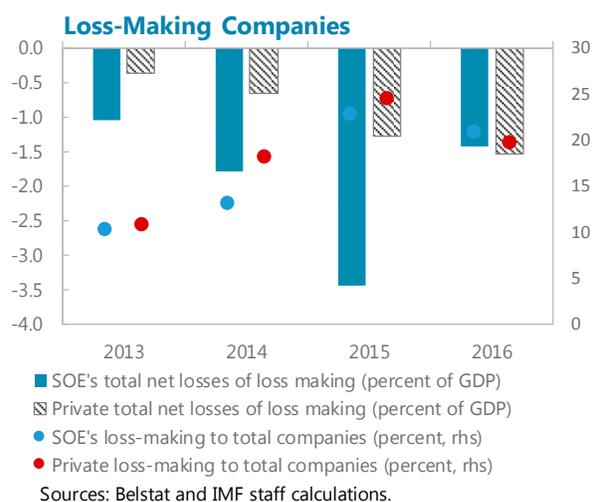
33 percentage points, in 2015 the ratio dropped in SOEs by 15 percentage points relative to 23 percentage points in private companies. SOEs' behavior was highly influenced by the state response in a form of extended direct and indirect support (see paragraph 6), the socio-economic policy objectives and the overall relative reluctance to liquidate even non-viable companies³³.



³³ Since January 2016 to end-August 2017 20 SOEs were liquidated (10 in 2016 and 10 in 2017).

25. There are also some noteworthy differences in the staffing and wage developments.

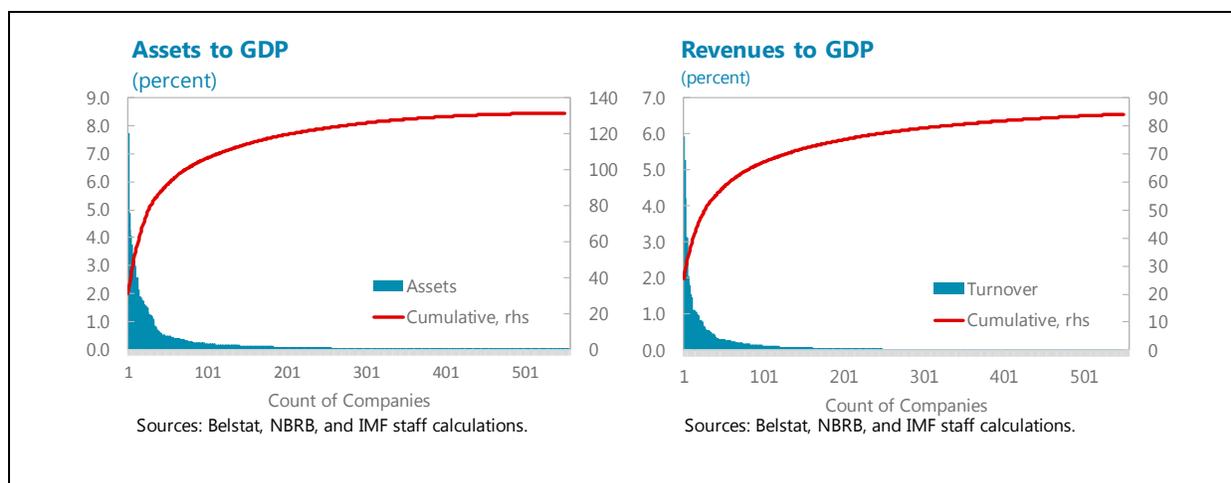
Whereas SOEs reduced both labor and wages (the real average monthly wages and salaries dropped by 9.5 percent in 2015-16), private companies cut employment, but at the same time increased wages (on average by 8 percent). As the growth in real wages was below the growth of real revenues from sales per worker, it would imply some labor productivity gains for private companies. The increase in real wages might have also allowed private companies to attract more qualified employees, despite the reduction in the overall employment. In 2016 the number of loss making companies decreased in both SOEs and private companies (changes in the national accounting rules likely had some impact), but for SOEs the drop came short of the decrease in the total number of companies. Although some of the loss-making companies may have been experiencing only temporary problems, it may also confirm the authorities' reluctance to liquidate even the likely non-viable loss making SOEs and some organizational changes within SOEs, including mergers of loss-making companies with more profitable ones.



C. Performance of SOEs

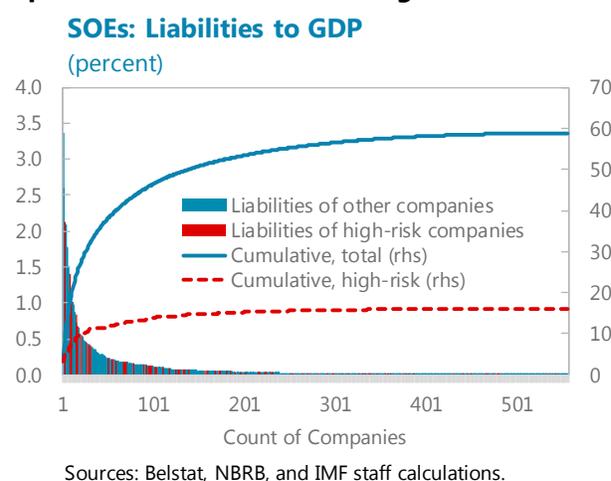
26. The company by company database on SOEs provides some insights into the analysis of SOEs' performance based on aggregated data. The database covers about 560 largest SOEs, i.e., representing some 90 percent of revenues from sales of SOEs with at least 25 percent state ownership. It also includes some additional information on 100 heavily indebted SOEs. The sample is relatively diverse in terms of the type and size of SOEs. As of end-2016, it covered 341 joint-stock companies (59 percent of revenues from sales of SOEs covered by the database) and 217 unitary enterprises, owned or partially owned by the republican or local governments. A majority of the SOEs covered by the database are relatively small companies. In 2016, the top 21 companies in terms of turnover generated 50 percent of revenues from sales and employed some 24 percent of workers.³⁴

³⁴ The largest 60 companies accounted for 70 percent of revenues and 42 percent employment. The largest 100 companies accounted to 79 percent of revenues and 52 percent of employed.



27. More detailed analysis of the largest SOEs points to the scale of existing difficulties with their financial performance, aggravated by the crisis.

In 2013-16, on average some 16 percent of SOEs did not generate enough revenues to cover their costs, 20 percent were loss making and 33 percent faced liquidity problems. Close to 4 percent of them were in protracted (i.e., for four consecutive years) financial distress (high-risk companies).³⁵ These problems were more prominent in joint-stock companies than unitary enterprises.³⁶ In 2015, total losses of loss making SOEs, once specific state subsidies are excluded, peaked at 3 percent of GDP (2.2 percent without excluding subsidies), but fell to 1.5 percent of GDP (0.8 percent of GDP) a year later, as the number of loss making entities dropped (from 152 to 118), following the SOEs' the response to the crisis and the state support. On average, after having reached a peak of 35 percent in 2015, the share of SOEs experiencing liquidity problems dropped to 33 percent in 2016, as did the share of SOEs in financial distress—from 19 percent (106 companies) to 15 percent (85 companies). However, liabilities of high-risk

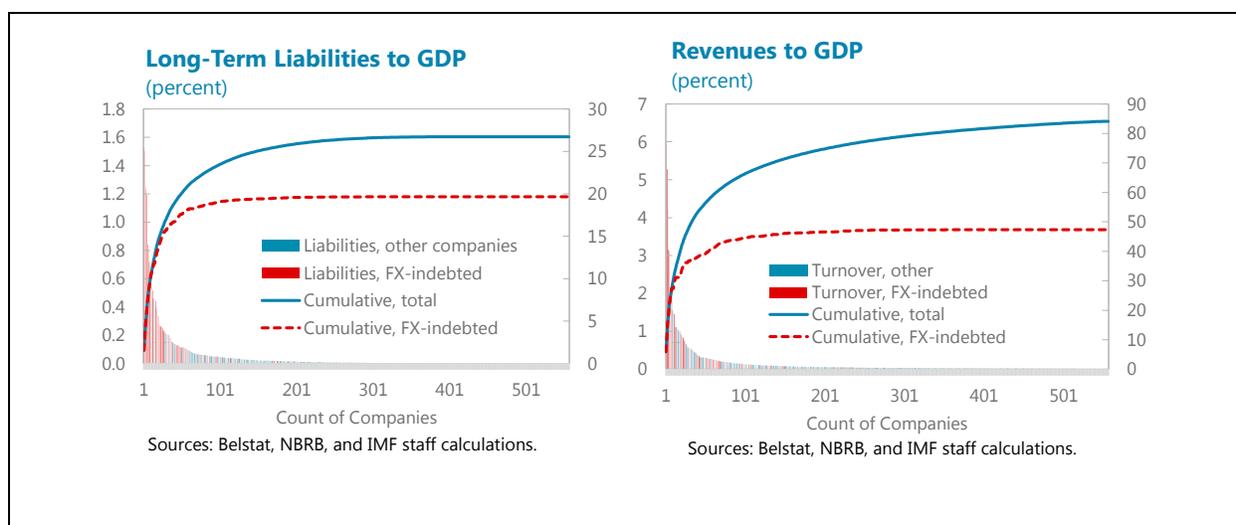


³⁵ Financing distressed is defined as simultaneously meeting three out of four criteria: (i) cost recovery < 1 (profitability); (ii) net profit before tax < 0 (profitability); (iii) current ratio < 1 (liquidity); and (iv) total assets to total liabilities < 1 (solvency). Most of them (slightly over 50 percent) were engaged in agriculture activities, with the rest involved in manufacturing, processing and repairs, construction and transportation. In addition, almost 5 percent (27 SOEs) were in financial distress for 3 years and almost 7.5 percent (41 SOEs) for 2 years.

³⁶ This can partially be explained by the fact that unitary enterprises seem to receive relatively more of the direct state support, at least in the form of specific subsidies (more than 70 percent of the total specific subsidies to SOEs).

companies reached over 16 percent of GDP at end 2016, thus remaining an important source of fiscal risks (text chart).

28. The depth of the problems with the SOEs' financial performance becomes more prominent, given their foreign currency exposure. The share of liabilities (around 40 percent of GDP) of the top 100 heavily indebted in foreign currency SOEs (high FX-indebted SOEs) in total liabilities of SOEs reaches 70 percent, while their share in total revenues from sales equals some 60 percent (text chart). On average, these companies—with long-term liabilities in foreign currencies at almost 18 percent of GDP—face significant foreign currency exposure and are vulnerable to currency fluctuations.³⁷ The existing currency mismatches between liabilities and revenues at least deepened, if not led to, SOEs' performance difficulties. In 2016 almost 90 percent of total long-term liabilities of high FX-indebted SOEs were in foreign currencies, comparing to some 40 percent of their revenues from sales. While the majority of these liabilities were in \$US and EUR, less than two-thirds³⁸ of foreign currency revenues from sales were collected in these currencies. In addition, in 2016 24 percent of high FX-indebted SOEs was in financial distress. This number decreased substantially comparing to 2015, at least partially because of the undertaken restructuring activities.³⁹



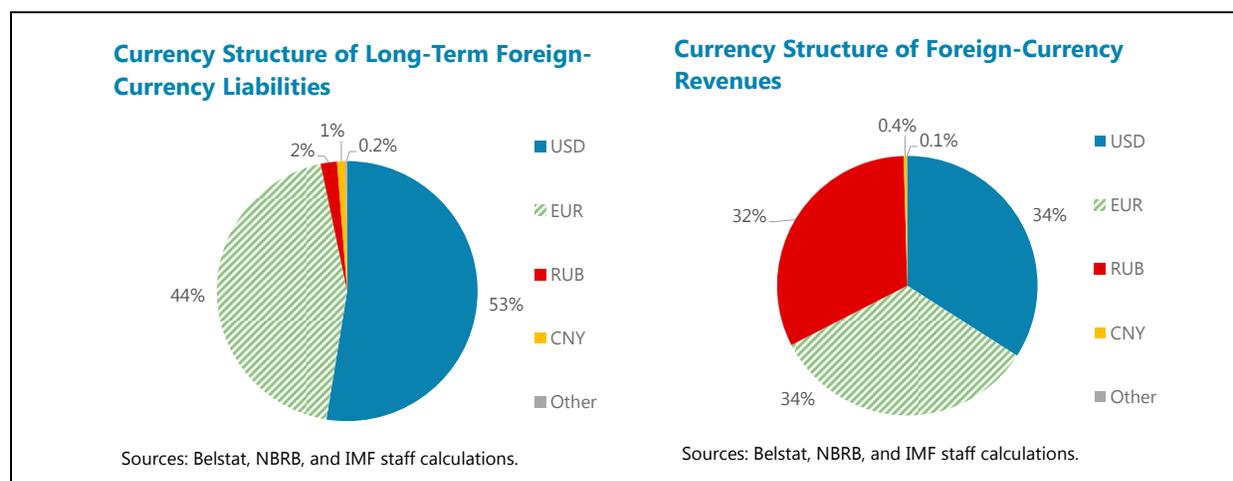
29. The majority (over 70 percent) of SOEs' long-term foreign currency liabilities of high FX-indebted SOEs is towards residents. Given the macro-financial nexus, high foreign-currency

³⁷ On average, based on a simplified calculation, a 10 percent depreciation of the BYN against the \$US would increase the debt by some 1.8 percentage points of GDP.

³⁸ Some 33 percent of revenues is in RUB.

³⁹ The financial performance of highly-indebted in foreign currency SOEs was subject to detailed reviews by a working group (consisting of representatives of the government, NBRB, banks and SOEs), which was responsible for identifying main problems within the SOEs and undertaking actions, including debt restructuring, to address them.

indebtedness towards the resident financial sector generates additional financial and fiscal risks and aggravates problems related to the already high dollarization of the economy.



D. International Experiences⁴⁰

30. The role assigned to SOEs in the economic development and related functions differ across countries. These are determined by the size of the state and its presence in the economy, as well as historical heritage regarding the economic development models and the stage of the economic transformation. In some countries, SOEs have a clearly defined role in the development of specific sectors (like the network industries, e.g., energy and transport). In others, SOEs in practice perform like executive branches of the government, focused on implementing public policy objectives or have mixed, commercial and non-commercial objectives. From the point of view of efficiency, the usefulness of SOEs evolves and usually diminishes, as a country becomes more developed and efficiency concerns gain prominence.

31. Government's participation as an owner in the capital of SOEs can be beneficial for public finances, but also comes with costs and fiscal risks. Well-performing SOEs can be an important source of fiscal inflows in a form of dividends and taxes. However, costs include investment needs to set up and develop a company, and financial support and associated fiscal risks in case an SOE experiences difficulties. The latter gains even more prominence in the context of the macro-financial nexus, where there are close links between SOEs and the financial sector. Therefore, SOEs' healthy balance sheets, the robustness of the institutional framework governing the sector, and SOEs' financial performance should be of critical importance for governments, including also from the point of view of effective allocation of resources in the economy.

⁴⁰ Section largely based on *State-Owned Enterprises in the EU: Lessons Learnt and Ways Forward in Post-Crisis Context*, European Commission, Institutional Paper 031, July 2016 and *State-Owned Enterprises in the Development Process*, OECD 2015.

32. Studies assessing the effectiveness of SOEs' performance are not always conclusive nor lead to identical results⁴¹. A large number of studies find that SOEs are less profitable and efficient than private companies. However, the market structure seems to play an important role—in markets with imperfect competition, the link between ownership and performance tends to be weaker. Other studies, focused on assessing SOE's performance pre- and post- privatization, find that performance tends to improve, but it may not always be the case. In addition, a comparison of performance of SOEs with majority and minority state ownership tends to show that the latter are more cost-efficient. However, the overall political set up in which SOEs operate, their role in fulfilling social function, and the regulatory environment determine companies' performance and, as concluded by some researchers, may matter more than the ownership.

33. Bearing these caveats in mind, an analysis of performance of SOEs in eight selected European countries, which underwent the economic transformation from a centrally-planned model, shows that on average SOEs underperform private companies⁴². These findings apply to countries regardless of the level of state involvement in the economy. Based on firm-level data the study found that profitability and productivity of SOEs tend to be lower in SOEs than that of private companies across the analyzed sectors. The gap was particularly evident in the manufacturing sector. Also, sectors in which a larger fraction of workers is employed in SOEs tend to show lower allocative efficiency (i.e., the extent to which the most productive firms have the largest market share⁴³). In addition, the gap between the performance of SOEs and private companies tended to become smaller (or statistically insignificant) during crisis, as the results of private companies worsened, and performance of SOEs was less affected. Other recent studies, including those prepared by the Fund staff, also find that on average SOEs performance lags that of private companies⁴⁴.

34. Studies, including those done by the OECD and the European Commission show that strong institutions and governance framework for SOEs, while ensuring level playing field for private companies, are critical for efficiency and effective risk management. They found that a comprehensive SOEs legal framework is essential for clearly defining (i) the role of the state as an owner (including clear separation between ownership, policy, and regulatory functions and centralization of state ownership), (ii) SOEs' reporting and accountability framework, and (iii) rules governing SOEs efficient performance, amid fiscal constraints and risks, and the need for private sector development. The efficiency and accountability of SOEs should be guided by a strong

⁴¹ EC p. 31-32.

⁴² EC p. 9-16; 47-65. Countries covered: Bulgaria, Czech Republic, Croatia, Hungary, Poland, Romania, Slovenia and Slovakia.

⁴³In a competitive environment, the most productive firms gain the largest market share. Barriers to competition can prevent reallocation of resources, enabling inefficient companies to survive, while hampering growth of efficient companies. Negative numbers of the index point at forces in the economy which prevent competition to work properly, like excessive regulation, rent-seeking, ineffective procurement. EC p. 55.

⁴⁴ E.g., in countries like Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia, Sweden.

corporate governance framework⁴⁵. One of the frameworks' critical roles is to ensure clear distinction between commercial and non-commercial activities of SOEs, essential for setting transparent performance targets (like profit maximization and social objectives) and accountability frameworks to monitor SOEs' effectiveness. The corporate governance framework should also guard the independence of the SOEs management and its operational autonomy in achieving well-defined targets and the transparent, based on best international practices, accounting and reporting standards.

35. Many countries have implemented SOEs reforms, including as a critical element of a broader economic transformation, to address the SOEs' weak performance and associated fiscal risks, and the existing insufficiencies in SOEs' regulatory frameworks. One of the challenges faced in the reform process in these countries was to ensure its transparency and non-discriminatory character towards the private sector development. Despite the existing differences in the SOEs' frameworks and SOEs' role in the economy, most of the reforms concentrated on improving SOEs' effectiveness in achieving non-commercial objectives and boosting their economic efficiency and value for money. These were achieved through the strengthening of the legal framework and improving the governance and transparency (e.g., in Lithuania, Croatia, Slovenia, Portugal, Romania, Sweden). Main elements of the reforms included (i) an inventory of SOEs, including their commercial and non-commercial objectives, (ii) separation of ownership and regulatory functions, (iii) centralization of SOEs' ownership and/or monitoring, and (iv) improvement of transparency of SOEs' performance, including SOEs' reporting and strengthening the process of appointing SOEs' Boards, aiming for transparency, impartiality, accuracy and independence.

E. Conclusions

36. Despite the arguably better business environment—given the state involvement and the role in fulfilling socio-economic objectives—SOEs' performance in Belarus lags that of private companies. In addition to the on average lower average efficiency and effectiveness, SOEs generate risks to fiscal and financial sectors through the macro-financial nexus. The inferior performance of SOEs is specifically visible in sectors of high importance for the economy - manufacturing, agriculture and construction.

37. Findings on SOEs' performance in Belarus are in line with results of studies for other countries. However, the large size of the SOE sector, relative to other countries, its prominence in the Belarusian economy, and tight macro-financial links imply that problems in the sector will have larger socio-economic consequences. Moreover, SOEs' existing inefficiencies show that further reliance on this sector as an engine of growth can hold back Belarus' economic development.

38. Deep reforms would be required to overhaul the SOE sector and transform it from being a drag on fiscal resources and growth. Reforms, drawing on other countries' experiences, should be based on a comprehensive SOE reform strategy and focused on strengthening institutions. To boost potential growth, it is also important to further develop the private sector and

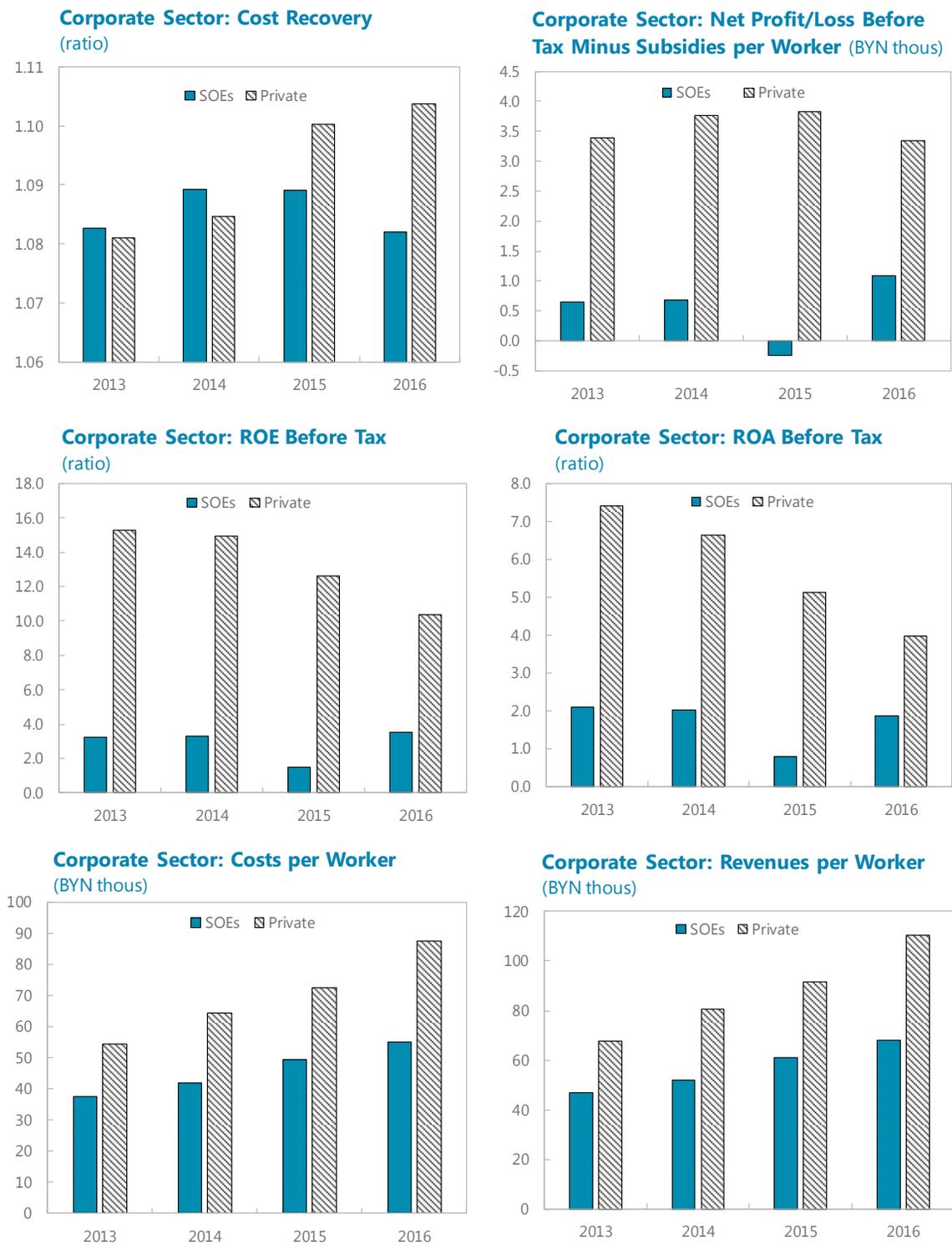
⁴⁵ OECD guidelines on corporate governance of SOEs.

create a non-discriminatory, level-playing field for private companies to compete with SOEs performing commercial functions. These would further ensure more efficient allocation of resources in the economy.

39. Detailed reforms of the SOE sector should aim at improving transparency, corporate governance, and minimizing fiscal risks. These should focus on (i) changing the system of incentives by providing clear distinction between SOEs' commercial and non-commercial objectives, and separation of ownership and regulatory functions, (ii) identifying viable and non-viable companies with the aim to reform the viable and liquidate the non-viable ones, and (iii) strengthening corporate governance, oversight and transparency. To guide these efforts, the authorities are advised to adopt a comprehensive SOE strategy that will (see 2017 Article IV Staff Report):

- continue tightening soft budget constraints, including by enforcing planned reductions in subsidized directed lending and state debt guarantees;
- unify government oversight of SOE assets;
- strengthen the fiscal risk assessment and reporting capacity of the MoF, and links to the budget, focusing initially on SOEs;
- strengthen corporate governance, including separation of ownership and regulatory functions and strengthening supervisory boards;
- proceed with plans for pilot privatizations;
- establish a comprehensive SOE inventory, and financial indicator database.
- implement a framework for identifying and tracking inefficient and loss-making SOEs, with strong criteria for subsequent restructuring or liquidation;
- prepare and implement clear criteria for continued state ownership or privatization;
- introduce measures to enhance competition, including possible privatization; and
- other complementary measures such as strengthening the legal, accounting, reporting and auditing framework (e.g. switch to IFRS), transparency, and close coordination of SOE restructuring with financial sector reforms.

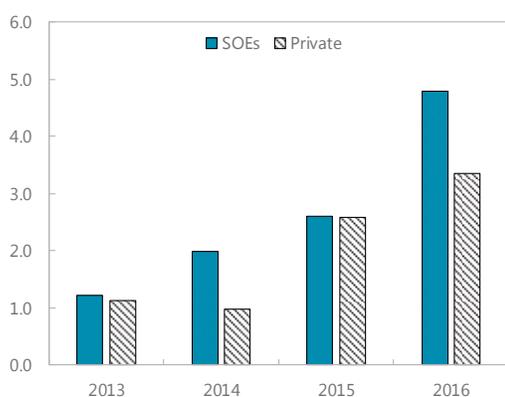
Figure 2. Non-Financial Corporate Sector: Profitability



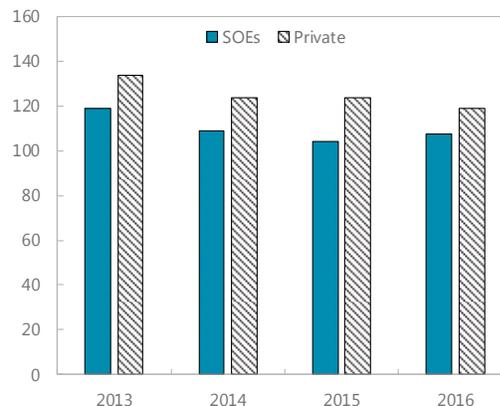
Sources: Belstat and IMF staff calculations.

Figure 3. Non-Financial Corporate Sector: Liquidity

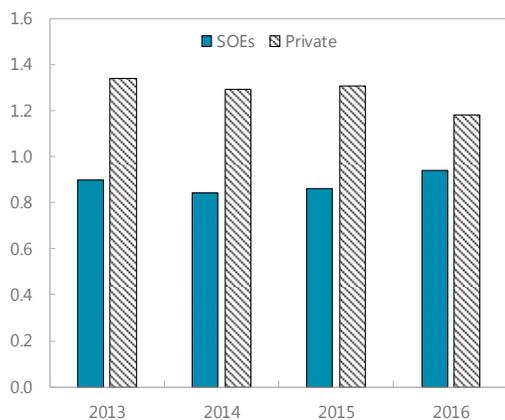
Corporate Sector: Arrears on Credit and Loans (percent of total credit and loans)



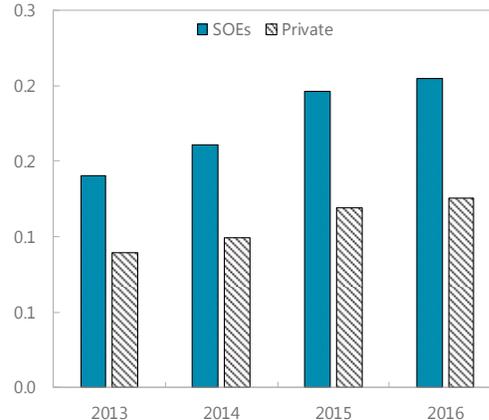
Corporate Sector: Current Liquidity (short-term assets as a percent of short-term liabilities)



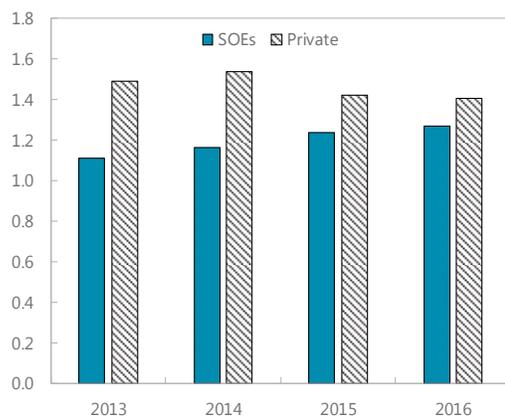
Corporate Sector: Payables Overdue to Receivables Overdue (ratio)



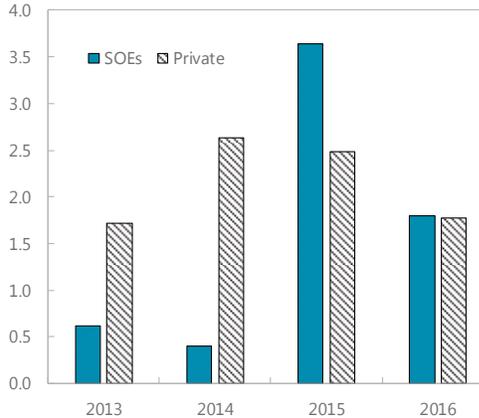
Corporate Sector: Payables Overdue (ratio)



Corporate Sector: Payables to Receivables (ratio)



Corporate Sector: Wage Arrears per Worker (BYN)



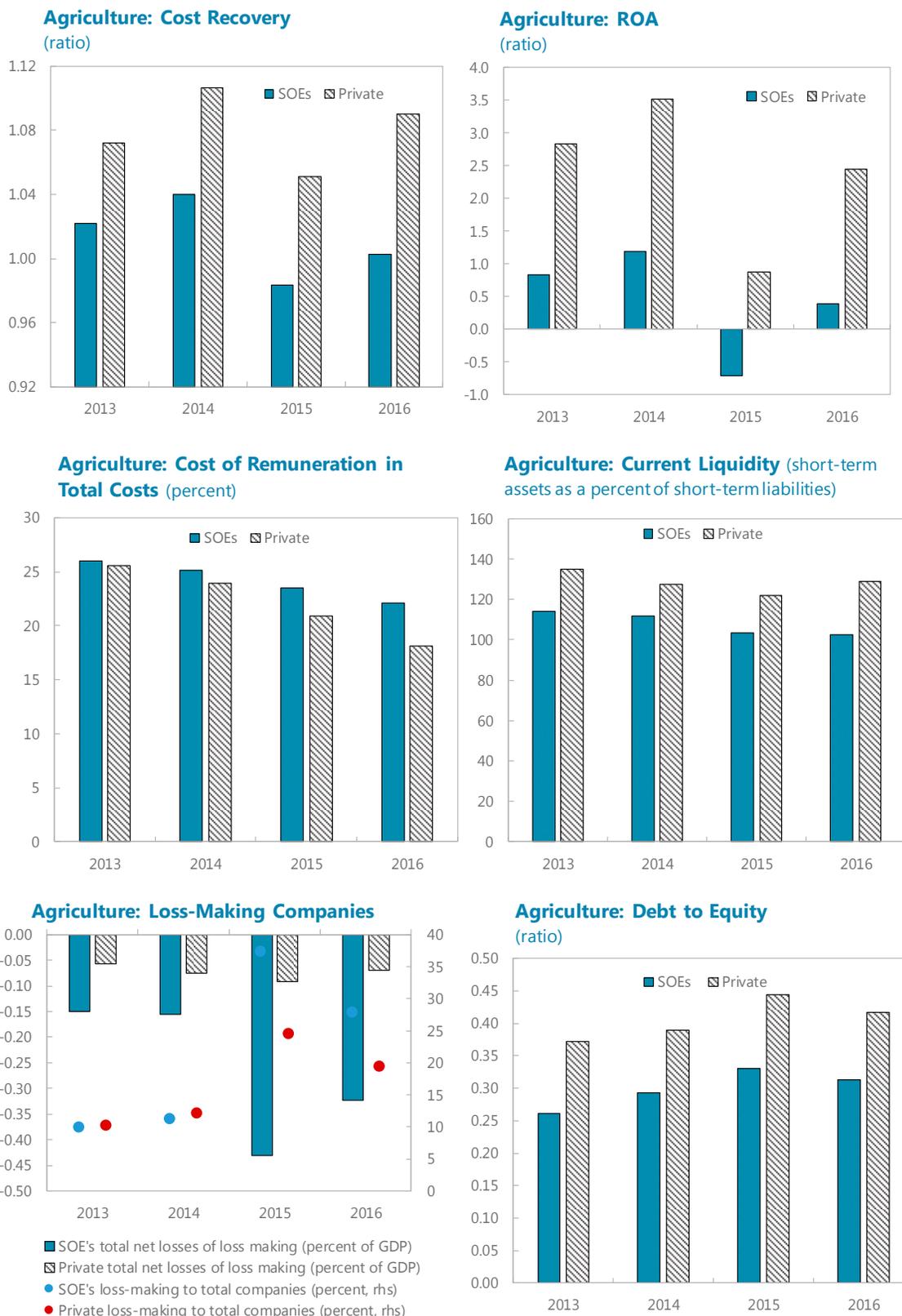
Sources: Belstat and IMF staff calculations.

Figure 4. Non-Financial Corporate Sector: Manufacturing



Sources: Belstat and IMF staff calculations.

Figure 5. Non-Financial Corporate Sector: Agriculture



Sources: Belstat and IMF staff calculations.

Figure 6. Non-Financial Corporate Sector: Construction



Sources: Belstat and IMF staff calculations.

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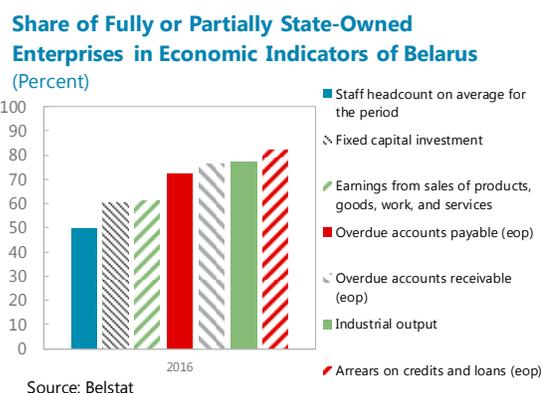
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STATE-OWNED ENTERPRISE RESTRUCTURING IN BELARUS: POTENTIAL LABOR ASPECTS¹

A. Background

1. The necessity of reform of state-owned enterprises (SOEs) in Belarus has been widely discussed in recent years. Fund staff have consistently urged deeper transformation of the state-owned enterprise sector to increase competitiveness and efficiency of allocation of resources, reduce risks to the budget and financial stability, and provide a better foundation for higher sustainable economic growth. Economic conditions are not favorable for a long-term support of inefficient SOEs to avoid the social costs of restructuring. Given the current and projected low economic growth, reduction of economic support from Russia compared to previous years, insufficient inflow of foreign direct investment and rather slow development of the private sector, the attempts to solve the financial problems of SOEs on case-by-case basis using increasingly complicated and non-transparent tools of state support are likely to result in the additional burden on the budget, further growth of non-performing loans in the banking system and government debt.²



2. The possibility of significant labor shedding in the context of SOE reform in Belarus is a matter of deep social concern — and a key argument made for delaying reforms. SOEs³ play a central role in the economy, accounting for more than 75 percent of industrial output, around 60 percent of fixed capital investment, and around 1.5 million of staff headcount in 2016. Observers cite the experience of other countries, where restructuring of SOEs has often been accompanied by decreases in employment. In addition, several studies have shown that SOEs in Belarus often have more staff (“tend to play a role of “employer of last resort”⁴) and are less efficient, compared with the similar private enterprises (Cuaresmo, et al. (2012) and World Bank (2012)).

3. The amount of excessive labor at SOEs in Belarus has received much attention, but with a wide range of estimates. The World Bank (2012) estimated overstaffing at SOEs to be around 10.3 percent, with industry and construction being the sectors with the most excessive labor.

¹ Prepared by Mariya Sviderskaya.

² See IMF Country Report No. 16/298 (2016) for more discussions on SOE and other structural reforms in Belarus.

³ Here and below state-owned enterprises are defined as fully state-owned enterprises and enterprises with any share of state.

⁴ Ehrke et. al (2014), p.10

The Eurasian Fund for Stabilization and Development (EFSD, 2016) presented an even larger estimate of 20 percent excess employment at SOEs and 14 percent of total employment in the economy. The Ministry of Labor and Social Protection found evidence of 5.4 percent excessive labor in the enterprises where overstaffing was detected, during January – September 2016. Analysis of Belstat data on involuntary part-time employment suggests 2.3 percent excess employment in the economy during 2016, but also shows a decline in the dynamics of hidden unemployment as the economy has come out of recession (Table 1).

Table 1. Belarus: Estimates of Hidden Unemployment

		2015	2016	H1 2017
All-day (whole shift) downtime	Number of employees, thousand	204.3	148.5	80.6
	Duration of downtime, days/person	21	18	10
Incomplete working hours on the initiative of the employer	Number of employees, thousand	320.2	252.4	115.3
	Duration, days/person	14	15	10.5
Hidden unemployment*, thousand		140.5	100.9	32.0
as percent of total employment		3.1	2.3	0.7

Source: Belstat, IPM Research Center 02/2016.

*Those not working for three months with 21 working days are considered potentially unemployed.

Enterprise monitoring conducted by the National Bank of Belarus also suggests that the number of enterprises with excessive employment has been decreasing as the economy strengthens. However, as of August 2017, those enterprises expecting further employment cuts still outnumber those expecting to hire new employees. The reported reduction in excess labor likely also reflects actual reduction in SOEs' staffing. Belstat data indicate that the staff headcount of SOEs declined at a rather constant average annual pace of 3.2 percent during 2014 – 2016. Lack of detailed data prevents from drawing definitive conclusions about the reasons behind staff downsizing at SOEs (however, available evidence suggests that it is likely related to retirement and voluntary departures of employees rather than driven by the objective of improving performance). At the same time, big and medium private and foreign companies, which are more flexible in their reaction to the changing macroeconomic conditions in

Enterprises Monitoring Results
(Balance of replies, percent)



Source: NBRB.

Note: The balance of replies are defined as the differences between the number of responses on overstaffing and understaffing, and between the number of responses on expected increase and decrease in employment, expressed as a percentage of the total sum of meaningful answers.

terms of hiring and terminations of employees, have reduced their staff headcount in 2016 by almost 10 percent compared with the previous year likely as a reaction to recession.

Dynamics of Staff Headcount of Large and Medium-Sized Enterprises Reporting Monthly to Belstat (Percent of 2013)

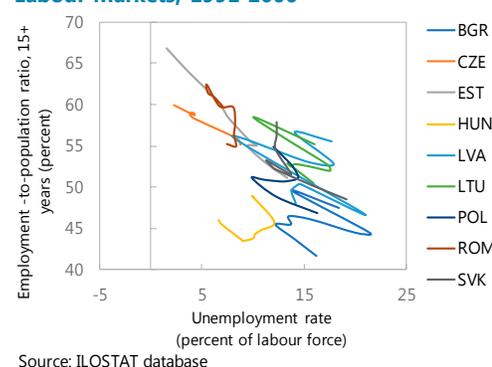


B. International Experience: Impact of SOE Restructuring on Unemployment

4. The experience of Eastern and Central Europe in the 1990s is often given as an example of more rapid transformations in the SOE sector.

The overall economic situation of that time can be described by collapse of sales networks, prices' and markets' deregulation as well as fiscal constraints that to great extent contributed to the labor market dynamics. Under such circumstances the countries could not afford to postpone the restructuring and privatization of SOEs. Even though the speed of transition varied across the countries of the region, in general this period was characterized by shifts in labor between the public and private sectors, which reflects both privatization processes as well as growth of the private sector (Schriff, et al., 2006). However, the private sector did not develop fast enough to fully offset the job shedding in the government and SOE sectors, which resulted in significant growth of unemployment and a decrease in overall employment due to early retirement, extended maternity leaves and withdrawals from the labor market by discouraged workers.

Labour Markets, 1991-2000



Share of Public and Non-Public Employment in Total Employment (1990=100)

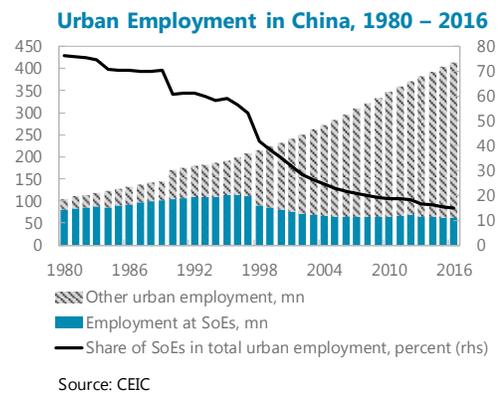


5. At the same time, stronger unemployment benefit systems were put in place.

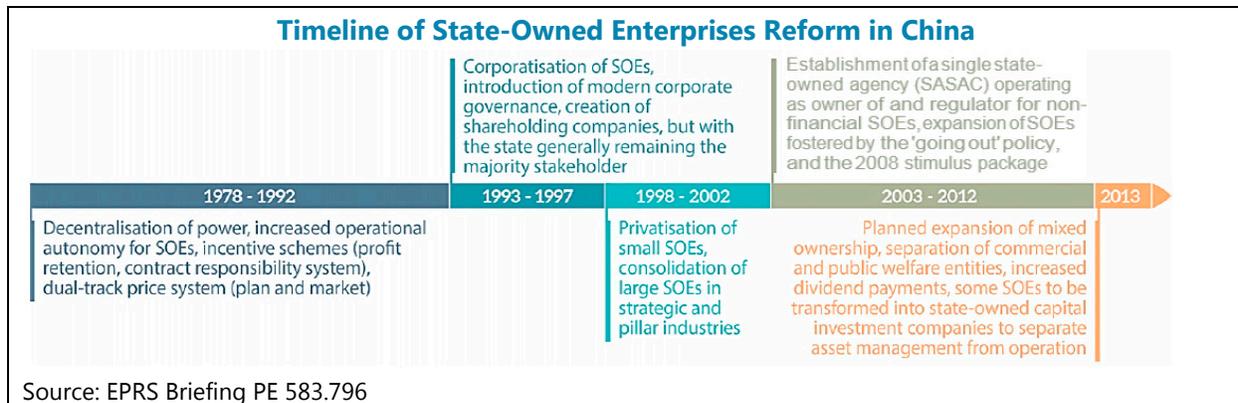
This was true both in terms of eligibility rules and the amount and duration of benefits, since it was assumed that the unemployment was of transitory character. But when the unemployment rates in many cases

accelerated rapidly and remained high, the eligibility criteria and benefit levels were restricted to save the limited resources and encourage the unemployed to take up new jobs (Nesporova, 2002).

6. China is a common example of more gradual approach to the reform of SOEs. The more rapid reform involving large-scale privatization and job losses was initially considered unacceptable both for political reasons and due to the absence of a state social security system to provide support to the dismissed workers. The transformation of the sector started in the 1980s, when SOEs for the first time received some independence in management decision-making, such as the possibility to sell output beyond quotas at market prices. However, the first stage of reforms did not bring sufficient



improvement of the state-owned sector performance and there was little change in employment levels. In the late 1990s, under the policy of “retain the large, let go of the small”, a rather large-scale change of ownership of small and medium SOEs happened and the consequences for employment were considerable. They were to some extent mitigated by introduction of various social protection and re-employment schemes (aimed inter alia to de-link social safety nets from SOEs)⁵ as well as the strong development of private sector during the period of substantial economic growth.



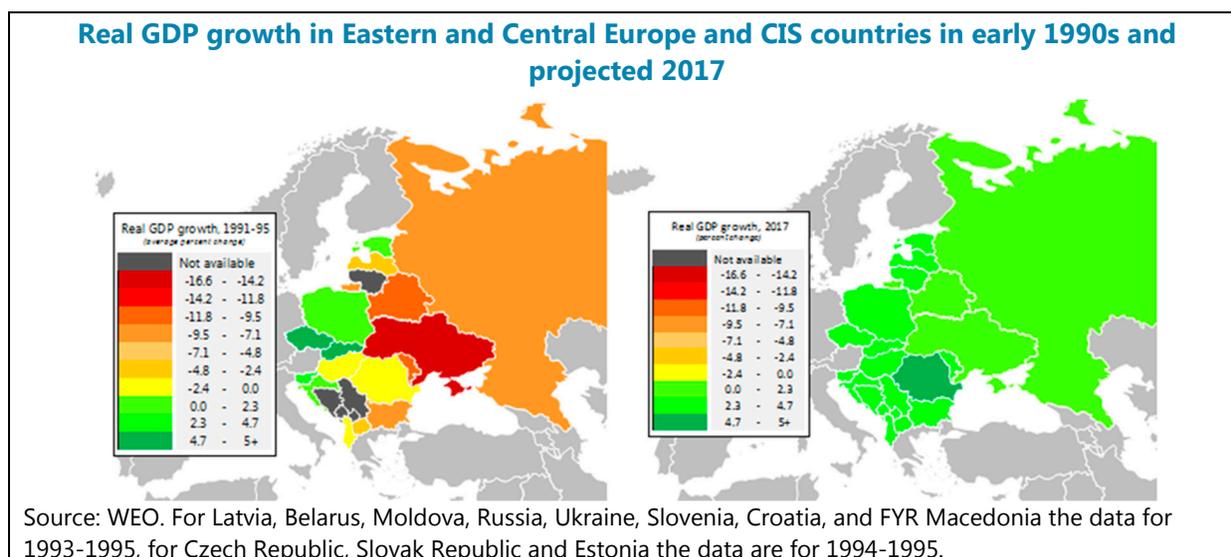
C. The Limits of International Lessons in SOE Reforms

7. Drawing lessons for Belarus from international experiences should be done with caution, given that the impact of SOE restructuring on employment depends on many factors. These include: (i) the pace of SOE reform; (ii) the pace of other macroeconomic reforms in the economy; (iii) the size of available policy buffers; (iv) domestic economic conditions (e.g. recession; private sector job prospects); (v) external trade and finance conditions; (vi) government regulations

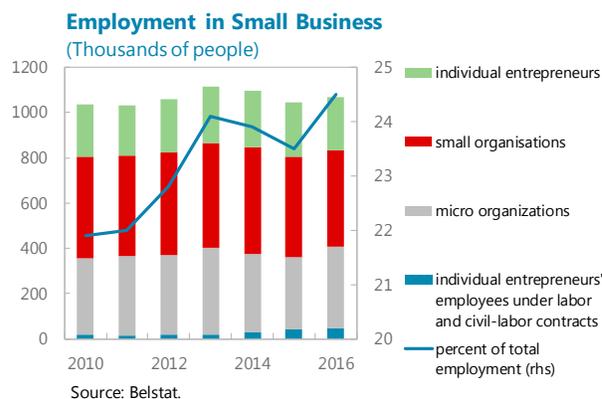
⁵ See Gang, F., M. Lunati and D. O'Connor (1998) and Garnaut, R.; Song, L. and Yao, Y., (2006)

and agreements (e.g. agreements of the new owners of privatized enterprises with the authorities on the pace and scale of staff optimization); and (vii) the size of the public sector prior to the reform.

8. External environment, even though worsened in recent years, is much more favorable than in the 1990s. The chart below illustrates the average GDP growth in 1991-1995 in Central and Eastern Europe as well as CIS countries and the projected GDP growth in 2017. Compared to the 1990s, sales networks and trade chains have been restored and stabilized, the countries of the region have transitioned to market economy and experience economic growth. At the same time, the outlook of Russian economy remains particularly important for Belarus in terms of exports prospects⁶ and financial support.



9. The impact of SOE reform on employment in Belarus might turn out not so significant as in case of Eastern and Central European countries. It is important to note that unlike the experience of the mentioned countries in the 1990s, where in most cases private sector was small or non-existent at the initial stage of economic transition, in Belarus private sector can absorb significant part of the dismissed workers of SOEs in case of adequate policy measures promoting its development. For instance, small and micro organizations⁷ (most of which are of



⁶ For more details, see Belarus: Selected Issues Paper, Export Diversification and Trade Barriers.

⁷ Small organizations – commercial organizations with an average number of employees 16 to 100 in a calendar year; micro organizations – commercial organizations with an average number of employees 15 or less in a calendar year.

private and mixed ownership), despite the decrease in average number of employees in 2014 – 2015, still employ around 785 thousand people, which is 18 percent of total employment in the economy in 2016. In turn, big and medium private and foreign companies have staff headcount of around 623 thousand people even after significant reductions of the last three years. The number of individual entrepreneurs remains rather stable in recent years, (236 thousand people or 5 percent of total employment in 2016). Thus, despite the negative impact of the recent recession the estimated number of workers of private and foreign companies and self-employed is close to the staff headcount of SOEs. According to Belstat, in 2014 the share of private (without state share) and foreign ownership in gross value added reached 50.1 percent, compared with 41.4 percent in 2009. Therefore, it is likely that comprehensive measures to promote private sector development along with improving macroeconomic environment can help to mitigate the consequences of restructuring of SOEs.

10. In addition, the authorities have tight control mechanisms over the pace and scale of layoffs, e.g. in accordance with the acting Law “On employment of population”. The employers must inform the state employment office on upcoming “mass release of workers”, including on qualification and salaries of dismissed employees. Mass release is defined as liquidation of enterprise with staff headcount more than 25 people; a layoff equivalent to a percentage of total staff headcount set by the Ministry of Labor and Social Protection for enterprises of different sizes, or as a percentage of employed in Oblast or district. Layoffs can be postponed by local authorities for up to six months or distributed in time during one year in case there are difficulties with job search. Moreover, the current system of social protection is developed sufficiently enough to manage the administration of benefits and other measures of employment promotion in case of increased demand. Also, any privatization transactions are also likely to be accompanied by the agreements on the employment dynamics at the corresponding enterprises.

D. Estimating the Size and Fiscal Costs of SOE Reform Labor Shedding in Belarus

11. Two approaches were used to estimate potential labor shedding during SOE restructuring. The assumptions of layoffs were derived based on overstaffing estimates discussed in previous chapters. For simplicity of calculations it is assumed that the workers are laid off at the beginning of each year of a three-year period. Half of the laid off workers who have not retired early find a job after one year, the rest will not find a job during the five-year period. Given significant uncertainties, both approaches should be considered as illustrative scenarios.⁸

- *The first approach* is based on assumptions that most layoffs during restructuring will happen at the SOEs in industry, construction and agriculture, mostly relying on the sectoral and aggregate estimates of excess employment of the World Bank (2012) due to the comprehensiveness of the used methodology. The gender and age profile of staff

⁸ A better assessment can be made by the authorities responsible for the management of state-owned enterprises and social protection based on a comprehensive analysis of state-owned enterprises sector performance, which will help to identify non-viable enterprises subject to liquidation as well as the ones with excessive labor more precisely.

headcount at SOEs of these economic activities was then estimated based on the economy-wide indicators for these types of economic activity.

- *The second approach* is based on the data of staff headcount by forms of ownership with the breakdown by age and gender, and assumes that the number of unemployed in 2016 according to labor force survey will double during a three-year period because of restructuring. The “state ownership” data are adjusted by the estimated staff headcount of budgetary organizations not subject to restructuring. For both approaches, 40 percent of total layoffs happen in first year, and 30 percent in the second and third years.

	Year 1	Year 2	Year 3	Total
Approach 1				
Men	64.7	48.5	48.5	161.6
Women	36.7	27.5	27.5	91.6
Total	101.3	76.0	76.0	253.3
Approach 2				
Men	61.6	46.2	46.2	153.9
Women	51.4	38.5	38.5	128.4
Total	112.9	84.7	84.7	282.3
Source: calculations based on Belstat data				

12. The fiscal costs considered include several policies in place, probable support, and enhanced social safety nets proposed in recent years by Fund staff (Box 1). The costs include severance payments, unemployment benefits, pensions for early retirees, reduction in contributions to the Social Protection Fund and in personal income tax, and state targeted social assistance (GASP) costs for the long term unemployed. At the same time, a greater assumed scale of layoffs can provide an upper bound of estimates of potential fiscal costs of social safety nets.

Box 1. Assumed Fiscal Costs of Social Support During SOE Restructuring

For the purposes of calculation, it is assumed that severance payments amounting to the average wage for three months will be paid to all the reduced workers. Even though severance payments are paid by an employer, loss-making state-owned enterprises are likely to receive budget support for such payments to employees. The expenditures on severance pay depend on the difference in the wages of men and women, as well as the gender breakdown of reduced workers. For calculation of severance payments as well as the reduction in total wage bill, the December 2016 data on nominal gross average monthly wages and salaries of men and women by types of ownership were used, excluding the wage bill of budgetary sector from state ownership category and adding the wage bill of organizations of mixed ownership without foreign participation.

In Belarus, it is possible to retire two years earlier than general retirement age in case of liquidation of the enterprise and absence of employment opportunities. Also, those who were laid off due to other valid reasons can retire one year earlier than the retirement age. Two assumptions were made for both approaches regarding the early retirement. Firstly, workers who are closer to retirement age are more likely to be laid off in case of restructuring. Secondly, they are more likely to become subject to early retirement and accept it when pension is significantly higher than the unemployment benefits. The number of potential early retirees depend on the assumption of gender and age structure of layoffs. Average old-age pension size in December 2016 was used to calculate the corresponding expenditures.

It is assumed that the size of the unemployment benefits is raised to the level of the minimum subsistence budget for employable population as of December 2016 (BYN 193.14), and is received by the registered unemployed for 12 months. The 12-month duration is to address the potential need for longer job search by the former workers of the state-owned enterprises and could be adjusted depending on the overall economic situation and based on a deeper analysis of the Labor Force Survey data¹. The number of recipients for each year is equivalent to the number of laid off workers less those who retired early.

Some additional fiscal costs not directly related to state-owned enterprise restructuring will arise if the unemployment benefits are increased, since those who have not registered as unemployed before may decide to apply to state employment service. Also, some small share of workers with very low salary might switch to unemployment benefits. However, in an absence of LFS data it is not possible to make reasonable assumptions on the dynamics of unemployment not related to dismissals from state-owned enterprises.

The revenue losses of the budget and the Social Protection Fund from the lower wage bill were also taken into account. They were calculated using the sum of the number of reduced workers in each year, the number of those who did not find a job from previous years and the number of early retirees who did not reach the general retirement age. The reduction of the wage bill was estimated using the gender specific nominal gross average monthly wages. Finally, it is assumed that half of the long-term unemployed due to state-owned enterprise restructuring with no other sources of income, many of which can be the principle earners in the households, will apply for state targeted social assistance (GASP) which would provide the benefit in the amount of the minimum substance budget on average per capita for a maximum period of six months during the calendar year. It should be noted that the design of GASP can be adjusted to address the issue of long-term unemployment.

¹ International experience of unemployment benefit duration is quite diverse (from 3 months to several years). It may depend on previous employment period (Croatia), period of insurance payments (Bulgaria, Estonia, Hungary, Lithuania), the age of the unemployed (Czech Republic), unemployment rate in particular area compared to national average (Poland), etc. See MISSOC Comparative Tables Database for more examples from EU and EFTA states.

Table 3. Belarus: Fiscal Costs Estimation Results

	Year 1	Year 2	Year 3	Year 4	Year 5
Approach 1 (BYN million, December 2016 prices)					
Severance pay	248.3	186.2	186.2	0.0	0.0
Early retirement	101.0	176.8	153.1	77.3	0.0
Unemployment benefits	171.0	128.2	127.3	0.0	0.0
TSA (GASP)	0.0	19.3	33.8	48.2	48.2
Revenue loss	476.6	660.5	758.4	532.0	433.1
Total	996.9	1171.1	1258.7	657.5	481.3
Approach 1 (percent of 2016 nominal GDP)					
Severance pay	0.3	0.2	0.2	0.0	0.0
Early retirement	0.1	0.2	0.2	0.1	0.0
Unemployment benefits	0.2	0.1	0.1	0.0	0.0
TSA (GASP)	0.0	0.02	0.04	0.05	0.05
Revenue loss	0.5	0.7	0.8	0.6	0.5
Total	1.1	1.2	1.3	0.7	0.5
Approach 2 (BYN million, December 2016 prices)					
Severance pay	273.4	205.1	205.1	0.0	0.0
Early retirement	185.9	325.3	282.8	143.4	0.0
Unemployment benefits	144.4	108.2	105.8	0.0	0.0
TSA (GASP)	0.0	13.3	23.3	32.8	32.8
Revenue loss	525.0	773.4	824.2	541.7	360.1
Total	1128.7	1425.3	1441.1	717.9	392.8
Approach 2 (percent of 2016 nominal GDP)					
Severance pay	0.3	0.2	0.2	0.0	0.0
Early retirement	0.2	0.3	0.3	0.2	0.0
Unemployment benefits	0.2	0.1	0.1	0.0	0.0
TSA (GASP)	0.0	0.01	0.02	0.03	0.03
Revenue loss	0.6	0.8	0.9	0.6	0.4
Total	1.2	1.5	1.5	0.8	0.4
Source: calculations based on Belstat data					

E. Further Mitigating and Complementary Policies During SOEs Restructuring

13. Macroeconomic and structural policies aimed at sustainable economic growth would help boost private sector growth. Well-balanced and responsible monetary and fiscal policy, further deregulation of prices and product markets, development of financial sector along with gradual phasing out of directed lending are among such measures in case of Belarus. Equal access

to resources for all market participants should be ensured by developing transparent and competitive markets.

14. Reforms aimed at eliminating barriers for job creation in the private sector and its development are of special importance. Strong private sector employment growth would help absorb redundant workers from state-owned enterprises. For example, to employ additional 150 thousand people in three years (around 10 percent of staff headcount of state-owned enterprises in 2016) big and medium-sized private and foreign companies will need to increase their staff headcount by 7.5 percent each year, which is a great contrast to the recent dynamics. These growth rates can be a bit lower assuming simultaneous growth in employment in small and micro organizations as well as increase of the number of individual entrepreneurs. Therefore, it is necessary to take measures to improve the business climate, e.g. by reducing the administrative burden for businesses, decreasing financial sanctions for minor breaches, decriminalizing selected economic offences, etc.⁹ The property rights should be strengthened, including but not limited to recognizing the privatization agreements not subject to legal challenges upon a certain period.

15. Considering the financial capacities, it is necessary to support small and medium businesses development¹⁰ as well as self-employment schemes. Some examples from the reforms period in the 1990s in Eastern and Central European Countries include scheme of loans for individual economic activity in Poland and self-employment assistance as a series of periodic support payments and a 50 per cent cost rebate on business advisory services in Hungary (Wilson and Adams, 1994). Currently the state employment office in Belarus already assists the unemployed in starting entrepreneurial activity via provision of consulting services and subsidies in the amount between 11 and 20 minimum subsistence budgets¹¹ on average per capita (BYN 197.57 from August 1, 2017), with 1810 people receiving assistance in 2016. Thus, the conditions of such financial support of self-employment can be adjusted to meet the potential increase in demand, provide the appropriate level of screening of the applicants and potentially introduce the recoverability of provided resources. Another way to support hiring by the private sector could be the provision of temporary financial support (directly or indirectly) for payment of salaries of new workers.

16. However, these measures alone will not be sufficient if private companies are not provided level playing field with state-owned ones. According to the survey of SMEs conducted by the IPM Research Center in April 2017, only 12.9 percent of surveyed stated that the conditions for state sector and private companies are equal. 25.5 percent mentioned unequal business conditions compared to state-owned enterprises as one of the five most significant barriers to

⁹ Some promising measures in this area are provided for in the draft package of regulations meant to improve business operation terms in Belarus, the public discussion of which has finished on May 12, 2017, majority of which was adopted in the autumn of 2017.

¹⁰ One of the projects in this area is being implemented by the Development Bank of Belarus since 2014.

¹¹ The minimum subsistence budget (MSB) is defined as the money value of the minimum subsistence level (which is the minimum set of food products, non-food goods and services necessary to preserve the health and well-being of a person of a particular social group, calculated by the Ministry of Labor and Social Protection).

business development. Unequal treatment by controlling bodies, different rental rates and prices for raw materials, unequal conditions for obtaining permits and licenses as well as access to credit were among the most commonly mentioned issues. Thus, the authorities should pursue the goal of equal treatment of enterprises of any type of ownership not only regarding state financial support, but also in other spheres of economic relationships.

F. Potential Adjustments to the Existing Social Protection Policies

17. The state should provide the proper social protection of workers made redundant due to state-owned enterprises restructuring. Severance payments as well as unemployment benefits are common instruments of immediate reaction. In Belarus severance payments in the amount of three monthly salaries are paid in case of termination of labor contract due to staff reduction or liquidation of the organization to employees with any tenure. According to the Doing Business 2017 database, currently the severance payments for employees with shorter tenure are more generous in Belarus than in other surveyed countries—and at the same time the country is close to the average size of severance payment for employees of all tenures. However, due to the widespread use of fixed-term labor contracts lasting from one to three years, most layoffs happen upon their expiry and severance pay is not applied in this case. For instance, in 2010 – 2016 the share of terminations due to liquidation or staff reduction was between 0.8 and 1.6 percent of total terminations by medium and big companies reporting to Belstat. It is necessary to revise the system of fixed-term labor contracts in the medium term toward the more frequent use of unlimited labor contracts¹², which would provide for more protection of workers and increase the motivation of employers to use the labor resources more efficiently.

18. The current level of unemployment benefits in Belarus is low and cannot provide proper social protection. It is reasonable to increase the unemployment benefits at least to the level of minimum subsistence budget (MSB) for employable population for all categories of registered unemployed. This would reduce the risks of poverty not only for the workers of state-owned enterprises in the process of restructuring, but also for those who have already lost their job due to the deterioration of the labor market situation during the recent recession¹³. In general, the size and duration of unemployment benefits should be chosen in a way to support the living standard of those who lost their job while they are actively searching for employment. In case of state-owned enterprises restructuring the duration of unemployment will be influenced by different factors such as the pace of complementary economic reforms and the phase of economic cycle. On the one hand, it is likely that part of dismissed workers will be unable to find a job quickly due to skills mismatch and will require a longer-term support, on the other hand budget constraints and maintaining incentives for job search should also be considered thoroughly. The data of labor force survey as well as the employment indicators of state-owned organizations reporting to Belstat on a

¹² Similar opinion has been voiced in September 2017 by the leadership of Federation of Trade Unions of Belarus – the largest association of workers of Belarus.

¹³ Nevertheless, differentiation in the amount of unemployment benefit based on the reason for the dismissal can also be considered to avoid excess generosity of the system.

regular basis should be utilized to full extent in the analysis of potential duration and size of unemployment benefits.

Table 4. Belarus: Replacement Rates Under Increased Unemployment Benefits

Gross nominal average wages May 2017 (BYN)	Share of workers (percent)	Mid-range wages (BYN)	MSB for employable population May 2017 (BYN)	Replacement rate (percent)
up to 300	10.4	300		68.1
300.1 to 400	13.5	350		58.4
400.1 to 500	13.5	450		45.4
500.1 to 600	12.8	550		37.2
600.1 to 800	20.6	700	204.35	29.2
800.1 to 1000	12.5	900		22.7
1000.1 to 1500	11.7	1250		16.3
1500.1 to 2000	2.8	1750		11.7
more than 2000	2.2	2000		10.2
Weighted average replacement rate, percent				37.2

Source: calculations based on Belstat data

19. It is also necessary to review the requirement on obligatory participation in paid public works for the registered unemployed. Paid public works serve as a job opportunity for those who do not have any other source of income as well as the test for willingness to work. In case of a larger scale layoffs paid public works would need to be expanded, which would likely reduce their efficiency. Also, the types of activities offered as public works should not coincide with temporary job opportunities in private sector.

20. Well-designed active labor market policies can be helpful in the medium term. The state employment service provides a variety of services, such as retraining, self-employment assistance, etc. (Table 5). However, the effectiveness of the existing measures is difficult to evaluate. The design of active labor market programs should be improved based on the information on potential significant layoffs that the state employment service gathers from employers along with much closer cooperation with the employers from private sector. The effectiveness of all the programs should be assessed on a regular basis to make the necessary adjustments.

Table 5. Belarus: Implementation of Active Labor Market Policies

	2014	2015	2016
Applied to the agencies of labor, employment and social protection for assistance in employment (thousand)	231.1	250.6	239.2
of which			
registered as unemployed (thousand)	148.1	182.1	167.6
Job placement - total (thousand)	159.1	151.8	159.8
of which			
job placement of registered unemployed (thousand)	108.6	107.4	109.0
Sent to professional training, retraining, advanced training, training courses (thousand)	9.2	8.7	11.0
Number of unemployed assisted in the starting entrepreneurial activities (people)	1979	1822	1810
Sent to paid public works (thousand)	53.3	55.3	55.8
Number of resettled families of the unemployed	252	168	151
Source: Ministry of Labor and Social Protection			

21. The authorities had been working on establishing the new system of unemployment insurance, but eventually decided not to introduce it in the near term, as well as not to increase unemployment benefits. The insurance scheme should have covered registered unemployed with at least one-year employment record and respective compulsory insurance contributions. The benefit should have amounted to 60 percent of the average wage of an employee, paid for up to six months (70 percent of average wage is paid during first 13 weeks of unemployment, and 50 percent - during the next 13 weeks). To fund the insurance scheme, it was proposed to increase the contributions from the current 35 percent to 35.5 percent. The additional 0.5 percent should have been earmarked for unemployment insurance only and managed by the Social Protection Fund. Contributions were supposed to be divided in equal shares between employee (0.25 percent) and employer (0.25 percent). However, in October 2017 it was announced that the Ministry of Labor and Social Protection decided not to introduce the unemployment insurance in the near future. It was also stated that the maximum amount of unemployment benefits will remain the same (two base rates, or BYN 46 as of October 2017).

G. Conclusions

22. Although the consequences of state-owned enterprises restructuring for the labor market are likely to be significant, their scale in Belarus might turn out to be much less severe than in Central and Eastern European countries in the 1990s. Many of the urgent macroeconomic reforms during the initial period of transition to the market economy have already taken place in Belarus. The fact that the share of employment in the organizations of state

ownership and mixed ownership with share of the state has declined from 64 percent in 2009 to around 58 percent in 2015 potentially indicates that the overstaffing (which is also likely to be less than in other countries right after the collapse of the Soviet Union) is being very gradually reduced through voluntary departures and retirement even without large-scale restructuring. The already existing private sector has the potential to absorb a significant part of reduced workers if the authorities take comprehensive policy measures to promote its development. At the same time, the well-developed system of administration of social support can be utilized to full extent to manage the pace and scale of layoffs. In case the authorities decide to continue with a more gradualist approach (e.g. as in China), the scale of dismissals will be lower, but the improvement in efficiency might turn out insufficient for higher economic growth in the longer term.

23. The estimate of fiscal costs of social protection measures during state-owned enterprise restructuring suggests that these costs are manageable even if the restructuring happens in a rather short period. Potential savings from the restructuring can turn out bigger than costs for social safety nets in the medium term since the constantly loss-making enterprises are likely to go through the restructuring process first. The improved allocation of resources as well as the reduced state support in various forms should increase the effectiveness of the state-owned enterprises and reduce the expenditures of the state. The restructured enterprises will also be able to economize on labor costs assuming they can keep the same level of output with less workers.

24. The well-designed and sufficiently financed system of social safety nets can help mitigate the adverse effects of state-owned enterprises restructuring on employment. The redundant employees should be provided sufficient level of social protection during the job search. A comprehensive analysis of available data and information can help to adjust the existing social protection measures to address the consequences of significant layoffs from state-owned enterprises. The efficiency of both passive and active labor market policies should be evaluated on a regular basis. The social protection agencies as well as local authorities should cooperate closely with the potential employers from the private sector. For example, the ICT sector staff headcount was around 85 thousand people in 2016, the 2017 EY survey among the Hi-Tech Park residents indicated that “88 percent of companies are planning to boost their headcount in the next two-three years, and 52 percent intend to expand it by more than 25 percent” (EY, 2017, p.42). Even though the assumptions on the scale of potential intersectoral movement should be realistic, it might be possible to organize retraining programs based on IT companies’ needs. Also, private companies of similar activities with the liquidated or downsized enterprises might be interested in receiving the information from the authorities on upcoming layoffs in advance to employ some of the dismissed workers.

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REPUBLIC OF BELARUS

The Resolution of the Ministry of Labor and Social Protection of the Republic of Belarus №47 “On criteria of mass release of workers” of April 2, 2009

The Decree of the President of the Republic of Belarus № 41 “On State Targeted Social Assistance” of January 19, 2012

CREDIT GROWTH: A CASE OF CREDITLESS RECOVERY?¹

A. Introduction

1. The growth in the credit to the economy in Belarus continues to decelerate, despite the early signs of economic recovery from the 2015–16 recession. While it is too early to determine if Belarus is entering a period of creditless recovery, there appear to be many supply and demand factors that are pointing to protracted weaknesses in credit growth. This paper examines credit developments prior to the recession, discusses the possibility of creditless recovery in Belarus, and makes policy recommendations to address structural weaknesses in financial and corporate sectors.

2. About one in five recessions are followed by creditless recoveries, where real credit growth remains negative in the first three years of the economic recovery (Abiad, Dell’Ariccia and Li, 2011). The analysis of 388 cases of creditless and normal recoveries in advanced, emerging and developing countries finds that economic growth under creditless recoveries is on average a third lower and more protracted. It also finds that the likelihood of such a creditless recovery is higher when preceded by a credit boom and bust and/or banking crisis. The paper suggests that while the anemic credit growth could reflect excess capacity and low financing needs, it could also be a result of the tighter credit conditions due to the impairment in banks’ balance sheets, hindering firms’ ability to obtain funding. Industries that are more reliant on financing from outside (e.g. bank loans) tend to grow less during creditless recoveries, suggesting the impaired financial intermediation as its primary cause.

B. Credit Developments in Belarus

Background

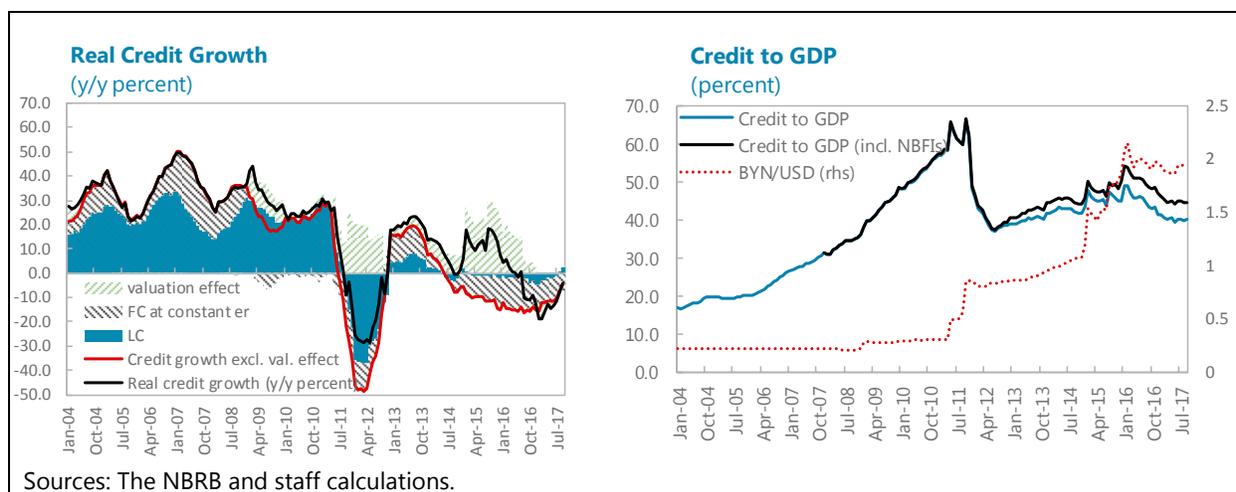
3. Belarus has experienced rapid growth in credit in the past decade and a half, backed by strong economic growth and directed by state policies. The annual growth in net credit to the economy averaged at 40 percent in nominal terms and 19 percent in real terms during Jan 2003-September 2017, and the credit-to-GDP ratio rose steadily from 15.7 percent at end-2002 to a peak of 66.1 percent in Oct-2011, before dropping to below 40 percent following the sharp depreciation in 2011 and 2012.

- *2004 to mid-2011.* With the relatively stable exchange rate, the real credit growth averaged at 34.6 percent in 2004-2008. Domestic currency credit led the increase, growing by close to 40 percent y/y in real term on average and accounting for over 2/3 of the total credit growth during the period. Foreign currency credit also grew rapidly, at around 22 percent on average for the period, with the interest rate on new loans 2-3 percent lower than that for

¹ Prepared by Sumiko Ogawa.

domestic currency credit. Following the depreciation in early 2009, however, the growth in foreign currency credit at constant exchange rate turned negative. Nevertheless, overall real credit continued to grow at a rapid pace of 28.7 percent on average through April 2011 driven by continued strong growth of domestic currency deposits. Credit dollarization declined from 49 percent at end-2003 to the low of 22.1 percent at end-2010, and credit-to-GDP increased sharply from 16.8 percent in Jan-04 to 58.3 percent in April-11 (just before the beginning of the depreciation).

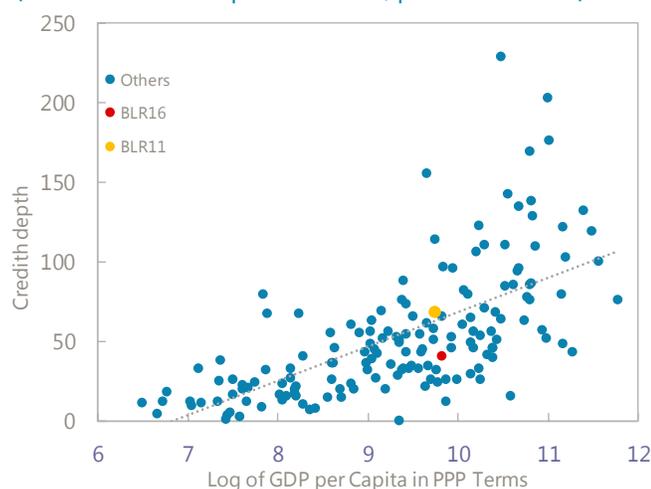
- *Mid-2011 to late-2012.* The exchange rate came under pressure as the current account deficit widened due to expansionary credit and wage policies and the reserve buffers eroded. Real credit growth turned sharply negative, both including and excluding valuation effects as inflation spiked. The credit-to-GDP ratio dropped sharply to 36.9 percent in July 2012. The cumulative depreciation of over 180 percent during the period resulted in the quadrupling of the nominal local currency value of credit extended in foreign currency, putting pressures on the corporate balance sheet and indebtedness.² Despite the significant impact on the stock and the debt service burden of foreign currency loans, especially for unhedged borrowers, the system-wide NPL ratio rose only moderately to 5.5 percent at the peak at end-2012 from 2.8 percent in 1Q 2011.
- *2013-15.* Following the stabilization of the exchange rate, the real credit growth resumed but at a slower pace (13.5 percent on average) and driven by foreign currency credit. Real credit growth excluding valuation effects turned negative in mid-2014, as the exchange rate depreciated further. As a result, the credit-to-GDP ratio increased more moderately to a little over 50 percent. At the same time, the Development Bank started to play an increasingly important role in extending directed lending, amounting to around 5 percent of GDP.



² Foreign currency lending to household is prohibited since October 2009, following the earlier episode of depreciation.

4. The rapid growth in credit was also guided by government subsidies, policy targets, and measures on financial sector performances. The Monetary Policy Guideline (MPG) set growth target of bank claims on the economy until as recent as 2015, and included other targets related to the performance of financial institutions such as the amount of new investment credit, the change in banks' regulatory capital, and the cap on the share of problem assets to total assets subject to credit risk. Furthermore, the lending under government program (directed lending) accounts for around 40 percent of total credit extended by banks, affecting the interest rates on market lending and banks' lending practices. More recently, caps on the lending rates in domestic currency were introduced above which additional provisioning were required. While current level of credit is not noticeably out of line from the trend in economies with similar level of income, directed lending and other distortive measures likely undermine the efficiency of resource allocation.

GDP per Capita and Credit Depth in 2016
(Bank credit to the private sector, percent of GDP¹)



Sources: IFS; WEO; and IMF staff estimates.

¹The sample includes all countries for which data are available.

Note: For Belarus, data includes credit to SOEs.

5. Unlike the rapid boom-bust cycles seen in other countries, Belarus had a protracted period of rapid credit growth backed by strong investment, which likely have been fueled by the distortive policy measures resulting in an inefficient resource allocation (see IMF (2016) on corporate sector performance). During 2016, with the economy in the second year of recession, some of these vulnerabilities started to materialize, and the real credit growth turned negative in May 2016. The decline in directed lending is more pronounced than in market-based lending in part reflecting a decision of the government to scale back (dropping by 5.6 percent on average in 2016 at constant exchange rate in nominal terms compared to an average decline of 3.7 percent for non-directed lending). Does the decline in credit reflects a cyclical trend, or does this reflect structural weaknesses? Would the market-based credit recover with the pick-up in the economic activity, or would the recovery be hindered by the balance sheet weaknesses that are faced by banks and corporates? Would the government try to stimulate credit growth and economic activity by enhancing directed lending? The following section discusses some of the structural problems both in supply and demand side, as well as one-off factors affecting the headline number, that may hinder the recovery in credit growth.

C. Factors Contributing to Weak Credit

6. Credit growth could lag the recovery in output for various reasons. The companies may have retained excess capacity during the recession, and may not need investments to meet the recovery in demand. The companies may have overborrowed during the boom period,

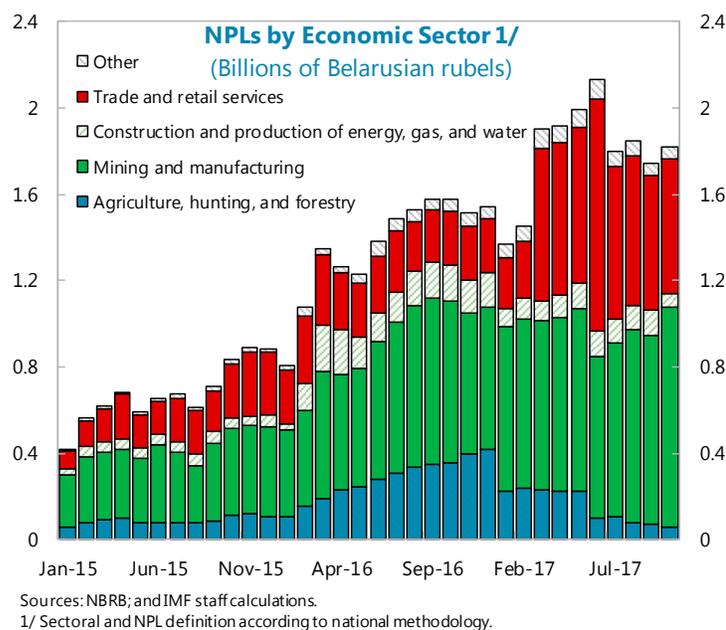
and may have little appetite and capacity to borrow further due to the subsequent deterioration in their balance sheets and weakened financial performance during the recession. Even if there is demand for credit to invest, the banks' ability and the appetite to lend may be impaired from the boom-bust cycle while alternative sources of funding (e.g. companies' internal resources and capital markets) are limited. Either due to supply or demand factors, the resulting anemic contribution of investment in part explains the lower output growth under creditless recoveries.

7. Belarus faces constraints not only in credit supply but also in demand. On the supply side, banks' lending conditions have tightened as they face pressures from weakened asset quality, the need to increase provisioning, and meet several domestic regulatory changes to tighten risk classification and provisioning requirements. While the NBRB has steadily reduced refinancing rate since early 2016, monetary policy (broad money growth) had been tight since mid-2016 through early 2017, reflecting the depreciation pressures on exchange rate and the decline in foreign currency deposits. On the demand side, deep-rooted efficiency and competitiveness issues continue to hinder corporate sector performances, especially in state-owned enterprises (SOEs), limiting their capacity to borrow. This highlights the importance of the corporate sector reform to restore financial viability and improve efficiency, and the reform of bankruptcy and resolution framework for non-viable companies, in addition to the efforts to improve the health of banks' balance sheet and strengthen regulation.

Bank Credit Quality

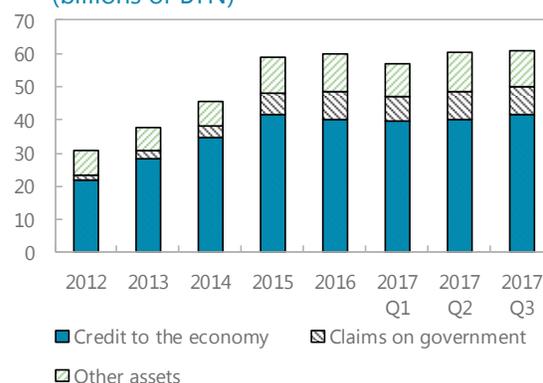
8. Banks have suffered from credit quality issues, as the NPL ratio has jumped to 11.5 percent in 2016Q1 from 6.8 percent at end-2015. In addition to the deterioration in

corporate financial performance, this jump also likely reflects the underlying asset quality issues that had been masked previously, as the exemption on the risk classification of certain state-supported loans expired and government support for SOEs dropped. The government had initiated policies to clean up banks' balance sheets by establishing the Asset Management Company (AMC) and transferring distressed agricultural sector loans to the AMC and local governments. Despite these efforts, the NPL ratio remains elevated at 12.8 percent as of September 2017, only slightly below the level prior to the asset transfer to the AMC at end-December 2016.



9. While the transfers have relieved banks of some of their lower quality assets, they are replaced by the holding of central and local government bonds. Given the lack of an active secondary market and the fact that banks hold a sizable share of government bonds³, the transfer will not likely create space for additional lending. With stagnant deposit growth and scarcity in alternative sources of funding (except possibly for the subsidiaries of foreign banks), scope for credit growth appears limited.

Commercial bank asset composition
(billions of BYN)



Source: IMF MFS database.

Box 1. The Transfer of Agricultural Loans

The authorities have been putting in place policies to provide temporary financial relief to agricultural firms and at the same time improve the banks' credit quality. Loans to certain agricultural companies were transferred from banks (primarily from the state-owned Belagroprombank) to the Asset Management Company, established in mid-2016, all of which were restructured to the maturity of seven years at the annual interest rate of 3 percent. The debtor companies have been placed under close monitoring, depending on their degree of financial distress, and received financial relief by being allowed to pay in installments, over an extended period, debt on penalties and late fees on the payments to the social protection fund; repayment of budgetary loans and unpaid interest; arrears in taxes and fees; and arrears in utility payment. Another set of loans to agricultural sector have been restructured and transferred to local governments. In both cases, the transfers were made at face value, primarily in exchange with central and local government bonds.

Based on these initiatives, BYN2.7bn of agricultural sector loans have been moved to outside the banking system by end-September 2017. This is equivalent to about 6¾ percent of banks' credit to the economy (2.7 percent of GDP). The NPL ratio declined to 12.8 percent at end-2016, when the transfer to the AMC of BYN0.6bn took place, before climbing up to 13.7 percent at end-June 2017 as the stock of total credit declined while NPL only saw a moderate increase.

Asset transfer (as of Oct-2017)

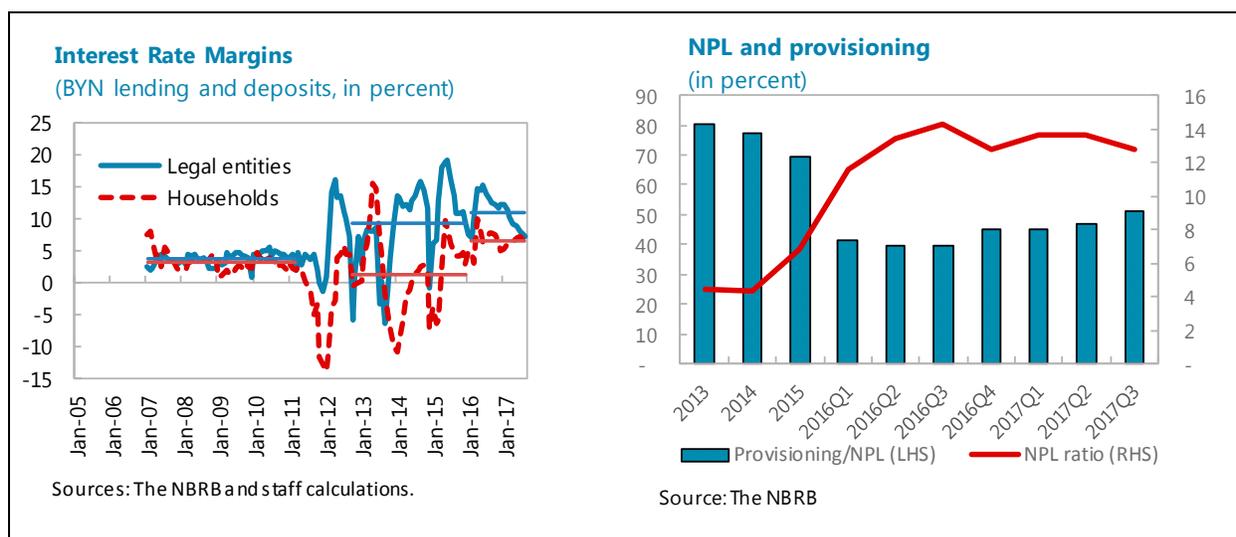
	BYN mn	percent
Total transferred	2,724.7	100.0
to AMC	772.4	28.3
to local governments	1,952.3	71.7
of which:		
loans to SOEs	2,472.4	90.7
NPLs	1,211.6	44.5
loans under DL category	469.6	17.2

Sources: the authorities and staff calculations.

³ Commercial banks held about 70 percent of domestic government bonds at end-2016. The claims on government has steadily increased to 14 percent of banks' assets at end-2016, more than doubling from 6.6 percent at end-2013, reflecting increased issuance of domestic government bonds in foreign currency to support international reserves, as well as the government's efforts to clean up banks' balance sheets.

Interest Margin and Bank Profitability

10. Despite the wider loan-deposit interest rate margins, particularly for legal entities, banks' profitability has deteriorated over the last three years. System-wide return on assets (ROA) almost halved to 1.2 percent as of 3Q2016 from 2.3 percent as of end-2013, and return on equity (ROE) fell to 9.4 percent from 16.2 percent over the same period. The faster decline in deposit rates than lending rates under the interest rate measures,⁴ implemented in 2015, resulted in further widening of interest margins. This, along with an ample liquidity, suggests that banks are taking a conservative approach to credit risks (choosing to risk deleveraging rather than extend credits). With the further increase in interest margins, and possibly helped by the interest income from government bonds they received in exchange for distressed assets, banks' profitability showed some signs of recovery in the last quarter of 2016. However, the need to ramp up provisioning, which has come down to below 40 percent of NPLs in September 2016 from 80 percent at end-2013, will likely weigh on banks' appetite to extend credit.



Regulatory Changes

11. The NBRB introduced several regulatory changes to strengthen risk classifications and provisioning requirements, which are likely influence the banks' appetite to extend credit:

- The NBRB introduced a standard definition of unhedged borrowers and provisioning requirement for such borrowers in January 2017. The provisioning requirements will be raised in a stepped manner to 5 percent by 2020.

⁴ The NBRB introduced caps on lending and deposit rates, tied to refinancing rate, above which special provisioning and higher reserves are required. See Annex IV in IMF (2016) for more detail.

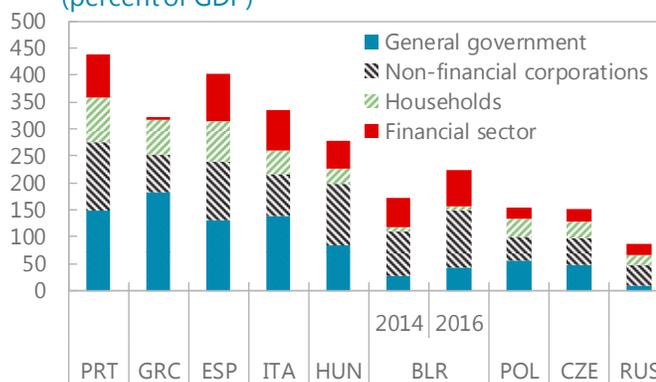
- A systemically important borrower category was introduced in May 2017, whose liabilities to the banking sector exceeds 10 percent of banking sector capital. Banks are required to assign 150 percent risk-weight on the full amount of the exposures to such clients, if any additional credit is extended.
- The NBRB is in the process of revising provisioning requirements on restructured loans, tightening the risk classification criteria and thus the resulting provisioning requirements.

12. While the initial direct impact of these changes appears manageable, the tighter regulatory requirements will likely affect banks' lending practices. Furthermore, the requirements on systemically important borrower could discourage banks to lend more to such clients, which are likely to be well-established and with good credit history, potentially limiting the scopes for the increase of high quality bank assets.

Corporate Financial Performance⁵

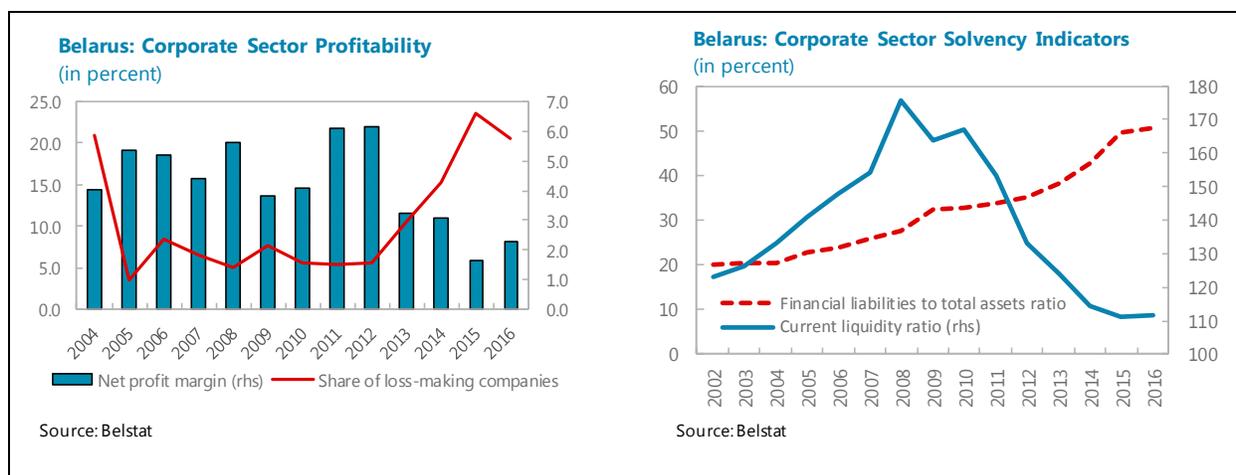
13. Corporate sector financial performance has deteriorated over the last few years. The sector-wide net profit margin has declined to a low of 1.6 percent in 2015 from 6.2 percent in 2012, and the share of loss-making companies has jumped to 23.5 percent from 5.5 percent for the same period. The solvency indicators also deteriorated, with the current liquidity ratio declining to 111 percent from 133 percent and corporate indebtedness increasing to 50 percent from 35 percent of asset over the same period. Non-financial corporate sector debt is estimated to have reached around 105 percent of GDP in 2016, from slightly above 80 percent in 2014, similar to the levels for Hungary and Spain. The elevated real lending rates since 2013, along with the reduced domestic demand during the recession, likely have contributed to the decline in profitability. The failure of corporate credit to respond to the significant decline in nominal (and to a lesser extent in real) lending rates also point to distress in corporate balance sheets.

Debt of the Economy, end-2014
(percent of GDP)



Sources: WEO, BIS, Haver Analytics, NBRB, McKinsey Global Institute analysis, and IMF staff calculations.

⁵ For more detail, see Belarus: Selected Issues Paper, *State-Owned Enterprises in Belarus*.



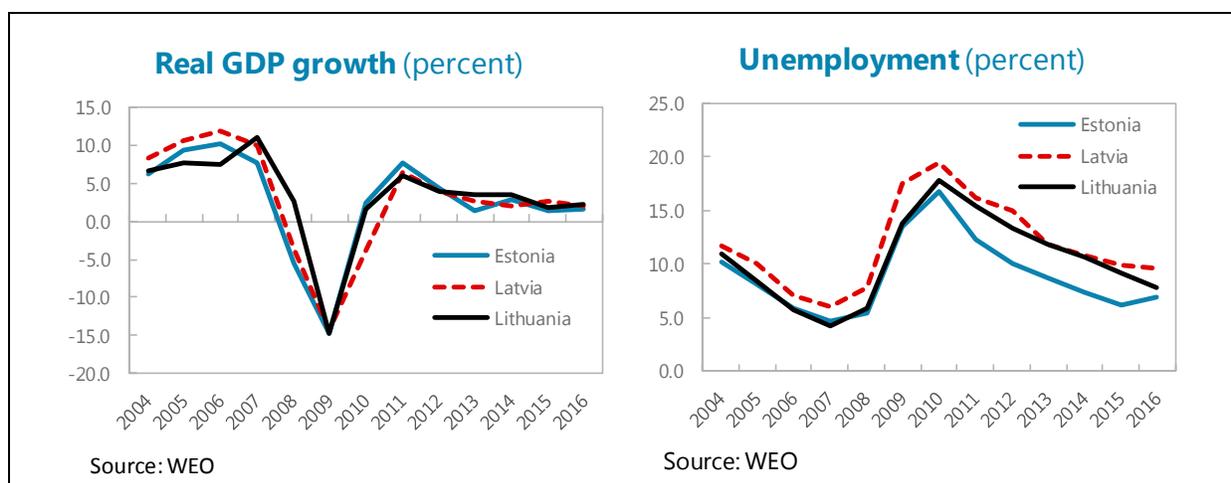
14. The SOE sector, which accounts for around ¾ of corporate sector assets and two-thirds of the country's workforce, is significantly less efficient compared to private sector companies. Despite the direct and indirect state support and preferential treatment they often receive, their return on equity dropped to below 2 percent at the bottom in 2015 compared to over 10 percent of the private sector companies. The gap in revenue per worker was between SOEs than at private companies widened to close to 40 percent in 2016, pointing to inefficiency and/or retaining of excess labor and capacity during the recession. SOEs will likely face tighter financing constraints as the government continues to reduce the stock of directed lending and the issuance of guarantees. Reforms to improve the efficiency will be needed for SOEs to adapt to the change in the framework of state support and to improve their creditworthiness.

D. Experiences in Baltics

15. Several countries in the region have experienced creditless recoveries, including the Baltics (Lian, Saksonovs, and Srour, 2014; Bakker and Korczak, 2017). Estonia, Latvia and Lithuania experienced creditless recoveries after the 2008-09 global financial crisis. While they experienced a very strong economic recovery following the sharp adjustments, the recovery in credit was delayed with credit growth turning positive only in 2013 in Estonia, and as late as 2015 and 2016 in Lithuania and Latvia. The boom-bust cycle negatively affected banks' asset quality and constrained credit supply, while private sector overborrowing during the boom led to impairment of corporate balance sheets and dampened the capacity and appetite to borrow following the bust. The steeper boom in the Baltic countries prior to the global financial crisis is consistent with the longer lag in the recovery in credit growth than those experienced in other emerging market economies. Much of CESEE had a creditless recovery, as Western parent banks were deleveraging.

16. Despite creditless, Baltic countries experienced strong recovery in real GDP growth after the significant decline in output and sharp increases in unemployment in 2007-10. Real GDP growth tanked by 14-15 percent in 2009 and unemployment peaked at 17-19½ percent in 2010. The output however recovered sharply by 6-7½ percent in 2011, while the private sector credit continued to decline. Bakker and Korczak (2017) attributes the strong recovery to the sharp

adjustment that took place during the crisis. The adjustment took place through significant correction in wages and labor, and corporate deleveraging, while the exchange rate pegs were maintained in all three countries. As a result, profitability of the non-financial corporate sector improved significantly by 2010 and exports took off, reflecting to reduced unit labor costs and improved competitiveness. On the other hand, the repair of banks' balance sheet took longer, with NPL remained elevated at 11.6 percent at end-2013 in Latvia (compared to a peak of 25 percent in 2010) and 8.7 percent at end-2012 in Latvia (15.8 percent in 1Q 2011).



17. The experiences in Baltics point to possibility of strong economic recovery in a creditless environment. However, the factors that supported the recovery (significant adjustment by corporate sector and the improvement in competitiveness) seems to be absent in case of Belarus. The unemployment rate remained extremely low, and corporate indebtedness continued to increase during the recession. While the improvement in external conditions (e.g. stronger economic growth of its key trading partners) provide some support, slow improvement in productivity and competitiveness as well as the low level of export diversification⁶ will likely limit its contribution to output growth.

E. Conclusion and Policy Implications

18. While Belarus' economy is starting to showing signs of recovery following two years of recession, credit growth will likely remain weak. The banking sector is still dealing with weak asset quality, low provisioning and profitability, and regulatory changes. The transfer of distressed agricultural sector loans out of the banking sector is also depressing the headline credit growth. While this asset transfer helps improve the banks' credit quality, the lack of a secondary market and limited additional funding sources constrain the increase in bank lending. With the NPL ratio still

⁶ For more detail, see Belarus: Selected Issues Paper, *Export Diversification and Trade Barriers*.

high and bankruptcy and insolvency framework in need of strengthening, the banks' lending conditions will likely remain tight for some time.

19. Improvement in corporate sector balance sheets and efficiency is critical for creating sustainable demand for credit. Corporate sector faces the need to improve its productivity, restore its financial performance, and deleverage its balance sheet. The lack of drastic adjustment during the recessions suggest that the investment and thus economic recovery will likely be weak, unlike the cases of Baltic countries where the improvement in competitiveness led to strong export growth.

20. Resorting to distortive measures to fuel credit growth should be avoided, as it would increase risks of a further deterioration in banks' asset quality in the future. The authorities could try to fuel credit growth, for example by increasing directed lending or provide subsidies, as already done for export financing and housing construction. But such measures could result in deterioration in banks' asset quality in the future, if not accompanied by structural reforms in the corporate sector to improve its efficiency and competitiveness.

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