2. Special Section: Belarus – The Transition Path and the Way Forward*

Programmes for Stabilisation and Revival of the Economy

2.1 A number of competing draft plans for economic stabilisation and growth have recently been presented, with the purpose of creating a unified plan. Initial plans were presented by the National Bank (NBB), the Cabinet of Ministers via the Ministry of Economy (MinEcon); independent group of Belarussian consultants headed by Mr. Eiden and; by the Supreme Soviet (Parliament).[1]

2.2 The latter plan was a list of general aims. Of the three remaining plans, the NBB and MinEcon plans represent the most market-oriented approaches and analysis. The Eiden Plan differs in the main because of its distinctive focus on the need for massive currency expansion.

2.3 The three plans agree on the following:

- the current economic situation, as defined by macroeconomic data.
- need for increased corporatisation and privatisation, especially at the small-scale level.
- all plans take as their objective the creation of a sustainable growth strategy toward some social market economy model.

2.4 The main disagreements in the plans are:

- the Eiden Plan differs from the NBB/MinEcon variant because of its belief in increasing money supply. The Plan argues that the current contraction of real GDP and production is due to a shortage in credit. In particular, the authors focus on the M3 velocity of circulation (GDP/M3) as a policy variable, arguing that in Belarus it is much higher than in other countries, implying that there should be a large increase in Money Supply to correct this.
- The Eiden Plan is strongly in favour of greater State intervention in the economy, and argues for the declaration of an economic emergency and the creation of " the Supreme Economic Council" under the President. State intervention would impinge on pricing decisions in product and labour markets. The MinEcon plan by contrast sees excessive government intervention as one cause of the current crisis.
- The NBB Plan represents the closest approach to a stabilisation plan based on tight monetary and appropriate exchange rate policies. The original Eiden Plan exhibits little coverage or understanding of exchange rate policy.
- The NBB Plan is weak however on non-monetary questions. The NBB/MinEcon harmonisation is therefore a combination of respective research capabilities and specialisations.

Combined Program of Social and Economic Development of Belarus

2.5 A synthesis of the plans was eventually put forward to the President on August 14th, after the initial deadline. The combined plan focuses more on the medium rather than purely on short-term

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* Prepared by Miguel de Freitas and Rupinder Singh.

[1] A further plan was developed by Bagdenkovitch and Zeiko – the former a previous incumbent of the National Bank and now a leading figure in Parliament.

problems and encompasses ideas from the Badey Plan of 1995 which was not ratified.[2]

2.6 The Plan fails to specify any minimum time-period for transition. Targets espoused are in principle positive, but lack as in the full document any concrete steps toward meeting the aims, as well as any clear expression of how the aims are to be achieved.

2.7 There is no model for the economy. The Plan has fundamental economic misconceptions for the current macroecoomic crisis in Belarus. One misconception concerns Production. It is argued that more financing would ensure higher production. However the problem in Belarus today is not of under-production, but of over-production. Inventories have risen by 40% in 1996 and comprise 17% of GDP, which implies that real effective GDP is in fact still declining once the stock of unsold goods is discounted for. The Plan states a strong preference for import-substitution manufacturing.

2.8 The need for privatisation is echoed, although conditioned on full agreements by workers' collectives.

2.9 The Plan overestimates the likely impact of the measures (see below), arguing that $1bn per annum foreign investment can be expected from 1999.

2.10 The exchange rate policy is to be more flexible, with the BRB to be tied 80-100% of inflation. A more market based role for the Minsk Interbank Currency Exchange is foreseen in the greater use of credit auctions. However, inflation is likely to overshoot because of proposed indexation of wages, pensions and allowances.

2.11 Because of a lack of consensus on the proposed measures and a growing realisation by officials in the Administration of the minimum steps required, the plan has effectively been put on hold, at least until after the November referendum.

Plan Forecasts

	1997	1998-2000
GDP	5%	4-6%
Industrial Production	6%	5-7%
Agriculture	3-4%	2-4%
Capital Investment	10%	15-25%
Inflation (monthly)	2%	0.5-1.5%
Budget Deficit (% GDP)	TO 4%	3-4%
BRB/$ exchange rate	80-100% of inflation rate	80-100% of inflation rate
Unemployment Rate	5.0	5.0-5.5
Trade Balance (% GDP)	-3.7%	+0.1 to -3.0%

The transition in Belarus

2.12 Before focusing on policy measures, we present a stylised model which presents the transition road-map taken by Belarus since 1991. In the last few years Belarus has experienced a dramatic change of its economic conditions. This change requires an adequate policy response by the economic authorities, in order for the transition costs to be minimised. Any economic plan needs to understand the fundamentals of economic policy and not only echo dry statistics.

2.13 The recent performance of the Belarussian economy is summarised in terms of two main objectives, the **internal** and **external** balances.[3]

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[2] Georgey Badei was the former Minister of Economy.

In that discussion we give special emphasis on the role of the exchange rate policy in the attainment of these objectives.

2.14 The real exchange plays a crucial role in macroeconomic adjustment. Evidence from other countries shows that, in the absence of structural reforms, real costs of an overvalued exchange rate are higher than those of an undervalued exchange rate. In fact, if the currency is undervalued, demand switches from foreign to domestically produced goods, expanding the economy and causing inflation, but in that case there exists a margin for the domestic inflation to be temporarily higher than the foreign one. On the contrary, when the real exchange rate is overvalued, demand will switch from domestic to foreign goods, deflating the economy. In this case, if the inflation inertia prevent the adjustment of the real exchange rate by prices, the deterioration of the external accounts will favoured the occurrence of speculative attacks.

A framework for analysis

2.15 The framework for this analysis will be the Krugman-Macedo[4] diagram. This diagram relates two **"strategic variables"** - **the real exchange rate gap** and the **output gap** - with **two policy objectives** - the internal balance and the external balance. Other exogenous and policy variables are considered as affecting the strategic variables. The role of economic authorities is to use the basic policy instruments (such as fiscal and monetary policies) in order to drive the strategic variables in the direction which promotes macroeconomic stability, given the exogenous shocks affecting the economy.

2.16 The **real output gap** is defined as the percentage deviation of actual GDP to potential GDP and measures the cyclical behaviour of the economy. When positive it indicates over-employment and demand-pull inflationary pressures and a negative value indicates under-utilisation of existing resources. **The real exchange rate** gap is defined as the percentage deviation of the actual real exchange rate to the *equilibrium* real exchange rate, the latter defined as the one that would be necessary for the economy to meet the external balance at the full employment output[5]. A negative real exchange rate gap

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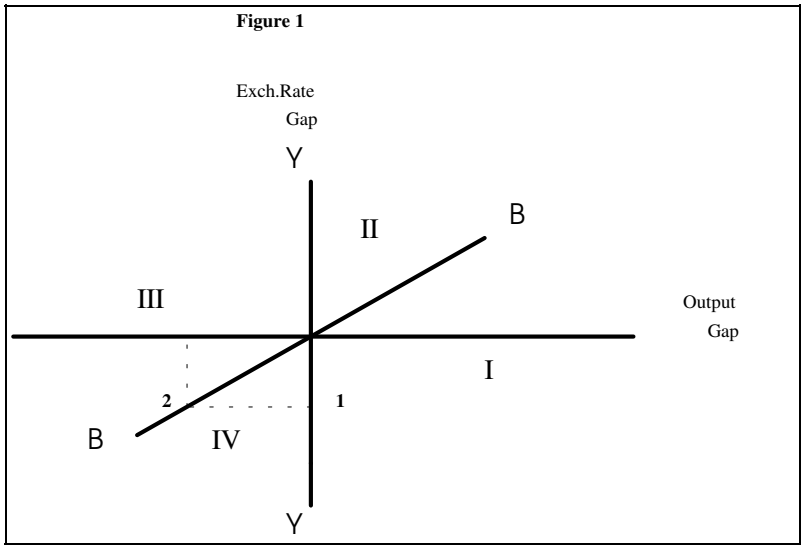
[3] To establish the real fundamentals for internal and external balance is the first of five requisites proposed by Michael Bruno for stabilization and structural reform in transition economies [Bruno, M. (1993), "Stabilization in Eastern Europe", in M.Bruno: *Crisis, stabilization and economic reform: therapy by consensus*, Oxford University Press, Oxford]. The other requisites are the adoption of multiple nominal anchors to coordinate disinflation, currency reform, the pursuit of structural reforms to remove distortions and the consolidation of democracy.

[4] Krugman, P. and J.B.Macedo (1979), "The economic consequences of the April 25th `revolution", *Economia* 3, 455-83.

[5] This definition is in accordance to the John Williamson proposal of Fundamental Equilibrium Exchange Rate (FEER) [Williamson, S. (1983), "The Exchange Rate System", Institute for International Economics, Washington D.C.]. In short the FEER is defined as the value of the real exchange rate consistent with the full employment external balance. External balance is attained in a particular moment if trade flows are financed by stable capital flows (those that do not necessarily have to be repaid in the event of a financial crisis). Obviously, the notion of equilibrium real exchange rate is a matter of discussion and one can always question the use of a particular concept. But for the purposes of this discussion, the above concept proves very convenient, because it allows for permanent shifts in the equilibrium real exchange rate in response to the occurrence of real shocks.

means that the domestic currency is overvalued in respect to the external balance target.[6]



2.17 Figure 1 reproduces the Krugman-Macedo diagram. The horizontal axis measures the real output gap and the vertical axes measures the real exchange rate gap. Along the vertical line YY the country is in full employment so that this is also the locus of internal balance.

2.18 The locus of external balance, BB, is depicted assuming that a positive output gap raises the demand for imports, deteriorating the current account.[7] On the other hand a real exchange rate depreciation improves the competitiveness of both export and import competing industries, improving the current account. Thus, if the domestic currency is overvalued the economy runs an external deficit when at full employment (point 1) but it can meet the external balance if there is unemployment (point 2).

2.19 The four zones of economic unhappiness are characterised respectively by inflation and external deficit (zone I), inflation and surplus (zone II), unemployment and surplus (zone III) and unemployment and deficit (zone IV). The target for policy-makers is thus to aim for the origin.

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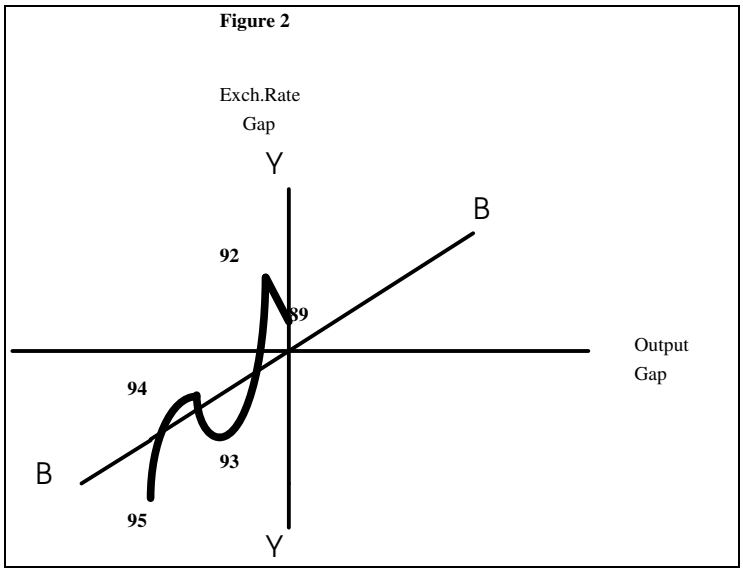
[6] Of course, requiring "external balance" each moment in time is not necessarily the optimal policy, because a country may borrow from abroad to finance economic growth.

[7] Locus BB can be non-linear.

The recent macroeconomic experience for Belarus



2.20 Figure 2 describes the transition path of Belarus since 1989. In the years prior to *perestroika* Belarus benefited from favourable terms of trade, as transformed products were priced higher than imported raw materials. In general the population was enjoying a higher standard of living than in other regions of the USSR. By 1989 the economy was near the point of full employment, but the existing external Republican surplus suggested that the real exchange rate could appreciate further.

The following years can be grouped in four different macroeconomic episodes: 1989-92, 1992-1993, 1993-1994 and 1994-1995.

Phase 1: 1989-92

2.21 With the collapse of the command system in 1989 state orders were substantially reduced, leading to a decline in the industrial production. A deeper fall in actual output in 1990-91 was however avoided, because the Government managed to create direct regional relations, with the Baltic states. The fall in output was 3% in 1990 and 1% in 1991, lower than in other CIS countries.

2.22 This fall in output does not necessarily mean that the output gap became negative, because potential output was also declining. Indeed, the progressive substitution of the command system by the market mechanism in a context of increasing challenge of the traditional export markets by foreign companies revealed the existence of technological and marketing gaps in domestic industries and a sub-optimal specialisation pattern in the economy. Consequently, the rate of economic depreciation of the specific equipment installed should have risen in the subsequent years. Since no significant investment was occurring to compensate for this, the potential output should have fallen continuously along the 1990s. This is in line with what happened in other CIS economies, where in general output fell by more than 50% in the first half of the decade, mostly for structural reasons. Accordingly, we assume that during these two years the economy remained near the full employment.

2.23 The domestic currency at this time was the Russian Ruble (RUR). Given the high dependence of Belarus on trade with other countries of the Ruble zone, we can think the effective exchange rate at that time as being fixed. The price policy was, however, different from the other states. As neighbouring republics were increasing prices in reaction to the deficit of goods, in Belarus the policy was to keep

prices at the current level, though introducing a system of rationing. The resulting real exchange rate depreciation rose the foreign demand for domestic goods, leading to an external surplus in 1991.

2.24 The BRB was introduced in 1992 displacing gradually the RUR. As money and credit were expanding and real money demand declining (due to the domestic recession and the higher attractiveness of the recently reformed RUR) in the context of price liberalisation, inflation accelerated sharply, reaching 1558%. However, the real exchange rate depreciated because the inflation rate in Russia reached 2318% and the nominal exchange rate stayed constant until November.

2.25 With an under-valued exchange rate and a 10% fall in output, the economy moved to the unemployment-external surplus zone. Some cutbacks in energy deliveries from Russia also help to explain the 43% drop in imports. Still the persistence of an higher subsidisation of food prices in Belarus than in neighbouring countries was inducing informal exports of food, while draining budgetary resources. Notwithstanding, the export volume dropped by 34% in 1992.

Phase 2: 1992-93

2.26 In this period the demand for exports (military production and investment goods) by the old partners was declining, reflecting both the economic crisis and the deficiency of the settlement system within the FSU. Furthermore, prices of imported energy and raw material started approaching their international levels, with most of the adjustment taking place in 1993. Import prices of oil and gas rose respectively from 50% and 25% of their world prices in the first quarter of 1993 to the world market prices at the beginning of 1994.

2.27 Both the sharp terms of trade deterioration and the fall in the external demand had a negative impact on the Balance of Payment, so that a significant real exchange rate depreciation was necessary to keep the external balance. However, the nominal exchange rate depreciation during the first half of 1993 was small compared to the required, as prices in Belarus were rising much faster than in Russia[8]. Hence, the real exchange rate gap became negative in the first half of 1993.

2.28 Despite the decline in industrial output, that lead to a 30% fall of energy imports, and the good performance of the services account (due to the collection of oil and gas transit fees from Russia), a significant external deficit emerged in 1993.

Phase 2: 1993-94

2.29 The lack of financial domestic discipline and the perception that the external situation was unsustainable lead to a foreign exchange crisis in the summer of 1993. Between September 1993 and March 1994 a large nominal depreciation occurred allowing for the recovery of the exports, although with a time lag[9].

[8] In this year an IMF-supported adjustment program was designed for Belarus. However, the programme was not adhered to, and inflation rose, reaching 1997%.

[9] At that time the real wages were falling (after a pick at the end-of-1992), as required by the productivity fall, contributing as well to improvement of margins of the export oriented sectors, but this effect is less important, because the wage costs account for a small fraction of total production costs in Belarus.

2.30 The narrowing of the real exchange rate gap and the continuous output decline induced an improvement of the trade balance along 1994. By the end of the year the economy was reachig the external balance.

Phase 4: 1994-95

2.31 The real appreciation against the RUR restarted in mid-1994, and acelerated in 1995, because the monetary authorities pegged the BRB exchange rate against the dollar in order to force down inflation. In the first half of 1995 the domestic interest rates were still high, which combined with the fixed exchange rate policy induced the entry of foreign capital and led to upward pressures on BRB.

2.32 However, the inflation rate in 1995 reached 244%, leading to a huge real exchange rate appreciation. As competiveness against the main trade partners was deteriorationg, the external deficit rised again in 1995, undermining the credibility on the exchange rate policy.

2.33 In the second half of 1995 the currency was subject to speculative attacks, but the NBB managed to delay the exchange rate devaluation until the beggining of 1996, although at the cost of introducing capital controls.

The Economic Position Today

2.34 The present position of the Belarus economy is one of unemployment and external deficit, as implied by a real exchange rate over-valuation and a negative output gap. The real over-valuation of the BRB is not only responsible for the external imbalance, but also for the accumulation of inventories, as demand shifts away from the domestic production.

2.35 The size of the deviations is, however, difficult to assert. On the one-hand, the external deficit may be over-reported, due to hidden capital flight. Indeed, if domestic agents wanted to send foreign currency abroad, an immediate way would be to make an agreement with the foreign partner to under-price exports and overprice imports, the difference used to obtain financial assets abroad. On the other hand, the output-gap may be overstated, because it is based on the observation of official statistics that do not take into account the emergence of new firms and industries installed after 1989. If the size of these effects is important, the extent of the real over-valuation may be lower than the suggested in our analysis.

2.36 The real depreciation initiated in the second quarter of 1996 is improving again the external competiveness, but less than the required to compensate for the terms of trade depreciation and the real appreciation of 1995. A further relaxation of the exchange rate policy, couppled with the elimination of capital controls, would be, in our view, desirable, in order to promote both exports and the economic recovery.

Policy Implications

2.37 The use of the exchange rate as nominal anchor to bring down inflation contributed to price stability in Belarus, but lead to an overvalued real exchange rate, in turn causing a considerable external imbalance. In consequence, the currency has been subject to speculative attacks that forced the NBB to revise the exchange rates, undermining its credibility. In responce, authorities imposed

controls on foreign exchange trading, and did de-facto nationalised the Minsk Interbank Currency Exchange.

2.38 Given these developments, it seams clear that exchange rate and monetary policy can no longer be viewed in Belarus as two separate policies, but rather as two sides of the broad monetary policy. Even if exchange controls are imposed to preserve the effectiveness of both instruments, sooner or later economic agents will find a way to avoid the obstacles created.

2.39 This does not mean that the intervention in the foreign exchange market should be abandoned. Indeed, a pure float policy would be itself a source of instability due to the extreme volatility of the exchange rate, creating uncertainty and providing ambiguous signs for the economic agents. A feasible alternative is to keep a managed float, but with a consistent monetary and exchange rate policy. If the exchange rate is kept at a level that is understood as reasonable by economic agents, the exchange rate is likely to be defended by the monetary authorities. On the contrary, to keep unrealistic nominal exchange rate targets will always lead to capital flight with the consequent depletion of reserves, as no rise in domestic interest rates will be enough to compensate investors from the risk of a financial crisis.

2.40 A faster real devaluation of the currency is necessary to attain external balance and to estimulate output growth. However, it is not clear whether an improvement in the competitiveness will, in itself, be sufficient to raise investment in new exporting sectors, as the credibility on the Belarus economy has to be rebuild. Unless a global package of liberalisation and stabilisation is adopted, this will not be enough to incentive entrepreneurs and to stop capital flight.

2.41 As part of this program, strengthening of Monetary Policy is of crucial importance to reduce inflationary expectations. Credit ceilings on both the private and public sectors may play an important role in stabilisation, but efforts have to be made to make the allocation of the credit more efficient. The adoption of a more market-oriented exchange rate reflecting the real costs of the resources will help to reduce the discrepancy. This is of crucial importance in a period where important structural transformation is expected to occur and obvious pressures to preserve some unviable industries exists. Subsidised credit needs to be replaced by direct funding from the Budget instead of imposing the burden on the banking system.

2.42 A more realistic official exchange rate would possibly restore the attractiveness of foreign currency deposits, which are declining in proportion to the total money supply. This would contribute to reduce capital flight and to rebuild the stock of foreign reserves. For this to be effective, however, it will be necessary to provide the absolute guarantee that these deposits will never be confiscated. The protection of property rights is, in general, of crucial importance to attract both domestic and foreign investors to the Belarussian economy.

2.43 In the long run, after a period of nominal stability, it is recommended that the BRB be pegged to RUR, taking into account the economic interdependence of the two economies and the political objective of joining a monetary union together. For this to be sustainable, it will be advisable to keep the monetary base below the existing stock of external reserves, so that the monetary authorities can "buy" all the money base in the event of a speculative attack on the currency.. This requirement has proved to be successful in avoiding the recovery of inflationary pressures in recently stabilised economies.