

## The new old choice for economic policymakers in Belarus

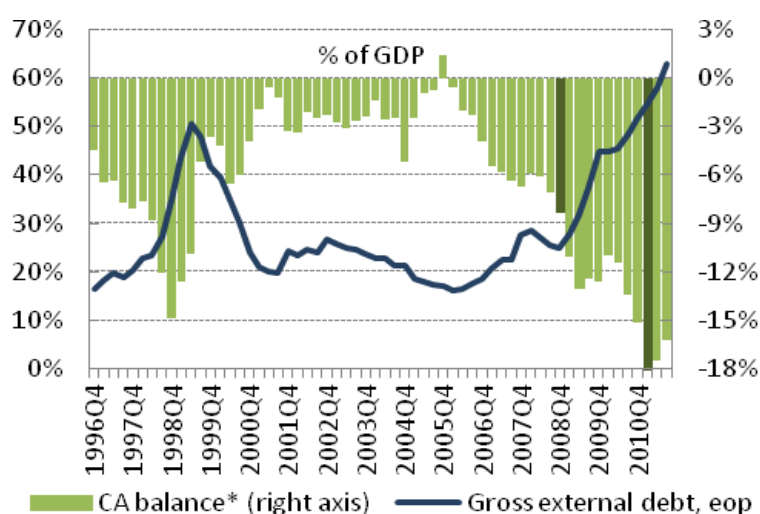
By Alexander Chubrik

In 2011, the Belarusian ruble lost nearly 2/3 of its value. In December, the inflation rate approached 110% yoy. At the same time, the economy grew by 5.3% that year and continued with 3.6% yoy growth in January 2012. Is this a sign of economic recovery? Will it turn into sustainable growth? Or has the country exited from the crisis at all? To address these questions, we will look at the roots of the 2011 crisis and compare them with the features of the long-lasting period of economic growth in Belarus.

### Pre-crisis imbalances

The first part of the crisis story is related to the fact that Belarus, according to EBRD estimates, remains one of the least reformed transition economies, with transition indicators that are even lower than regional averages (see EBRD (2011)). Nevertheless, it has remained one of the fastest growing economies in the region since 1996. Even during the 2009 crisis, its GDP did not fall (unlike most of its neighbours) and recovered much faster than any of them in 2010. This growth was fuelled mainly by domestic demand (Kruk (2010)) that led to an accumulation of dramatic external imbalances. Another reason for the recent current account deterioration was the substantial reduction of Russian gas subsidies<sup>1</sup>. The current account went from a surplus of 1.4% of GDP in 2005 to a deficit of 8.2% of GDP in 2008 and 15.1% of GDP in 2010 (see Figure 1).

**Figure 1.** Current account balance and gross external debt



\*Annualized (sum of the last 4 quarters).

Source: own estimates based on NBB, Belstat and IPM Research Centre's data.

These imbalances were financed (especially since 2008Q4) by the rapid accumulation of external debt. Within 2 years (2009–2010), external debt (as a share of GDP) doubled, and as of the end of 2011 it tripled (according to preliminary estimates) compared to the end of 2008. As a result, a balance of payments crisis became unavoidable.

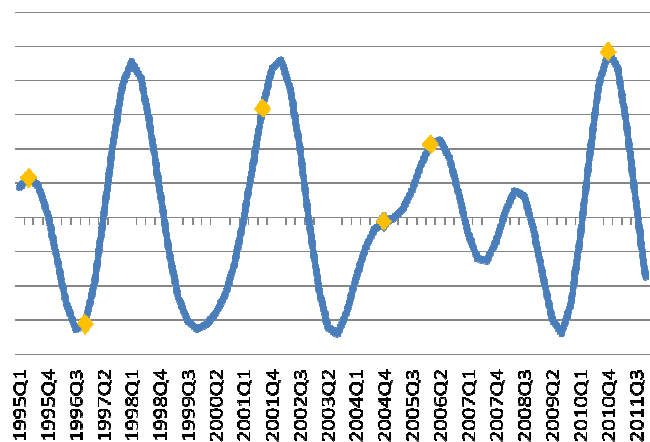
### The role of the electoral cycle

Economic policies in Belarus (especially income policy) are related to the electoral cycle. This phenomenon was described as a political business cycle in a number of studies (e.g. Haiduk et al. (2006), Chubrik, Kruk, Pelipas (2006), Chubrik, Kruk (2008)). Statistically it can be estimated as a cyclical component of real wages with cycle periods equal to the minimum and maximum lengths of the electoral cycle. The latest estimates

<sup>1</sup> Russia's gas price for Belarus increased from 22.1% of its world market price in 2008Q4 to 70.4% in 2011Q4.

based on the quarterly real wages time series (1995Q1–2011Q4) are presented in Figure 2.

**Figure 2.** Cyclical component of real wages\*



\*Logarithmic scale.

Note: The yellow points represent major electoral events: the constitutional referendums of 1995 (May), 1996 (November) and 2004 (October), and the presidential elections of 2001 (September), 2006 (March), and 2010 (December).

Source: IPM Research Centre (based on Belstat data).

As one can see, after the presidential elections of 2006, wages entered the declining phase of the cycle. In mid-2007, despite the fact that Russia's gas price for Belarus more than doubled, real wages started to increase again thanks to the increase in revenues from refined oil products exports. However, the 2008 global crisis put an end to this trend, and real wages reached a new low point in the cycle in 2009Q2. Subsequently, a new peak (2010Q4) was reached in 1.5 years, despite the fact that moving from a trough to a peak usually takes about 2.5 – 3 years. This is the first explanation of the crisis – the economy was stimulated too quickly.

### Imbalances that have been removed

The main feature of the 2011 crisis is related to the huge nominal depreciation of the national currency. For about eight months Belarus returned to foreign exchange controls and a multiple exchange rate system. The NBB carried out 2 devaluations of the official exchange rate and the finally switched from a currency band to a managed float on October 20, 2011 in order to unify the exchange rate again. All in all, the Belarusian rouble lost almost 2/3 of its nominal value against the US dollar. The real exchange rate also depreciated dramatically (by more than 20% yoy and more than 30% compared to its maximum value in 2011Q1). This depreciation had a

strong effect on exports and imports: exports of goods (excluding oil products and potash fertilizers)<sup>2</sup> increased in 2011 in real terms by 16.9% yoy, while imports of goods (excluding oil, oil products and natural gas)<sup>3</sup> fell by 7.4% yoy.

Another part of the story is related to domestic demand. In the second half of 2011, gross fixed capital formation stagnated while household consumption fell dramatically (see Table 1), contributing to a decline in imports.

**Table 1.** Contribution to real GDP growth\*

	2011Q1	2011Q2	2011Q3	2011Q4
<b>Real GDP, % yoy</b>	<b>10.8</b>	<b>11.4</b>	<b>1.9</b>	<b>-1.5</b>
Household consumption	10.3	4.8	-0.4	-8.7
Gross fixed capital formation	7.6	9.8	-1.3	1.7
Other domestic demand	3.5	-3.3	0.3	-0.2
Net exports +S.D.	-10.6	0.2	3.4	5.7

\* Percentage points.

Source: IPM Research Centre (based on Belstat data); 2011Q4 – preliminary estimate.

Coming back to the analysis of the political business cycle, in 2011Q2, the economy entered its declining phase, manifested by significant corrections of labour costs: they fell from 44.3% of GDP in 2010Q4 to 37.5% of GDP in 2011Q4<sup>4</sup>. The IPM Research Centre estimates (quarterly data, 1995–2011) give a “normal” share of the wage bill in GDP of 38.5%, i.e. wages at the end of 2011 had fallen in line with labour productivity, improving national competitiveness.

To summarize, the domestic and external demand behaviour in the second half of 2011 can be explained not only by currency depreciation, but also by more restrictive government policies. The NBB stopped offering direct credit to enterprises, and the government cut investment programs and moderated wages and growth transfers, facilitating macroeconomic stabilization.

### Short- and medium-term growth perspectives

As a result, the economy of Belarus is returning to macroeconomic stability. However, returning to the same growth “model” as before the crisis seems unlikely...

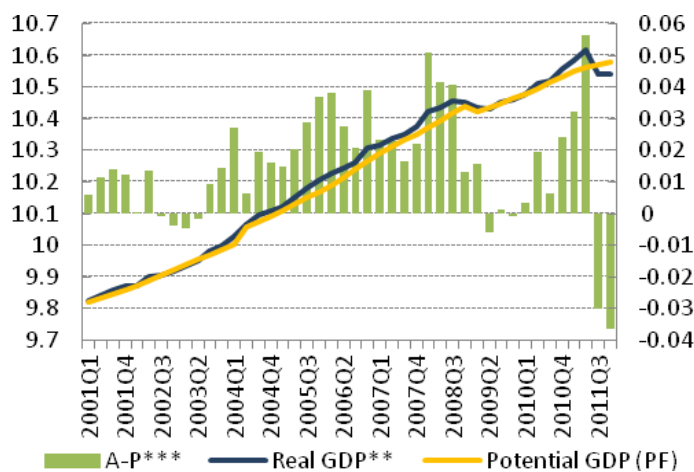
<sup>2</sup> Harmonized system codes 2710 and 3104.

<sup>3</sup> Harmonized system codes 2709, 2710, 271111 and 271121.

<sup>4</sup> Both indicators are seasonally adjusted.

First, estimates of potential GDP indicate a declining trend (see Kruk (2010)). For instance, according to the IPM Research Centre's econometric estimate of production function equation (quarterly data, 1995–2011), the annual growth rate of potential GDP fell from around 9% in 2004–2008 to about 7% in 2009–2010 and to 3% at the end of 2011<sup>5</sup> (Figure 3). Coming to the factors of production, labour has reached its peak (the working-age population has reached a maximum point and is beginning to decrease), while sources of capital accumulation are about to be exhausted.

**Figure 3.** Real GDP, actual and potential\*



\* Logarithmic scale.

\*\* Actual real GDP is seasonally adjusted.

\*\*\* Actual minus potential real GDP.

Source: IPM Research Center (based on Belstat data).

Second, in 2009–2011, Belarus accumulated large external debt that is unlikely to be sustainable in the medium and long term (Shymanovich, Kirchner (2011)).

As a result, room for higher than potential growth narrowed dramatically; it was possible for more than five years between late 2003 and late 2008 but for only five quarters between 2010Q2 and 2011Q1 (Figure 3). Thus, another attempt to repeat the overheating scenario with administrative mobilization is still possible but is unlikely to work for a long time. In other words, the government will be unable to continue financing domestic demand with additional external borrowing (at least to the extent possible before the crisis).

<sup>5</sup> This rapid change in the potential GDP growth rate is related to a co-movement in labour and capital: employment fell, while capital accumulation (according to the preliminary estimates) either stopped or became slightly negative.

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## Post-crisis risks and possible scenarios

The authorities now find themselves in a “strategic” dilemma for the first time since 1996. Depending on their reaction, one can distinguish between the two major scenarios: altering medium-term stability in favour of short-term growth or altering short-term growth plans in favour of structural reforms (possibly within the new IMF programme).

The first scenario would materialize if the government attempted to keep its plans to increase real GDP by 5–5.5% in 2012<sup>6</sup> (Table 2). Taking into account the priority of the economic growth target over other targets, the government may pressure the NBB to soften monetary policy in order to finance a domestic demand increase, and after a short period of growth fuelled by money emission the economy will enter the next period of instability and recession<sup>7</sup>.

**Table 2.** Selected macroeconomic indicators in 2012

	2011	2012 (forecast)	
		IPM RC (Nov. 2011)	Official (Dec. 2011)
Real GDP growth	5.3	1.6	5–5.5
CPI, % yoy	53.2	72.7	70.0
CPI, % eop	108.7	25–30	19–22
Current account balance, % of GDP*	-14.4	-4.7	0.0

\* 2011 – estimate (IPM Research Centre (2011)).

Source: IPM Research Centre (2011); Presidential Edict # 590 of December 23, 2011.

The second scenario is not totally unrealistic due to the following reasons. First, at the end of 2012, Belarus needs to start repaying substantial portions of its external debt, and about half of the NBB's reserves are still filled with foreign currency liabilities to the commercial banks. So the country needs foreign currency to avoid devaluation pressures. Second, the economy needs structural reforms that help to eliminate fundamental reasons of existing imbalances, and it

<sup>6</sup> Until November 2011, the government expected a much slower growth of 1–1.5%, similar to independent forecasts. Later, President Lukashenko stressed that these figures are too low and the economy should grow by 5–5.5%; as a result, the government revised the growth figure but left other important parameters (such as the current account balance and inflation) unchanged.

<sup>7</sup> The problem is aggravated by the absence of a nominal anchor for monetary policy. Prior to the crisis, it was exchange rate (exchange rate band), now the NBB switched to a managed float. Inflation is the government's responsibility, and no other strict targets for the NBB exist.

would be good to have somebody paying for their elaboration and implementation. Without going into detail, in both cases the IMF (together with other IFIs) seems the most rational source of such funding. However, in order to start negotiations about the new programme the government should ensure the IMF that it really intends to stabilize the economy. In other words, “critical measures as prior actions” should be implemented (IMF (2011)). Monetary policy loosening is not in line with such

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measures, that is why one can expect that the authorities will alter growth plans in favor of cooperation with the Fund.

All in all, the 2011 crisis showed that short-term growth-enhancing instruments are no longer a viable option, while the long-term growth potential of the economy is low. It seems that the only way to recover this potential is to implement comprehensive reforms aimed at removing fundamental economic imbalances.

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