

Systematic Country Diagnostic: *Towards a Competitive, Inclusive and Dynamic Belarus*

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Abbreviations and Acronyms

Belstat	National Statistical Committee	HBS	Household Budget Surveys
BOP	Balance of Payments	HDI	Human Development Index
BSSR	Belarusian Soviet Socialist Republic	JSC	Joint-Stock Company
BYR	Belarusian Ruble	IFC	International Finance Corporation
CAD	Current Account Deficit	IMF	International Monetary Fund
CIS	Commonwealth of Independent States	MSEs	Micro and small enterprises
DBB	Development Bank of Belarus	MSMEs	Micro, small, and medium enterprises
EAER	Eurasian Economic Union		
EBRD	European Bank for Reconstruction and Development		
ECA	Europe and Central Asia	PPG	Public and Publicly Guaranteed
ECAPOV	ECA Poverty Monitoring Project	PPP	Purchasing Power Parity
EU	European Union		
GDP	Gross Domestic Product	SCD	Systematic Country Diagnostic
		SOEs	State-Owned Enterprises
GNI	Gross National Income	SPC	State Property Committee

Overview

Since the collapse of the Soviet Union, Belarus has pursued a gradual transition path characterized by slow opening of the economy to the private sector and a limited reform of the governance system of state-owned enterprises (SOEs). This second characteristic largely preserved the leading role of the state in SOE management and is at the heart of a legacy challenge looking forward. One consequence of this strategy has been modest expansion of the private sector. In 2016 a quarter of a century after the beginning of the transition, the share of the SOE sector¹ in Gross Domestic Product (GDP) remained at 46.7 percent, while in total employment it accounted for 49.6 percent. At the same time, the shares of SOEs in industrial output and exports amounted to 70 and 38.7 percent, respectively (Belstat, 2016).

Until 2008 the gradualist strategy was highly successful in terms of per capita GDP growth, human development, and poverty reduction. From 1996 to 2000, real GDP growth averaged about 6.3 percent per annum, and in 2001-2008, it accelerated further to 8.3 percent per annum—more rapidly than the 5.7 percent average for both the Europe and Central Asia (ECA) region and the 7.1 percent average for the Commonwealth of Independent States (CIS). The record of Belarus during these periods was particularly impressive in view of the very high costs of dealing with the Chernobyl legacy.

Economic growth was accompanied by a remarkable fall in the number of households below the national poverty line and an increase in the incomes of households at the bottom forty percent. From 2003 to 2014, Belarus had the largest reduction in poverty rates in the ECA region. Measured at the internationally comparable purchasing power parity (PPP) US\$5/day threshold,² the poverty headcount in Belarus fell from 32 percent in 2003 to less than one percent in 2014, while in ECA it fell from 38 percent in 2003 to 13 percent in 2013. Inequality fell along with poverty, and is low by regional standards.

Inclusive economic growth over the past decade is also mirrored in the broader dimensions of human development. Belarus was ranked 52nd in the world according to the 2016 Human Development Index (HDI)³—a composite index of life expectancy, education, and GNI per capita dimensions—19 positions higher than its Gross National Income (GNI) rank, meaning that its HDI ranking was higher than would have been expected based on per capita income.

The 1991-2008 successes were facilitated by both the government of Belarus' strong governance and favorable external circumstances. Strong governance—including extensive controls over economic activities—prevented asset stripping and disruption of commercial networks that were costly in other CIS countries. Avoiding asset stripping and the dismantling of SOEs preserved intangible assets inherent to working organizations that possessed these assets, thus circumventing the social costs frequently associated with shock reforms. However, it also allowed many enterprises that did not have any economic value to be kept alive by subsidizing their investments and sometimes their current operations. In most cases, these practices had the effect of maintaining in operation parts of enterprises that could not otherwise break-even, but at the expense of other efficient parts of vertically-integrated enterprises that as a result had to cross-subsidize the weaker sections.

¹ Including mixed ownership companies, excluding foreign companies.

² The PPP US\$5/day per person threshold based on the 2005 International Comparison Program (ICP) prices is equivalent to BYN 2.67/day per person in national currency at 2016 prices.

³ The report was published in 2016 while the data are for 2015.

Moreover, by reducing the independence of decision-making by SOE managers, it stifled innovation and adaptation of these companies to changes in market conditions.

Favorable external circumstances included integration with the Eurasian Economic Union and favorable energy trade policy and capital flows from the Russian Federation. On energy, Belarus benefited from importing gas and oil at below world market prices, while exporting oil products at world market prices. From 2001-2010, the benefits from these gas and oil trade arrangements averaged 13.3 percent of Belarus's GDP annually.⁴ On trade, Belarus benefitted from strong economic growth in Russia and other CIS trading partners, which stimulated demand for Belarus's manufacturing and agricultural exports. On capital flows, Belarus benefitted from significant capital inflows from Russia, especially between 2007 and 2011. The combined effect of these forces resulted in economic inefficiencies remaining largely hidden.

The end of Belarus's growth boom started with the financial crisis of 2008 and the gradual revision of the terms fixing the price of oil imports from the Russian Federation. In 2009, the economy stagnated and while demand-management measures led to a short-term growth rebound in 2010-2011, the economy never resumed the vigorous expansion path of the previous decade. From 2009-2014, annual growth averaged three percent, and in 2015-2016 the economy entered a recession—for the first time since 1995.

There is increasing evidence that some of the factors contributing to Belarus's remarkable growth record pre-2008 are no longer present, and that the potential growth of Belarus is substantially lower than had previously been observed. First, the size of the benefits from the oil and gas trade arrangements has declined significantly in recent years, especially after the steep decline in the price of oil in the international market that began in the second half of 2014. As of 2016 the gain was about 4.6 percent of GDP, a cumulative reduction of about 9 percentage points as compared to 2010. In April 2017 Russia agreed to restore its crude oil supply volumes to Belarus, but the relatively moderate recovery in global oil prices eroded the benefits to Belarus from processing imported crude oil. In addition, a further increase in the crude oil export price to Belarus is envisaged throughout the 2017–2018 period because of tax changes in Russia, while global prices are expected to recover very slowly and limit the size of the effective level of oil-related benefits from Russia.

Second, the subsequent tightening of the external borrowing constraint in 2014 for Belarus forced a drastic adjustment. At 5.7 percentage points of GDP, the adjustment of the current account of the balance of payments (BOP), the savings investment gap, undergone by the Belarus's economy was severe, and the adjustment of the private savings investment gap, 7.2 percentage points of GDP, was even more pronounced.⁵

Less favorable external circumstances have revealed previously hidden inefficiencies and deep seated structural rigidities of Belarus's economic model. For example, growth of total factor productivity—adjusted for factor utilization and oil transfers—has been negative for the last five years. Subsidizing inefficient parts of the SOEs when the country is simultaneously receiving a transfer equivalent to more than ten percent of its GDP may have been feasible in the past, but is becoming unsustainable when external borrowing is the only way to finance economic inefficiencies. The ratio of external public debt to GDP increased from 6.1 percent in 2008 to 19.4 percent in 2011, and then up to 28.5 percent in 2016. If a broad definition of the external public sector's debt is applied (to include external debt obligations of the government, the central bank, and deposit and non-deposit organizations owned by the state), its ratio to GDP went up from 8 percent of GDP in 2008 to 31.9 percent in 2011, and then 46.8 percent in 2016.

As a result, Belarus is facing substantial refinancing needs because of sizeable public debt maturity concentration in the medium and long-term due to Eurobonds maturing in 2018, followed by large repayments due to Russia, China, and the Eurasian Fund for Stabilization and Development (EFSD). Meeting these obligations will require continued access to domestic and external financing sources. Belarus's experience with the 2017 Eurobond issuance indicates that access to external financing would come at a high cost—sovereign US\$1.4 billion bonds

⁴ See World Bank, 2012, p. 3.

⁵ There is no information available at this point to disaggregate the private S-I gap between households and firms.

issued in two tranches were priced at relatively high annual interest rates of 6.875 percent (5.5 years) and 7.625 percent (10 years), among the highest in emerging market countries.⁶

Sustaining a high rate of growth based on the expansion of economically inefficient activities is unsustainable without access to cheap sizable external transfers. The situation in Belarus's agriculture over 2005-2014 is illustrative because growth there achieved at a high cost to the rest of the economy. The average rate of return on capital invested in agriculture during this period was about 6.3 percent, while the rate of return on capital invested in the rest of the economy (the non-agriculture sector) was about 14.1 percent. Moreover, investment in agriculture amounted to 50 percent of the sector's GDP. This implies that had investment in agriculture⁷ been 10 percent of the total (rather than 13.9 percent) the annual rate of growth of Belarus's GDP would have been 1.2 percent higher than it was. The nonperforming loans in the agriculture sector and the current attempt to restructure loss-making state farms reflect this reality.

Changes in Belarus's economic growth prospects have undermined its achievements towards the World Bank's twin goals of eliminating extreme poverty and increasing shared prosperity by 2030. Recent downturn has put real income growth on hold, and made households more vulnerable. In 2015 the poverty headcount at PPP US\$10/day increased by 2 percentage points at the national level, and even more in rural areas where the poverty headcount increased by 4.4 percentage points (that is, by 24 percent) in just one year. During 2016, the incidence of poverty increased by a further 1 percentage point, again with a larger absolute increase in the poverty headcount in rural areas. However, the continued recession was also felt in Minsk and its surrounding areas, as well as in Grodno region, where there were no recorded increases in poverty in 2015, but where the incidence of poverty increased in 2016. The objective measures of deteriorating household welfare are also mirrored by subjective measures of well-being. According to the Life in Transition Survey (LiTS), between 2006 and 2016, Belarus recorded the largest deterioration of reported well-being among all ECA countries (European Bank for Reconstruction and Development (EBRD), 2016). The share of adults reporting to be satisfied with life fell from 66 percent in 2006 (one of the highest in the ECA region at that time, and significantly higher than the transition region average) to 50 percent in 2010, and then to 41 percent in 2016.

Against this background one of the most important challenges facing Belarus is to gradually modify state institutions previously associated with command and control rules and procedures. With the shift in the role of government from direct to indirect economic involvement, the social protection and labor market policies will also have to shift away from protecting jobs to protecting income of workers and their ability to earn income, as well as providing adequate support to the unemployed. The presence of these bureaucratic institutions implies a legacy burden that works against the modernization of the SOEs and the development of the private sector. The costs associated with this legacy are augmented by the fact that the resistance to change is very difficult to anticipate and that the resulting uncertainty deters more productive investment and required transformation.

Over the last two years, the government has turned its attention to structural weaknesses in the economy. It has taken several macroeconomic stabilization measures and adopted policies to support private sector development. According to the Government Action Plan for 2016-2020, the agenda for reforms is more comprehensive than before and is internally consistent with the long-term economic development goals. There is enhanced understanding about benefits and risks of reforms. However, high dollarization (suggesting low trust in domestic economic institutions), continued heavy state involvement in economic activities, and remaining weak budget constraints for SOEs (e.g. debt rescheduling during 2015-2016) suggest that many key structural rigidities in the economy are yet to be addressed.

Recent improvements in the external environment—a tentative recovery of the global economy and stabilization of growth in neighboring countries—offer Belarus many opportunities. But they also give rise to many risks if policies are not adjusted in time. Growth is projected to stabilize at the current rate of about 2 percent per

⁶ For comparison, in 2017 Tajikistan issued US\$ 500 million Eurobond at 7.125 percent (10 years), and Iraq placed a US\$ 1 billion Eurobond at 6.75 percent (5 years).

⁷ Includes agriculture, hunting and forestry.

annum, and there is a risk that growth will fall in a low growth trajectory. There is a strong case to be made for Belarus to continue reforms and adjust its policies. First, in the past, opportunities—including favorable energy trade arrangements from Russia and growing external demand—were not used by Belarus to restructure its domestic economy, to reorient export patterns strategically, or to lay down the foundations for sustainable export-driven growth. Moreover, recent episodes of growth volatility have demonstrated that cyclical volatilities in the external environment are amplified by remaining structural rigidities in the domestic economy. Second, the drivers of global economic growth are changing. Growth of global commodity prices is moderating, trade liberalization is slowing, and there is more uncertainty about global policy. All these factors will have significant implications for countries that are trying to integrate into global manufacturing value chains, which will be much harder than before, given the increased degrees of competition. It is also clear that Belarus is unlikely to benefit as much as in the past from growth in Russia and increases in commodity prices. A realistic appreciation of these changing external and domestic factors is a huge incentive to reform. Maintaining the current *status quo* is not an option for achieving a sustainable trajectory of GDP growth and increase of household incomes.








This Systematic Country Diagnostic (SCD) demonstrates that there is a window of opportunity to proactively lay down foundations towards a new vision—a competitive, inclusive and dynamic Belarus. At the core of this new vision is managing a transition to a new growth path that is sustainable and inclusive. Seizing this opportunity and achieving this vision will require Belarus to complete its economic, social, and institutional transformation by:

- (i) increasing the economy’s competitiveness by expanding the role of market forces in both real and financial sectors and increasing public sector efficiency;
- (ii) safeguarding social inclusion by strengthening social safety nets and aligning labor market policies with the increased role of markets; and
- (iii) upgrading institutional frameworks to make Belarus’s business environment more dynamic and market-oriented.

Undertaking this economic, social and institutional transformation will incur costs, but these costs can be mitigated. There is also a broad consensus as to this direction of change among policy makers, but there are diverging views about the pace and timeline of needed changes. The cost of transformation is not likely to be insignificant. For example, there could be an increase in budget outlays for social safety nets, or a decline in real incomes as energy and other utility tariffs are aligned to costs. Tightening of budget constraints for state-owned enterprises could potentially have adverse social impacts, such as an increase in unemployment. However, the *status quo* path would also have its costs, and these would be much higher from a longer-term perspective, risking a reversal of progress that Belarus has achieved over the last decades.

The SCD has identified seven key priorities for achieving further progress towards the twin goals in Belarus. Six priorities are aimed at making the most of opportunities towards a new vision of a complete, inclusive, and dynamic Belarus, while mitigating identified challenges. Finally, there is one cross-cutting priority related to mitigating the impact of climate change and disaster risk. The resulting priorities are shown in Table 0.1 below.

Table 0.1: Priorities

POLICY AREAS			IMPACT ON	
			Reducing poverty	Increasing shared prosperity
PRIORITIES				
	1. Maintain macroeconomic stability	<ul style="list-style-type: none"> ▪ Maintain prudent economic policy management ▪ Address financial sector vulnerabilities ▪ Enhance fiscal and public debt sustainability 	x	x
	2. Strengthen social resilience	<ul style="list-style-type: none"> ▪ Strengthen social safety-nets ▪ Develop adequate unemployment protection mechanisms ▪ Develop active labor market policies 	x	x
	3. Improve economic governance	<ul style="list-style-type: none"> ▪ Improve efficiency of state-owned enterprises and reform the state-owned banks ▪ Improve cooperation and coordination between private and public sectors ▪ Strengthen property rights protection ▪ Strengthen the role of the market signals in allocation of capital and labor 	x	x
	4. Unleash private sector growth potential	<ul style="list-style-type: none"> ▪ Ensure competitive neutrality and deregulation of product and factor markets ▪ Eliminate cross-subsidization and improve public utility service delivery 	x	x
	5. Maintain human capital edge	<ul style="list-style-type: none"> ▪ Increase the relevance, responsiveness, and quality of the higher education, research, and innovation systems in accordance with labor market needs and international trends ▪ Promote active and healthy aging 		x
	6. Enhance connectivity	<ul style="list-style-type: none"> ▪ Transition to a rules-based trading system (World Trade Organization accession) ▪ Strengthen public investment management and management of SOEs ▪ Improve logistics potential and offer competitive transport services 		x
CROSS-CUTTING PRIORITIES				
	7. Climate change adaptation and disaster risk mitigation	<ul style="list-style-type: none"> ▪ Increase energy efficiency ▪ Assess systematic needs and risk financing strategies ▪ Promote creation of resilient forests 	x	

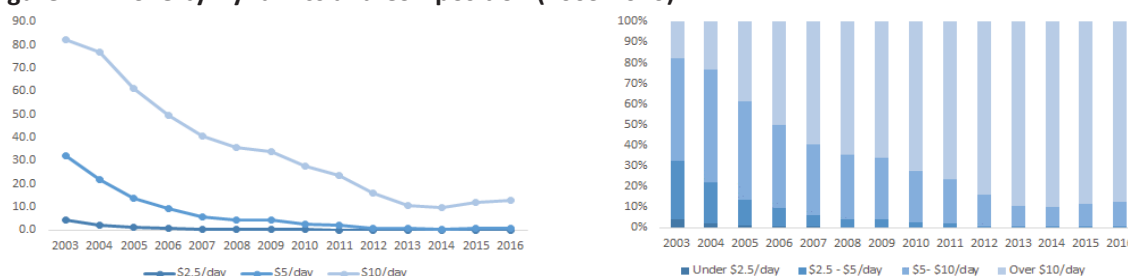
The Report is structured as follows. Chapter 1 describes trends in poverty reduction and in shared prosperity and examines the conjecture that economic growth was the main determinant of improvements in income distribution. Chapter 2 analyzes the sustainability of economic growth and income distribution gains. Chapter 3 sketches a vision of socio-economic development for Belarus in the next decade and formulates three pathways towards the sustainable and inclusive growth of an internationally competitive economy. Chapter 4 describes priority actions to achieve that vision.

Chapter 1 Achievements: Poverty Reduced, Prosperity Shared

A. Progress towards Poverty Reduction and Shared Prosperity

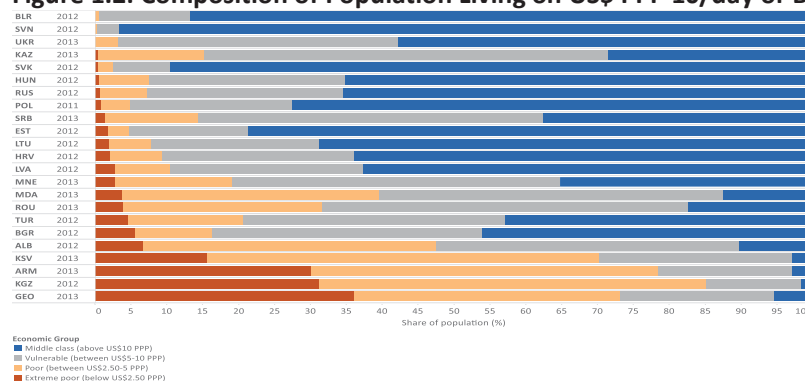
From 2003 to 2014, Belarus had the largest reduction in poverty rates in the ECA region. Measured at the internationally comparable PPP US\$5/day threshold,⁸ Belarus's poverty headcount fell from 32 percent in 2003 to less than one percent in 2014, while in ECA it fell from 38 percent in 2003 to 13 percent in 2013. Measured at the threshold of PPP US\$10/day, the poverty headcount in Belarus fell from 82 percent in 2003 to less than 10 percent in 2014 (Figure 1.1); while in ECA it fell from 73 percent to just below 47 percent (Figure 1.2). The poverty rate based on the national poverty line declined from 27.3 percent in 2003 to 5.7 percent in 2016. Along with the drop in the poverty rate, the share of the middle-class population (defined as those with per capita expenditures in excess of PPP US\$10/day) increased from under 20 percent to 90 percent by 2014, before declining somewhat during the recession years.⁹

Figure 1.1: Poverty Dynamics and Composition (2003-2016)



Source: Staff estimates based on the ECA Poverty Monitoring Project (ECAPOV) harmonization of Household Budget Survey data.

Figure 1.2: Composition of Population Living on US\$ PPP 10/day or Below in the ECA Region in 2012-2013



Source: ECA Team for Statistical Development (ECATSD) calculations using ECAPOV data, based on Household Budget Surveys (HBS) and European Union Statistics on Income and Living Conditions (EU-SILC) surveys.

⁸ The PPP US\$5/day per person threshold based on the 2005 ICP prices is equivalent to BYN 2.67/day per person in national currency at 2016 prices.

⁹ Cancho et al. (2015) defines the following four economic classes: individuals living on less than \$2.5 PPP per day (the ECA regional extreme poverty line); individuals living on US\$2.5 to \$5 PPP per day (the ECA regional moderate poverty line); individuals living on \$5 to \$10 PPP per day; and individuals living with \$10 PPP or more per day. Individuals with per capita expenditures of US\$5-10 per day are considered as being vulnerable to falling back into poverty, whereas individuals with per capita expenditures in excess of US\$10 per day are defined as middle class. Note the definition of middle class as corresponding to incomes in excess of PPP US\$10/day is also consistent with recent work on economic mobility in Latin America (Ferreira et al., 2013).

The pace of poverty reduction and the improvement in living standards were in line with growth patterns. The poverty rate fell steeply during periods of high economic growth (2003-2008) and later (2010-2011), slowed down during periods of low economic growth (2009 and 2013-2014), and increased as the economy entered a recession in 2015. The share of population vulnerable to poverty fell from 50 percent in 2003 to less than 10 percent of the population in 2014. Alongside the fall in the poverty rate, the share of the middle-class population (defined as those with per capita expenditures more than PPP US\$10/day) increased from under 20 percent to over 90 percent during the same period. Notably, the pace of the reduction of the share of poor and vulnerable population, and, on the other hand, the expansion of the middle class, were quite constant throughout the whole period, only slowing down during the last 2 years (2013-2014), before the recession uptick in poverty in 2015-2016.¹⁰

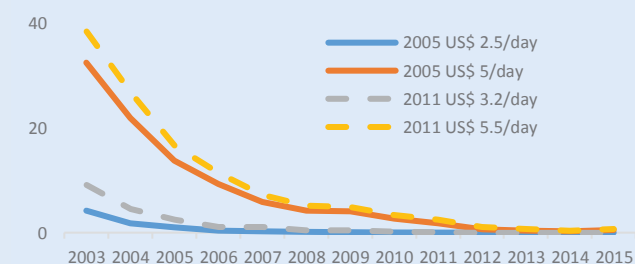
Box 1.1: Robustness of poverty trends to changes in international poverty thresholds

In 2017 the World Bank has transitioned from using the Purchasing Power Parity (PPP) estimates based on the 2005 round of the International Comparison Program (ICP)—a worldwide statistical partnership to collect comparative price data and compile detailed expenditure values of countries' gross domestic products (GDP), and to estimate purchasing power parities (PPPs) of the world's economies—to those based on the latest, 2011 ICP round. Simultaneously, the World Bank has also adopted new comparable poverty threshold, that are based on country income levels, as opposed to the earlier practice of having regional poverty thresholds. Two new poverty thresholds were introduced, that are relevant for Belarus: (i) lower middle-income poverty line (\$3.2 in 2011 PPP), and (ii) upper middle-income poverty line (\$5.5 in 2011 PPP). These thresholds roughly correspond to the previous extreme and moderate poverty lines in the Europe and Central Asia region (2.5 and 5 USD/day in 2005 PPP correspondingly).

Given the timing of this transition, the SCD still relies on the poverty thresholds based on the 2005 ICP round. However, the recent methodological changes do not affect the picture of poverty dynamics in Belarus over the past decade (Box Figure 1). In the first half of 2000-s decade, there was a gap in levels between old and new thresholds, but dynamics over time were similar and starting from 2009, when the PPP US\$5/day poverty headcount was below 5 percent, the difference between the two sets of estimates became negligible. This implies that other aspects of the analysis such as the profile of the poor, or regional poverty rates are not affected by the update in methodology.

The small differences in poverty rates under old and new lines are explained by very close conversion factors for two International Comparison Program (ICP) rounds. The PPP conversion factor for the 2005 ICP round for Belarus equals 759.6, while the PPP conversion factor for the 2011 ICP round for Belarus equals 1,832.4. The cumulative inflation between 2005 and 2011 was 148 percent. This means that the US\$ 5 /day threshold in 2005 PPP in was equal to 9437.2 Belarussian rubles in 2011 prices. This is very close to the values of new upper middle-income poverty line (US\$ 5.5 in 2011 PPP) in local currency - 9162.2 Belarussian rubles.

Box Figure 1. Poverty rates in Belarus using old and new poverty thresholds, percent.



Source: Staff calculations using Belarus HBS and World Bank ECAPOV database.

Inequality fell alongside poverty, and is low by regional standards. Strong growth at the bottom of the distribution were associated with a reduction in the level of overall inequality in Belarus, which fell from a Gini of 0.31 in 2000 to 0.27 in 2015. This is unlike many European countries, as well as Russia, where inequality in 2012-2014 increased relative to its level in 2000-2003 (World Bank, 2016). Poverty fell across all regions of Belarus (Figure 1.3; Figure 1.4). Differences in poverty rates across regions (outside the City of Minsk) were less

¹⁰ See Cojocar and Matytsin (2017) for more details.

than 5 percentage points at the US\$10/day threshold during the whole period. Internal migration, primarily from rural areas to urban areas, especially to Minsk, also helped contain regional disparities.¹¹

Gender disparities are generally low, and improving over time, although some challenges remain. Belarus is a leader in ECA in terms of ensuring legal and institutional equality as well as in advancing women's agency, but some disparities, particularly in the labor market, persist (see Box 1.2).

Box 1.2: Gender disparities in Belarus

Gender gaps in Belarus are much smaller than in other countries in ECA or the world. Belarus ranks 30th (between Spain and Portugal) among 144 countries covered by the 2016 World Economic Forum Global Gender Gap Index. The high ranking is due to good education and labor market outcomes—Belarus ranks 1st on female enrollment in all levels of education, and on having female professionals and technical workers. Healthy life expectancy for women is also high.

Gender equality and gender policies are given formal priority in Belarus and levels of legal and institutional discrimination are low. Belarus ranks 12th out of 108 countries in the latest OECD Social Institutions and Gender Index, which captures gender discrimination in social institutions. Belarus has signed and ratified all relevant international legal frameworks, and many legal bodies reflect this commitment to no discrimination and equality. Women's political representation at the national and local levels is high compared to other ECA countries, even though there is no formal gender quota system. However, executive branch representation is lagging behind – no female deputy prime ministers out of 5, and only one sector minister out of 24 is a woman. All state committee chairs are male, and so are most deputy chairs and regional state committee chairs.

Men and women still have different views on the role of women in society. World Values Survey results show that men are more likely to think that men are better political leaders or business executives than women, or that men should be given priority over women when jobs are scarce, or that a job is the best way for women to gain independence.

Women are less likely than men to participate in firms' ownership and management, but Belarus outperforms the ECA region. According to BEEPS (2013) data, a smaller share of firms is owned or managed by women in Belarus, although Belarus is closer to parity than the ECA region (44%/31% compared to 33%/19% in ECA). Women in Belarus are more likely to manage small firms, and are also concentrated in particular sectors (textiles, hotels and restaurants, garments and retail).

Women are paid less in Belarus, despite greater educational attainment. The gender wage gap increased from 19 percent in 2001 to 24 percent in 2014. The gender wage gap was the highest in male-dominated occupations (mining, manufacturing) and smallest in female-dominated sectors such as education, health and social work, as well as agriculture. Men have higher predicted wages than women for almost all educational categories. The persistent wage gender gap in Belarus is explained by two key factors: (i) women are generally employed in sectors where the pay is lower; (ii) even in sectors where this is not the case, women are often underrepresented in higher-paid positions.

Overall, Belarus continues to show that is in the lead toward achieving gender equality among lead other ECA countries in terms of gender equality, several key challenges remain. The significant progress made by Belarus in ensuring legal and institutional equality, as well as advancing women's agency, needs to be complemented by further efforts to (i) close the gender wage gap; (ii) improving men's life expectancy and years of healthy living; and (iii) increasing women's opportunities in decision-making positions in public office. Finally, increasing the availability of gender-disaggregated data, and making survey data (e.g. HHS, LFS, Time Use Survey) freely available to the wider research community would be beneficial to increasing our understanding of, and ability to respond to, the gender disparities that remain.

Source: *Belarus Country Gender Profile: 2016 Update*.

Inclusive economic growth over the past decade is also mirrored in the broader dimensions of human development. Belarus was ranked 52nd in the world according to the 2016 HDI¹²—a composite index of life expectancy, education and GNI per capita dimensions—19 positions higher than its GNI rank, meaning that its HDI ranking is higher than would be expected based on per capita income. Together with the Russian Federation (ranked 49th in 2014), Belarus had the highest HDI ranking among former Soviet republics.

Belarus experienced a rapid increase in its HDI during the 2000-2015 period when the value of the HDI for Belarus increased by 16.9 percent. Among countries classified with either “very high human development” or “high human development” based on the 2015 HDI value (this includes the highest ranked 106 countries in the

¹¹ During 2005-2009 Minsk had a net migration rate of 25.5 per 1,000 persons, with the Minsk oblast being the only other region with a positive net migration rate (3.1 per 1,000), whereas all other regions saw a net outflow of residents (from -12.4 per 1,000 in Brest, to -1.2 per 1,000 in Mogilev). In addition, the Government also undertook active measures to develop net migration loss regions through investments in rural education/health/culture, rural housing, and improvements in rural infrastructure, as well as through a program to relocate the unemployed to rural areas with available vacancies, although it is not clear how successful some of these measures were in practice (European Commission, 2012).

¹² The report was published in 2016 while the data are for 2015.

world), only six other countries experienced an increase (relative) in the HDI that was faster than that of Belarus (Azerbaijan, China, Mongolia, Turkey, Uzbekistan and Maldives). The evolution of the overall HDI in Belarus during this period was the result of improvements in the education and GNI per capita components of the index, although improvements in life expectancy at birth were also observed during this period.

The good performance of Belarus, and improvements over the past decade, on the human development indicators was based on improvements across a number of domains. The multifaceted character of human development progress in Belarus, as is implicit in the multidimensional character of indicators such as HDI, reflect dynamics during this period in a number of social domains, including the provision of education and health services (see Box 1.3), as well as support provided to the population, and in particular to low income households, by the social protection system.

Box 1.3: Health outcomes in Belarus

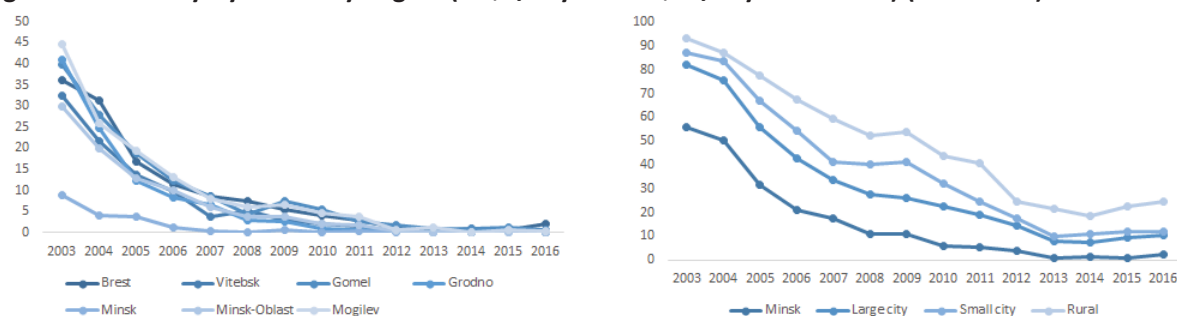
Belarus has remained committed to the principle of universal access to health care, provided free at the point of use through predominantly state-owned facilities organized hierarchically on a territorial basis. Belarus has historically emphasized maintaining access to its health care system for all citizens in contrast to several other former Soviet Union countries. As a result, out-of-pocket payments as a share of total health expenditures in Belarus are one of the lowest in the region (20 percent). Since health services are free of charge at the point of delivery, most private spending (over 70 percent) relates to medicines.

The health system has performed effectively on a range of indicators, including maternal and child health and containment of communicable diseases, including HIV and tuberculosis. In the last 15 years, infant and maternal mortality have improved remarkably to place Belarus among the lowest in the region (infant and maternal mortality of 3.2/1,000 and 2/100,000 live births in 2016, down from 11.9/1,000 and 22/100,000 live births, respectively in 1990). Belarus has also performed successfully with regard to other Millennium Development Goals indicators such as the fight against communicable diseases (mainly HIV and tuberculosis).

However, life expectancy at birth has not changed substantially—74.1 years in 2016 compared to 71.1 years in 1990 for both sexes¹³. A key reason for low life expectancy in Belarus is the growing incidence of non-communicable diseases (NCD), especially of cardiovascular diseases, which are now the main cause of mortality. About 98,300 out of a total of 119,400 deaths were registered under the heading NCDs in 2016, while only 1,200 deaths were registered under ‘communicable, maternal, perinatal and nutritional conditions’. The remaining 8,300 and 11,600 deaths were respectively registered under the heading “injuries” and “old age”. In other words, with more than 82 percent of total deaths, NCDs explain the lack of major improvements in life expectancy at birth in the last two decades. The causes and mechanisms of the above disease patterns in Belarus are multifaceted. Some identifiable generic causes are the influence of poor dietary patterns, excess tobacco and alcohol consumption and sedentary habits and lifestyles. Insufficient emphasis on health promotion and disease prevention as well as on interventions at the primary health care level with demonstrated effectiveness against NCDs (for example, monitoring personal behavioral issues and metabolic and other risk factors) also influence the emergence of NCD-derived problems.

Source: Belarus: Public expenditure review: enhancing public services in times of austerity, The World Bank, 2016 and Belstat.

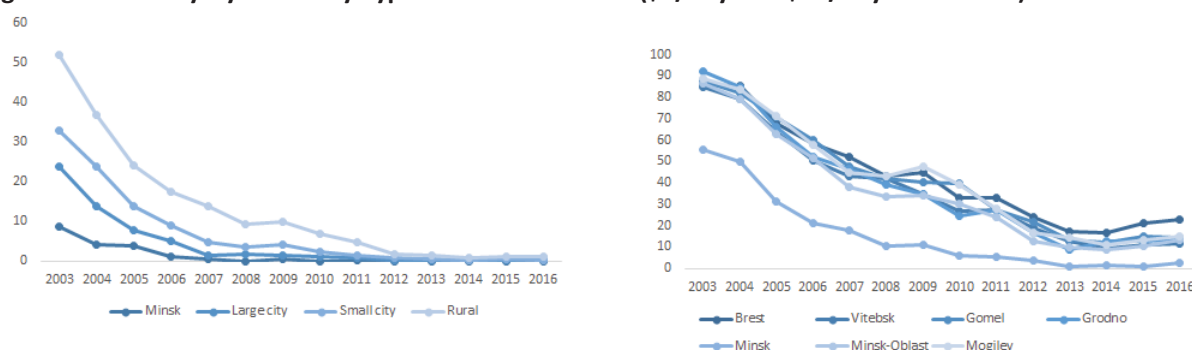
Figure 1.3: Poverty Dynamics by Region (US\$5/day and US\$10/day Thresholds) (2003-2016)



Source: Staff estimates based on the ECAPOV harmonization of HBS data.

¹³ Average life expectancy for women is now higher than it was before independence (79 years in 2016), is now equal to the average of 79 years for the WHO European region and disability-adjusted life expectancy of only 66 years. Average life expectancy for men has improved (68.9 years in 2016), but it still has yet to recover pre-independence levels and is below the European average of 72 years.

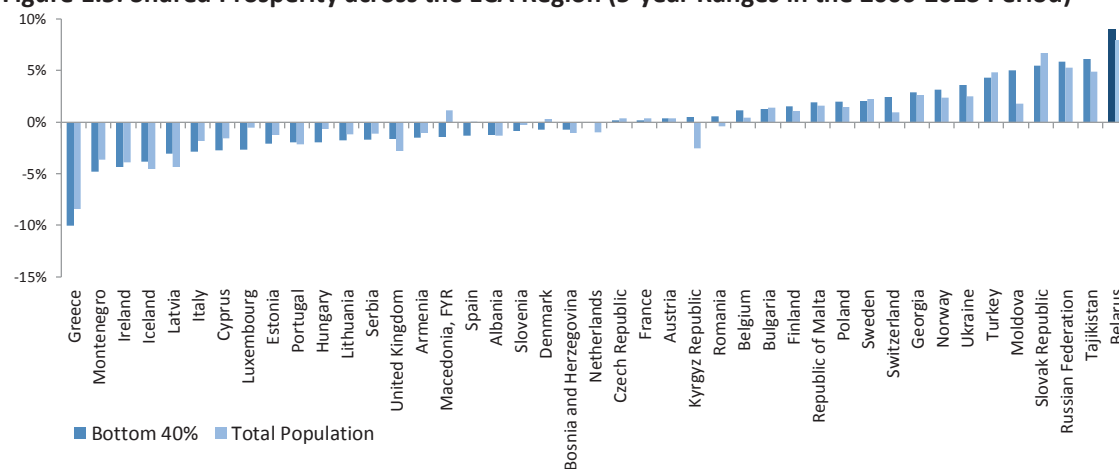
Figure 1.4: Poverty Dynamics by Type of Residence Area (\$5/day and \$10/day Thresholds)



Source: Staff estimates based on the ECAPOV harmonization of HBS data.

Belarus has performed well in terms of the World Bank's shared prosperity indicator¹⁴ within the ECA region. For a region-wide comparable period, 2006-2011, Belarus exhibited the highest rate of growth of expenditures in the bottom 40 group (almost 9 percent on an annualized basis). This took place at a time when many of the European countries were suffering from adverse effects of the financial crisis, registering negative growth of incomes both for the population overall and households in the bottom 40 group (Figure 1.5).

Figure 1.5: Shared Prosperity across the ECA Region (5-year Ranges in the 2006-2013 Period)



Notes: Estimates are based on the ECAPOV harmonization. The Five-year window differs across countries, but in all cases is within the 2006-2013 period.

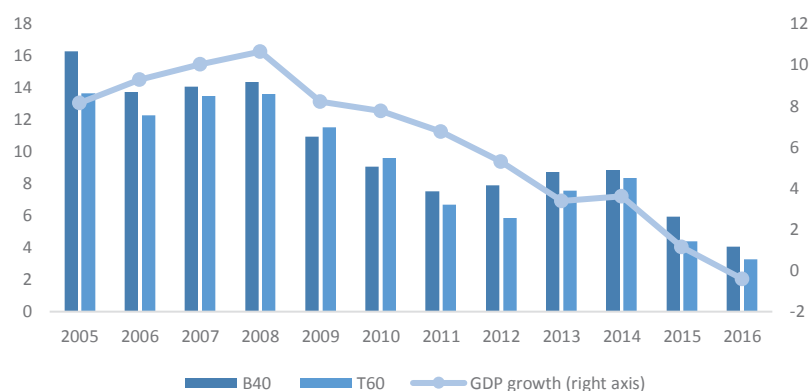
Source: Staff estimates based on the ECAPOV harmonization of HBS data.

Over the last 15 years, Belarus consistently recorded high growth rates of real household expenditures, except for the most recent years (Figure 1.6). This indicator averaged over 10 percent on an annualized basis until 2009, and ranged between 7 and 9 percent on an annualized basis during the five-year interval from 2010 to 2014. Figure 1.6 also shows that the shared prosperity indicators track the growth dynamics of GDP growth rates reasonably well—increasing up to 2008, declining slowly until roughly 2012, becoming stable in 2012-2014, and falling again in 2015 and 2016. For the most part, the B40 growth rates exceeded those for the population as a whole. However, by the end of the period, for the 2010-2015 or 2011-2016 five-year windows, annualized growth rates of the B40 percent were more than three times lower than before the financial crisis of 2009.¹⁵

¹⁴ The rate of growth of consumption of the bottom 40 percent (B40) of the population, measured in real terms, meaning that the growth of consumption that is measured after inflation between the end points of a given time period has been taken into account.

¹⁵ This is the case for all five-year windows with the exception of those ending in 2009 and 2010.

Figure 1.6: Shared Prosperity in Belarus: 5-year Moving Window (2001–2016)



Source: Staff estimates based on the ECAPOV harmonization of HBS data.

Notes: year 2005 corresponds to the period 2000–2005; year 2015 corresponds to the period 2010–2015; B40 refers to the bottom 40 percent of the population, ranked by household expenditures per capita; and T60 refers to the top 60 percent of the population in the same ranking.

The dynamics of households' expenditures in Belarus tracks closely the evolution of household incomes, both for the B40 and T60 groups. The Shapley decomposition of household real disposable income growth by income component is shown in Figure 1.7. The period 2003–2015 is broken down into a pre-financial crisis period (2003–2009) and post-financial crisis period (2009–2015). During 2003–2009, total household incomes per capita in the B40 group rose by 13 percent on an annualized basis. A large share of this income growth (60 percent of the total) was due to growth in real wages during the same period. Aside from growth in real wages, the second most important factor was growth in real pensions, followed by other income components, which includes privileges (e.g. discounts on certain services) and other transfers.

Figure 1.7: Shapley Decomposition of Income Changes by Component 2003–2008 and 2009–2015 (Relative Contributions of Each Source to Overall Disposable Income Growth, Percent of Total)

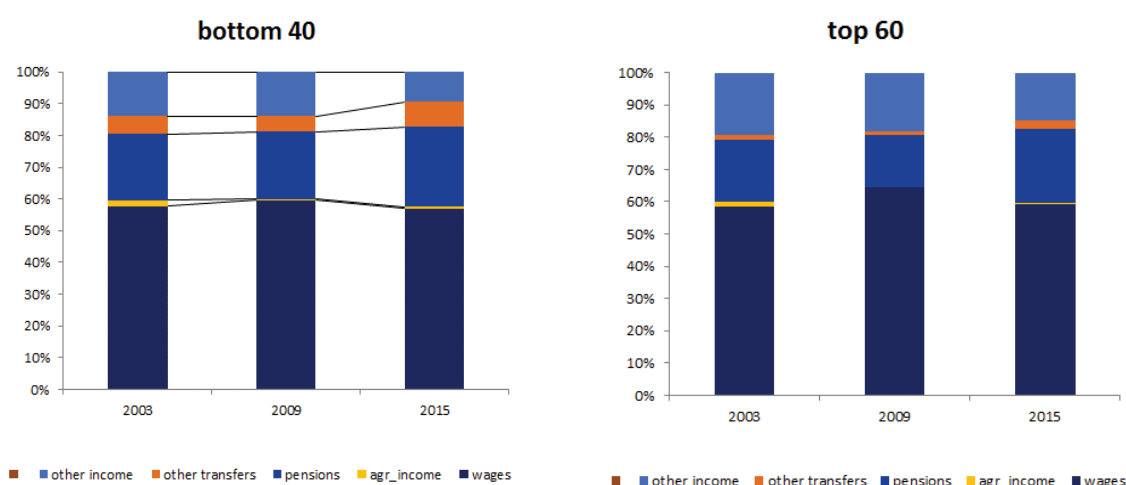


Source: Staff estimates based on the ECAPOV harmonization of HBS data.

The importance of the contribution of growth in wages and pensions derives from the importance of incomes from labor and pensions in overall household livelihoods. On average, according to household surveys, labor income accounts for about fifty percent of total household income. The other key income categories are pensions, transfers, and other income sources, an important component of which is various “social benefits” (such as discounts on medicine, transport and public services, non-cash benefits, and so forth) (Figure 1.8). The share of pensions and transfers in total income was higher for households at the bottom 40 (B40) than for those at the top 60 (T60). Over time, the relative importance of labor income in total income of the B40 group

increased during the early period, and subsequently decreased during the 2009-2015 period, while the share of pensions increased throughout, and the share of social transfers increased after the financial crisis of 2009.¹⁶

Figure 1.8: Composition of Household Income by Source in 2003, 2009, and 2015



Source: Staff estimates based on HBS data.

Human capital increases contributed to wage income growth. In Belarus, human capital improvements are a key driver of shared prosperity¹⁷. Over the past decade and a half, educational endowments have increased. In particular, tertiary enrollment rates increased for both men and women from an already high level.¹⁸ There was also a partial (absolute) convergence between B40 and T60 educational endowments during the past decade.¹⁹ Related to intensity of asset use, survey data shows that (i) the probability of employment in Belarus increases monotonically with the level of education, and (ii) the probability of holding a professional occupation is also higher for those with higher levels of education. Assessment of the changes in the quality of education over time is an important ingredient for determining human capital improvements. However, this assessment was not available for Belarus and hence constituted an important knowledge gap. Nevertheless, a recent analysis of returns to education in Belarus for the period 1995-2011 showed that wages were positively correlated with education levels, and that returns to education were relatively stable throughout the entire period (Chubrik and Shymanovich, 2013).

During the period 2009-2015, the growth of incomes in both the B40 group and the T60 group slowed down in comparison to the pre-financial crisis period. In the post-financial crisis period, the growth of real disposable incomes in the B40 group slowed down to 7.9 percent on an annualized basis. In terms of key contributors to overall income growth during 2009-2015, it was still the case that the key drivers were wages and pensions, but the relative contribution of wages became lower—53 percent. Due to the expansion of child benefits, wage contributions increased from 2 percent before the crisis to 12 percent in the second period, while, at the same

¹⁶ The share of other income sources (notably privileges), was lower in 2015. In the T60 group an increase in the share of labor income was observed between 2003 and 2009, and a subsequent decline of the share of labor income category was observed between 2009 and 2015, with an increase of the importance of pensions and transfers, and a decreasing importance of other income, mirroring similar compositional changes in the B40 group.

¹⁷ Bussolo and Lopez-Calva (2014) proposed a framework for analyzing the drivers of shared prosperity in which the differential ability of households to improve their income is a function of (i) asset (human, physical, social) endowment, including education; (ii) intensity of asset use; and (iii) returns to assets (for example, wages in the case of human capital).

¹⁸ Belarus started at already high levels relative to its GNI per capita, as compared to other ECA countries, and by 2013 tertiary enrollment was virtually universal for women and was the highest in the ECA region, and higher than would have been predicted based on GNI levels alone.

¹⁹ The share of the 22+ age group in the B40 population with general secondary education or below decreased from 50 percent in 2003 to 32 percent in 2015. Correspondingly, the share of B40 group with higher education increased from 8 percent in 2003 to 14.8 percent in 2015. At the same time, the share of those in the T60 group with tertiary education increased from 22.7 percent to 32.2 percent during the same period. In other words, in terms of percentage points, the decline in the share of population with no more than general secondary population was greater in the B40 group, but the T60 group experienced a more rapid expansion of share of population with higher education.

time, the reforms to the privileges system essentially eliminated the contribution of privileges to overall disposable income growth.

Household welfare was also supported by an extensive system of privileges and subsidized service provision, which have decreased overtime. Historically, a large share of the population (over 60 percent in 2003) benefited from an extensive system of privileges (for example, public transport, health care, and utilities, among others), and accounted for a third of the total social assistance budget at the beginning of the 2000s. Furthermore, important expenditure categories, including heating and utilities, were offered at tariffs considerably below cost-recovery levels (58 percent in 2015) (IMF, 2016). These benefits, along with state-provision of education and healthcare, were important contributors to household welfare. However, neither the system of privileges, nor the subsidization of utilities, were fiscally sustainable. The reliance on privileges fell notably, beginning with reforms introduced in 2007, and by 2015 the share of population receiving privileges fell to 33 percent.

B. Determinants of Progress towards Twin Goals

High rates of economic growth were the main determinant of progress towards the twin goals in Belarus. At 5.6 percent Belarus's annual average rate of growth of per capita GDP over the past two decades was very strong, compared to the performance of 216 other countries in the world. 58 European and Central Asia (ECA) countries and 28 transition economies in the ECA region (Table 1.1). As with countries in the rest of the world, and especially other countries in the ECA region, performance was very strong in 1995-2008 and weak following the financial crisis of 2008. Economic growth had an impact on poverty and shared prosperity, directly through the increase in labor income resulting from growing real wages and employment, and indirectly through the increase in pension transfers and the extensive system of privileges and subsidized service provision made possible by higher tax revenue.

Table 1.1: Rate of Growth of Per Capita GDP (1995-2015)

Period	ALL COUNTRIES		ECA		TRANSITION		BELARUS
	Median	Mean	Median	Mean	Median	Mean	Mean
1995-2008	2.4	2.8	3.1	3.9	4.8	5.5	6.7
2009-2015	1.3	1.6	0.7	1.0	1.5	1.8	2.0
1995-2015	2.0	2.4	2.4	3.0	4.1	4.4	5.6

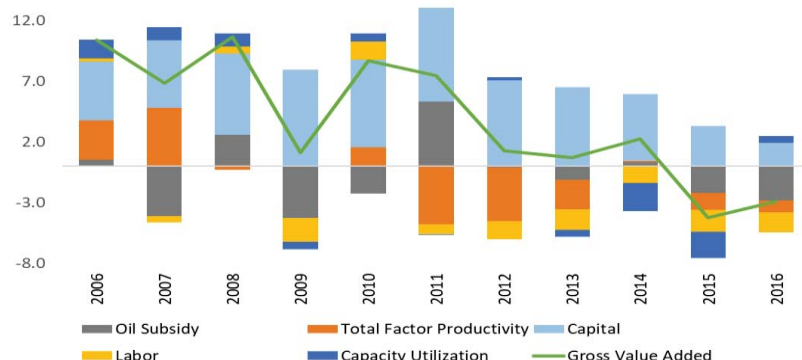
Note: Geometric average based on GDP at constant local currency units.

Source: WDI.

Belarus was able to grow quickly in the 2000s because it retained skills and capital goods from the earlier Soviet Union period. In the aftermath of the collapse of the Soviet Union, the main constraint to increasing Belarus's output was low aggregate demand rather than limited capacity. Labor skills, machinery, and equipment were available to produce goods and services but the markets to sell these goods and services were severely disrupted by the collapse of the Soviet Union. Thus, from 2000 to 2007, excess capacity in capital (although subject to depreciation) and labor made it possible to respond quickly to the renewed export demand from Russia and other CIS countries. From an accounting standpoint, most of economic growth can be explained by improvements in capacity utilization, total factor productivity (TFP), and as discussed in Box 1.4, economic benefits from favorable energy trade arrangements (Figure 1.9).²⁰ Thereafter, capital accumulation played a more important role in explaining growth, and, from 2011-2015, it was the almost exclusive source of economic growth (Figure 1.9).

²⁰ To account for these facts this section adjusts the endowment of factors of production by a factor that approximates capacity utilization. A similar adjustment is applied to account for the special circumstances that surround value-added factors in the oil refining and derived sub-products sector. The consideration of these factors implies that it is observationally very difficult to separate the contribution of TFP to growth from that of changes in capacity utilization, in energy policy regime, or labor force participation, unless the latter can be measured with precision.

Figure 1.9: Growth Decomposition—Contributions to Real Value-added Growth, Percentage Points (2006-2015)



Notes: In this growth decomposition, the contributions of capital to gross value added are obtained by applying the use of capital services approach in order to address the problem of biased-fixed investment deflators. Available data on capital stock display its unnatural stability, because throughout the last 20 years, the annual growth rate of capital stock in real terms fluctuated at about two percent. In order to minimize the bias, alternative deflators for both the whole economy and the selected sectors are constructed by reevaluating the capital stock.

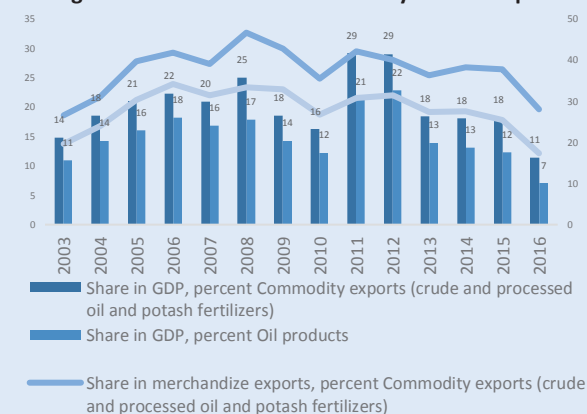
Source: WB staff calculation based on Belstat data.

Box 1.4: The Importance of Oil for Belarus's Economy

Belarus imports most of its crude oil and nearly all natural gas from Russia, and refined oil products are 17 to 18 percent of the country's exports. Belarus imports crude oil and produces oil products, mainly for exports, at its two refineries whose combined annual capacity is 24 million tons. Since the early 2000s, Belarus has benefited from importing crude oil from Russia at a steep discount, while exporting refined oil products at world market prices. As a result, oil product exports generated about one-third of total merchandise export revenues (see Box Figure B1.2.1 below). Between 2001 and 2009, implicit transfers associated with imports of oil from Russia at prices below those of the world market were estimated to be on average 7.4 percent of GDP per year.

In recent years, direct benefits associated with oil product exports eroded due to periodic disputes over the terms of crude oil supplies from Russia, and the steep decline in world oil prices. By 2010, the size of the benefit from the favorable energy trade arrangements had dropped to 3.3 percent of GDP from 10.1 percent of GDP in 2006 due to a protracted bilateral controversy with Russia on gas and oil supplies. At the end of 2010, the two countries reached an agreement and supplies resumed, doubling the average annual oil benefit up to 7.2 percent of GDP in 2011–2014. However, with the steep downward trend in world oil prices since mid-2014, the benefit element also took a dive. In 2016, the oil-related benefits received by Belarus dropped further to 4.6 percent of GDP from a 2015 level of 7.6 percent of GDP. This reduction occurred due to (i) the introduction of additional taxes by Russia (tax maneuver), which effectively increased crude oil import prices for Belarus, (ii) the decline of world oil prices, because the average oil import price for Belarus in 2016 was about US\$30 per barrel compared to the world price of US\$43 (in 2014, the respective prices were US\$48 and US\$96 a barrel); (iii) the global industry-wide fall in refining margins since mid-2015; and (iv) the reduction of oil supplies due to bilateral disputes on gas prices.

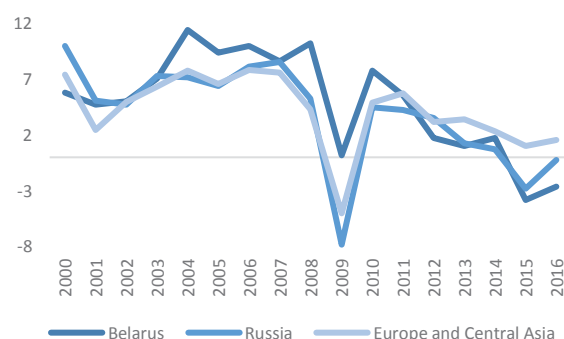
Box Figure B1.2.1: Shares of Commodity and Oil Exports in Total Exports and GDP, Percent (2003-2016)



Source: Staff estimates based on Belstat data.

External factors played an important role in Belarus's economic growth. A trajectory of solid economic growth was shaped by energy, trade, and capital flows from Russia. From 2000 to 2016, the trajectory of the rate of growth of Belarus's GDP followed closely that of Russia and the rest of the European and Central Asia region (Figure 1.10). The coherence between the path of the rates of growth of Belarus, Russia and the ECA region was remarkable up until 2012 but the trends departed in the remainder of the period.²¹ Three main channels connect the economies of Belarus and the Russian Federation: energy, trade, and capital flows.

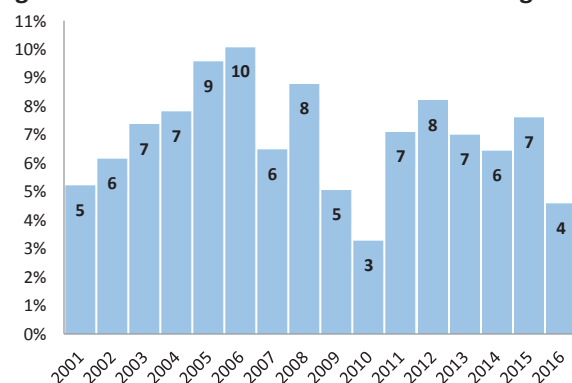
Figure 1.10: Rate of Growth of GDP: Belarus, Russian Federation, and ECA Region (2000-2016)



Source: World Development Indicators.

On energy, Belarus benefited from importing gas and oil at below world market prices, while exporting oil products at world market prices. The “oil factor” accounts for a notable reliance on favorable energy trade arrangements with Russia. Over the period 2001-2010, gas and oil subsidies averaged 13.3 percent of GDP annually.²² Between 2001 and 2009, implicit transfers associated with imports of crude oil from Russia were estimated to be on average at 7.4 percent of GDP per year, and of natural gas—another 8.4 percent (Figure 1.11). Then beginning in 2007, Russia began revising the terms of bilateral energy trade and reducing its oil subsidies, and in 2010 even temporarily stopped exporting crude oil at subsidized prices.

Figure 1.11: Economic Benefits from Receiving Duty-free Crude Oil from Russia, Percent of GDP (2001-2016)



Source: World Bank Staff estimates based on Belstat data, Ministry of Economic Development of Russia, Federal Customs Services of the Russian Federation. Note: Calculations consider agreements on oil products customs duties for 2011–2014 and 2015–2016.

On trade, Belarus benefitted from strong economic growth in Russia and other CIS trading partners, which stimulated demand for Belarus's manufacturing and agricultural exports. From 2001 to 2008, Russia alone accounted for over two-thirds of Belarus's exports of machinery and agricultural goods. The share of the CIS in machinery and agricultural exports was even higher at over 85 and almost 90 percent, respectively.

²¹ While Belarus's trade with the rest of the ECA region is significantly less important than with Russia and other CIS countries, the coherence between the path of the rates of growth of Belarus and ECA suggests there are links that deserve further study.

²² See World Bank, 2012, p. 3.

To secure access to the markets of the former Soviet Union republics, especially in Russia, Belarus has been actively participating in regional integration initiatives since the early 1990s. Currently, the most advanced arrangement is the Eurasian Economic Union (EAEU), which was a next step after the Customs Union established in 2009. The EAEU seeks to remove all barriers to the movement of goods, services, capital, and people and to coordinate sectoral policies in energy, industry, agriculture, and transport. In addition, the EAEU Treaty builds the legal framework for harmonization of macroeconomic and monetary, trade, investment, and tax policies over the medium to the long run (see Box 1.5 for details).

Box 1.5: Belarus's Participation in Regional Integration Arrangements

In 2012, Belarus, Kazakhstan, and Russia established a Common Economic Space (CES), declaring “four freedoms”—free movement of goods, services, capital, and labor—with exemptions for “strategic sectors” (including oil, energy transit, and so forth). The members created a supranational governing body, the Eurasian Economic Commission, to support the functioning of the Customs Union and to implement integration initiatives. In addition, members support the EAEU Court, the Eurasian Development Bank (EDB), and the Eurasian Fund for Stabilization and Development (EFSD).

The Eurasian Economic Union is the most important regional integration agreement for Belarus, with several important implications. The tariff regime of the Customs Union is based on the level of Russia's duties. After Russia's WTO accession, the rates of the Common Customs Tariff (CCT) are to be adjusted to Russia's WTO commitments. Belarus is expected to adjust about one-fourth of its tariff lines to adopt the approved Common Customs Tariff. However, Belarus managed to preserve some country-specific exemptions, such as existence of legal entities ‘realizing the exclusive right of the state for importing alcoholic beverages and tobacco’.

Belarus's participation in the Eurasian Economic Union is expected to generate some benefits beyond obtaining market access and fuel at preferential prices. The EAEU member states agreed on creating a common market for oil and gas, including unrestricted mutual access for transit purposes. Also, the EAEU Treaty stipulated the possibility of purchasing/selling of electricity from/to other member states. In the areas of transport and logistics, member states agreed to grant access to the internal markets of railway services and to liberalize road freight transport. More importantly, EAEU membership is expected to improve market access as the member states gradually remove existing non-tariff barriers and offer each other national treatment rules for government procurement.

The Eurasian Economic Union challenges the extensive state intervention in the economy in Belarus. In particular, Belarus is obliged to reduce agricultural support. In 2015, this support was supposed to drop to 12 percent of total agricultural production value, and to 10 percent in 2016. One assessment (Akhramovich, Chubrik, and Shymanovich, 2015) calculated higher rates, about 14-15 percent of total agricultural production value. Also, the EAEU Treaty established a set of common rules for the provision of industrial subsidies which differ from the existing system of provision of state subsidies in Belarus. The financing of import-substitution projects has to be adjusted accordingly to the rules of “substitute subsidy”, to be used for domestically-produced goods only. In the field of finance, Belarus should eliminate the existing surrender requirements for exporters and grant reciprocal admission of professional participants in the securities market and of securities themselves.

The Belarus's economy was stimulated by significant capital inflows, especially between 2007 and 2011. Part of these inflows corresponded to foreign direct investment (made up mostly of reinvested profits), and the remainder is explained by borrowing (other investment). The mirror image of this development is visible in the widening gap between the shares of imports and exports in the GDP (Figures 1.12 and 1.13) and the steep deterioration of the current account balance as a percentage of GDP (average of 10.2 percent of GDP between 2007 and 2011). While most of the capital inflows financed higher imports, thus reducing the multiplier effect of the stimulus to the domestic economy, the inflows also stimulated aggregate demand, especially in sectors such as construction and services.

Figure 1.12: Share of Imports, Exports and Current Account Balance, Percent of GDP (1996-2016)

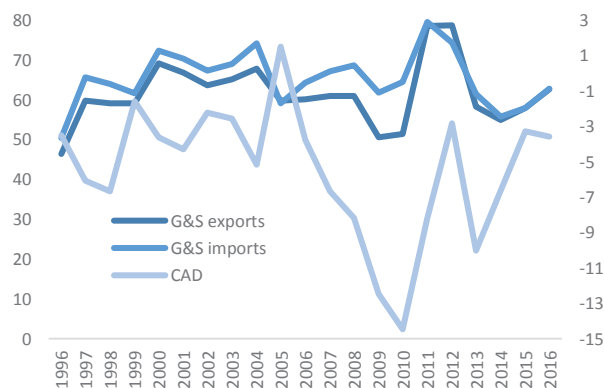
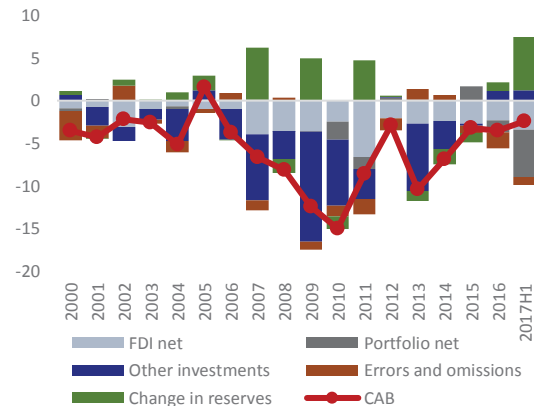


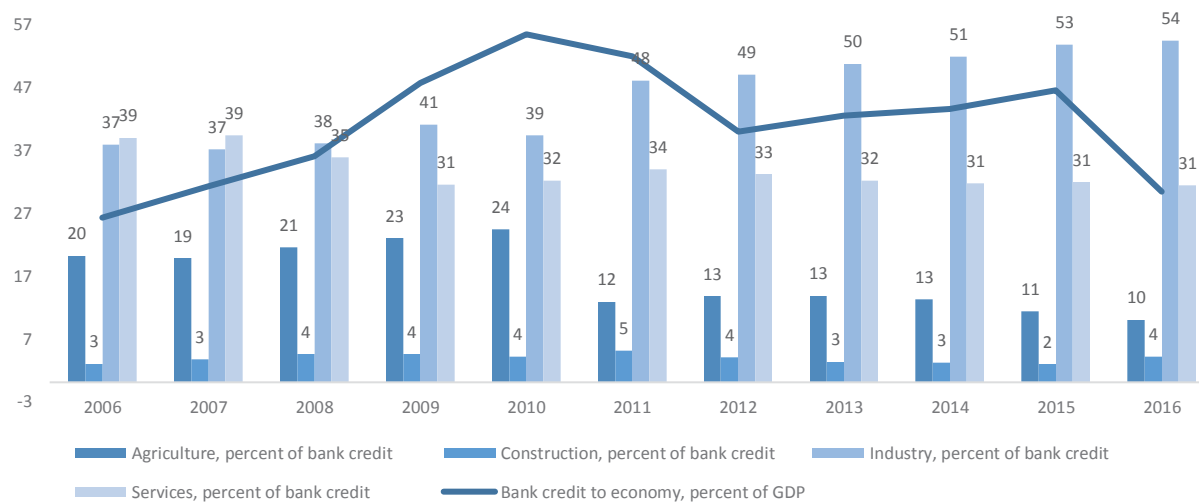
Figure 1.13: Sources of Current Account Deficit (CAD) Financing (1996-2016)



CAD current account deficit, G&S – Goods and Services.
Source World Economic Indicators, National Bank

The impact of capital inflows on the economy was amplified via the banking credit multiplier. State-owned commercial banks supported mainly state-owned enterprises in agriculture, industry, and services (Figure 1.14). The ratio of credit to GDP peaked in 2010 and as of 2015 had not recovered to that level.

Figure 1.14: Credit Supply to the Economy: Growth and Sectoral Composition, 2006–2016, Percent of Total



Source: World Bank Staff calculations based on National Bank data.

Chapter 2 Challenges: Avoiding a Low-growth Trajectory and Preserving Income Distribution Gains

Belarus's growth boom ended with the financial crisis of 2008, although except for the setback of 2009, the full impact of the crisis on Belarus was not entirely felt until 2014. The global financial crisis led to lower export demand and made the access to foreign financing more difficult, resulting in a rising current account deficit averaging 9.4 percent of GDP during 2009-2014. Cumulative inflation during this period amounted to 183.2 percent. The dollarization of household financial assets—foreign currency deposits—averaged around 62 percent, reaching 70 percent by the end of 2016. The steep fall in the price of oil in the world market after June 2014 and the subsequent tightening of the external borrowing constraint facing Belarus triggered a recession in 2015. At 5.7 percentage points of GDP, and with the adjustment of the current account of the balance of payments (BOP), the savings investment gap, S-I, undergone by the Belarus economy was severe, and the adjustment of the private savings investment gap, 7.7 percentage points of GDP, was even more pronounced (Table 2.1).²³

Table 2.1: Belarus: Savings Investment Gap, (Percent of GDP)

Year	Savings-Investment Gap	Government Savings-Investment Gap	Private Savings-Investment Gap
2010	-14.5	-2.3	-12.2
2011	-8.2	2.5	-10.7
2012	-2.8	-0.1	-2.7
2013	-10.0	-2.8	-7.3
2014	-6.6	-1.7	-5.0
2015	-3.6	-4.1	0.5
2016 (estimate)	-4.3	-4.6	0.3
Change 2010-2016	10.2	-2.3	12.5
Change 2013-2016	5.7	-1.8	7.6

Source: World Economic Outlook Database.

Belarus had responded to past pressures with short episodes of tight macroeconomic policies, but structural weaknesses were left largely unaddressed. While in 2008-2009, authorities responded to macroeconomic and financial pressures by tightening fiscal policy, restraining wage growth, allowing one-off exchange rate adjustment, and taking some structural measures, later policies tended to relax after immediate pressures abated, and deeper-rooted vulnerabilities persisted. Moreover, while fiscal revenues remained constrained, quasi-fiscal expenditures—mainly recapitalizations of state-owned banks and enterprises—remained significant.

As a result, the deceleration of growth coincided with a rapid buildup of public debt, and especially external public debt (Figure 2.2). Fueled by loose monetary policies in a dollarized environment, bank assets grew at an average rate of 21 percent annually. By boosting domestic demand, the rapid expansion in credit not only exacerbated external imbalances, but also undermined investment efficiency. Stagnating returns on capital and growing rates of nonperforming loans are worrying signs of deteriorating asset quality and associated banking system risks, especially in the context of hardening budget constraints.

In addressing the 2015-2016 economic downturn, the authorities have undertaken more sustained stabilization efforts and demonstrated stronger ownership of reforms (see Chapter 3 on policy responses). However, high

²³ There is no information available at this point to disaggregate the private S-I gap between households and firms.

dollarization, heavy state involvement in the banking and corporate sectors, and weak budget constraints for SOEs remain key structural rigidities for Belarus.

Figure 2.1: Contribution of Factors to Change in Oil Benefits for Belarus, Percentage Points of GDP (2002-2016)

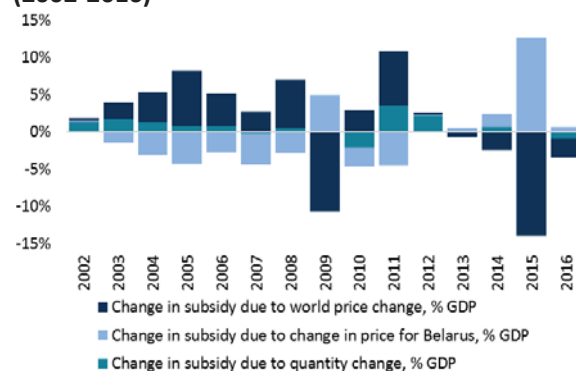
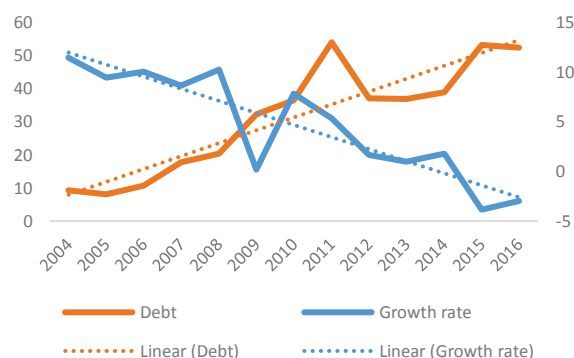


Figure 2.2: Annual GDP Growth Rate (RHS) and Public Debt as a Share of GDP (2004-2016)

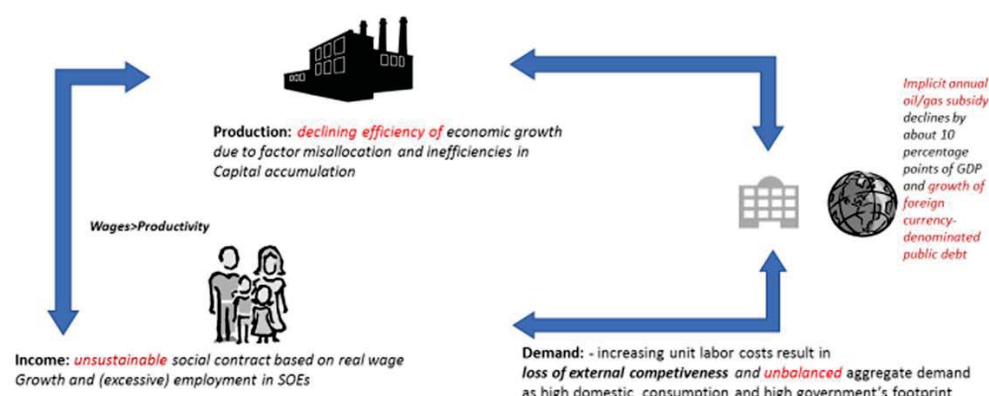


Source: World Bank staff estimates based on official data.

While exogenous factors—shifts in commodity prices and deteriorating terms of trade—are often highlighted as key reasons for the recent growth slowdown, there is increasing recognition that the main causes of the contraction are deep-seated domestic structural rigidities that have made Belarus' economic growth model inefficient, unsustainable, and unbalanced. On the production side, economic growth has losing its inefficiency—increasingly driven by capital accumulation as misallocation of factors of production have undermined sustainable productivity growth (Figure 2.3). The current social contract based on stable increases in income—a key source of reducing poverty and increasing shared prosperity—becomes unsustainable, while excessive dependence of external sources of finance has resulted in unbalanced aggregate demand, making Belarus's economy and financial sector potentially vulnerable.

Figure 2.3: Key Pressure Points of Belarus Economic Growth Model

Key pressure points: inefficient, unsustainable and potentially unstable growth trajectory



Source: SCD team.

A. Improving allocation of capital and labor

The slowdown of the rate of economic growth which is driven by a decline in total factor productivity suggests that the state-driven growth model may be reaching its limits. The sources of competitive advantage that served Belarusian industry well until the mid-2000s—economies of scale in production, economies of scope in distribution and sales, brand recognition with channels serving the traditional former Soviet Union markets, and better information about customers' preferences—began to dissipate under rising competitive pressures, including at traditional markets. While heavy government interventions in the economy have helped Belarus to avoid the social costs associated with economic restructuring, these policies have distorted the allocation of resources and have severely eroded the competitiveness of Belarus.

The misallocation of labor is an outcome of stalled structural shifts in the economy. In Belarus, strong labor productivity growth over the last decades came mainly from productivity growth within sectors rather than from the reallocation of labor to more productive sectors. In recent years, while there has been a gradual shift in employment from industry and agriculture towards services, this shift is associated with a decline in average labor productivity, and employment growth is observed primarily in the low value-added services industry. Thus, over the past decade, labor was, on average, moving toward less productive sectors, and, as a result, the overall contribution of structural change to productivity was negative (Figure 2.4).

Figure 2.4: Decomposition of Labor Productivity Changes, Annual Averages in Nominal Terms (2000-2015)

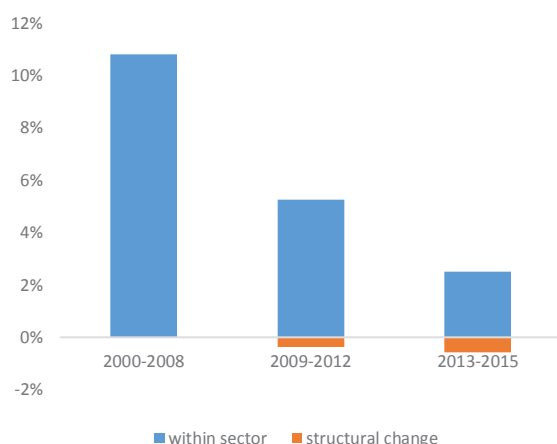
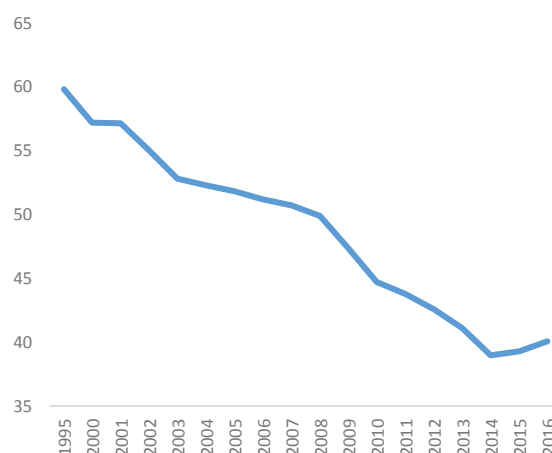


Figure 2.5: Employment Share of SOEs (1995-2016)



Source: World Bank staff calculations based on Belstat data.

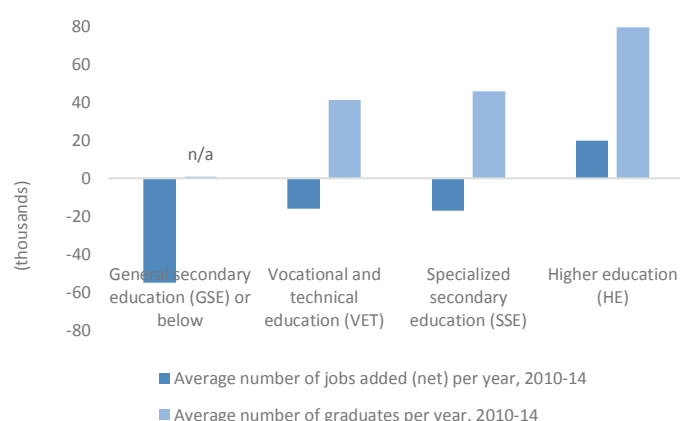
Moreover, overemployment in SOEs suggests that there are sufficient spare labor resources to support non-inflationary growth in the private sector employment. While in recent decades there was a gradual decline in the total share of employment in SOEs (Figure 2.5), employment in SOEs stabilized at a high 40 percent level in 2016, registering even a modest increase during the recession. Estimates done in 2012 suggest that overemployment in the Belarus SOE sector was at about 10 percent on average (World Bank, 2012). If excess labor were to be entirely shed, the current unemployment rate would go up by 4.2 percentage points. Due to employment targets set for SOEs in the past, labor market rigidities persisted, limiting the extent of workforce adjustments, even during periods of economic downturn. Today, the share of employment in the private sector in Belarus is among the lowest in the region.

While revenues per employee in the private sector—a proxy of higher labor productivity—exceeded those in the SOE sector, pay differences were not significant. Revenues per employee in the private sector systematically exceeded the same indicator in the public sector by almost two times in the period of 2001-2016, averaging

around US\$47,300 per year for a private sector firm.²⁴ However, for a short period of 2010-2013, official statistics recorded that average wages in the public sector exceeded wages of domestic private companies, in US\$ terms (for example, US\$413 vs. US\$362 in 2010). The economic downturn has affected wage levels of both private and public companies, but in 2016, wages in domestic private companies again exceeded wages in public enterprises (US\$387 vs. US\$340).²⁵

Despite the reported abundance of university graduates, many enterprises—especially in the private sector—often report skill shortages. The profiles of graduates and their initial skills may not be the heavily demanded in contemporary markets. The data (Belstat, 2017a) show that about 68 percent of students of higher education study social science and humanities, while the remaining percentage specialize in various scientific and technical disciplines, including medicine (Figure 2.6). The vocational training institutions are less popular than the institutions of higher education. In order to support training facilities for future blue-collar workers, who seem to be relatively scarce in Belarus, the Government has focused on the development of vocational training. In particular, Minsk-based institutions began to enroll students from other regions of Belarus on an increasing scale, and increased wages of instructors (see Box 2-1). Yet, these measures have not been able to bridge the gap between skills and market demand.

Figure 2.6: Belarus: Supply and Demand of Workers by Education Attainment Level (2010-2014)



Source: World Bank staff calculations based on Belstat data.

Box 2.1: The Educational System of Belarus

Belarus has a developed system of education, and the educational level of the population is high. It is, however, difficult to assess the quality of secondary education because Belarus does not take part in international programs for student assessment, such as the Program for International Student Assessment (PISA), the Progress in International Literacy Study (PIRLS), and the Trends in International Mathematics and Science Study (TIMSS). Instead, the education of teachers, class size, pupil-to-teacher ratio, and participation at the international Olympiads for schools could be used as proxies. The majority of general secondary education teachers (87 percent) have higher education degrees, and a much smaller share (11.4 percent)—specialized education degrees. The average class sizes are comparable to EU averages (17.1 for primary school, and 18.5 for basic and upper secondary schools). Belarusian pupils are successful in international Olympiads. For example, in 2016, Belarusian school students won 42 medals, including 5 golds, 17 silvers, and 20 bronzes. And in 2017, the total medals count was 52, including 5 golds, 20 silvers, and 27 bronzes.

The pattern of capital allocation has been heavily distorted due to the widespread state interference in the financial system. The banking system, the primary channel of financial intermediation, is highly concentrated and controlled by large state-owned banks. Nearly 65 percent of total assets of the banking system are state-owned, while the remainder is shared among foreign banks (34 percent) and domestic private banks (only 1 percent). In 2016 more than 40 percent all gross fixed capital investment was made by SOEs or the government

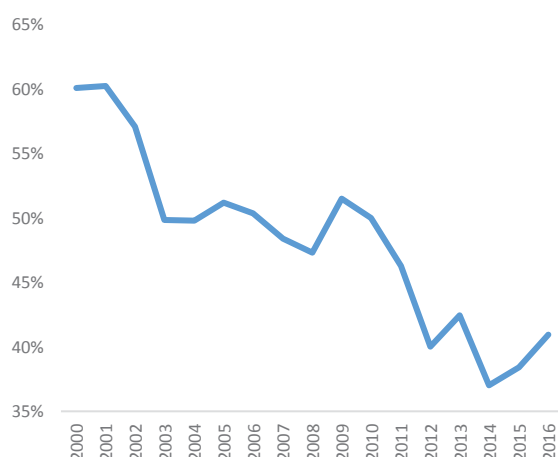
²⁴ Revenues per employee of private companies with foreign participation were even higher: US\$100,900.

²⁵ At the same time, salaries in private companies with foreign participation have been higher than in domestic private companies and SOEs.

(Figure 2.7). Due to the practices of directed lending²⁶ by state-owned commercial banks, Belarus’s financial sector has been channeling a significant share of financing to less productive parts of the economy, including SOEs which enjoy privileged access to and lower costs of financing. Moreover, while capital investments did decline in real terms over the last two recession-hit years, the decline was driven by a significant fall of investment done by private sector entities and local governments, with investments by the central level of government remaining broadly stable (Figure 2.8).

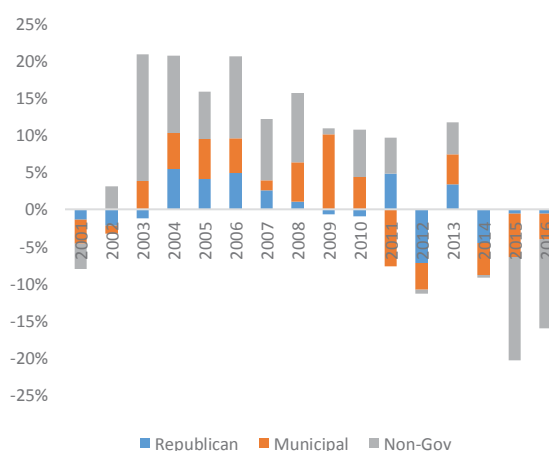
Commercial banks have historically been the main agents of government directed lending (GDL), with the Development Bank of Belarus (DBB) taking on an increasing role in recent years. The DBB was founded as a fully state-owned institution to provide financing for investment projects within the framework of state programs and providing support to exports and SMEs²⁷. The Government holds subsidiary liability on the bonds issued by the DBB²⁸. The DBB loans are essentially long-term, focusing on the real sector of the economy, infrastructure development, and leasing²⁹. In the past, the two largest state-owned banks—“Belarusbank” and “Belagroprombank”—have provided the bulk of directed loans, while the Development Bank of Belarus has progressively played a larger role in recent years. In addition to financing industry and agriculture, “Belarusbank” provides loans for housing construction, while “Belagroprombank” focuses mainly on agriculture. According to the National Bank of Belarus data in 2016, the share of directed loans by “Belarusbank” and “Belagroprombank” were estimated to be about 39 percent and 25 percent of the planned GDL portfolio, respectively, while the share of the DBB reached almost 28.9 percent.

Figure 2.7: Share of All Fixed Capital Investments Done by SOEs at Republican or Local Level, Percent (2000-2016)



Source: World Bank staff calculations based on Belstat data.

Figure 2.8: Real Growth of Gross Fixed Capital Formation, Contributions to Growth by Ownership, Percent (2001-2016)



In addition to preferential loans, various types of fiscal and quasi-fiscal support to SOEs has also contributed to inefficient allocation of capital. SOEs receive budget support to cover losses and compensate for below-market prices and tariffs—especially in utilities and other social services sectors. The International Monetary Fund (IMF) staff has estimated that the overall cost of state support, such as interest rate subsidization, issued and called government loan guarantees, budget credit support, capital injections, and privileged tax arrangements,

²⁶ Typically, loans have been provided within the framework of five-year sectoral and economy-wide development plans to fund long-term investment projects in industry, agriculture, and infrastructure, as well as to support housing construction.

²⁷ In 2016, the DBB loan portfolio was composed of credits to agriculture and industry (34.4 percent), infrastructure (34.1 percent), and purchase of equipment (21.5 percent) for leasing purposes.

²⁸ The scope of the bond issue is determined by the Government, and the DBB could issue bonds without collateral on these securities.

²⁹ The DBB purchases equipment and offers it for leasing.

amounted to 9.5 percent of GDP in 2015.³⁰ Of these, subsidies for housing, utilities, and transport services amounted to 1.2 percent of GDP in 2015.

Indirect subsidies have also been large, typically equity injections to state-owned commercial banks (95 percent of recapitalizations). In 2015, these recapitalizations were 1.6 percent of GDP, averaging annually about 2 percent of GDP over 2010-2015.³¹ At the same time, the Ministry of Finance (MOF) reported that during the period of 2009-2016, the sum of loan interest support, budget loans, and tax benefits averaged only about 1 percent of GDP per year.³² In mid-2015, the Government began to issue bonds to convert loans issued to SOEs,³³ including state-owned agriculture enterprises, effectively stretching their debt repayments with expectation of improved enterprise performance in the future. During 2015-2016, the volume of debt rescheduling operations amounted to US\$1.8 billion, causing the volume of public debt denominated in foreign currency to rise.

Where did the new investment go? Investment in the manufacturing industry and agriculture, provided within the framework of five-year sectoral and economy-wide development plans to fund long-term investment projects, were dominant throughout the entire period (Figure 2.9).³⁴ The share of the manufacturing industry, especially agriculture, in total investment suggests that a significant part of the capital accumulation in the period was done by SOEs in support of the old economy. In particular, the 2009-2010 sharp increase in investment in agriculture was likely to be the result of a “solution” to the high inventories accumulated at the time in the manufacturing sector rather than the consequence of economic calculus. A full answer to the question would require a more in-depth analysis searching inside the sectors and within the SOEs, but that is not possible at this time due to data limitations.

³⁰ In comparison, in EU countries, state aid averaged only about 0.67 percent of GDP in 2016.

³¹ The exception was 2013 and 2014, when equity injections to nonfinancial SOEs were 0.3 and 0.6 percent of GDP, respectively.

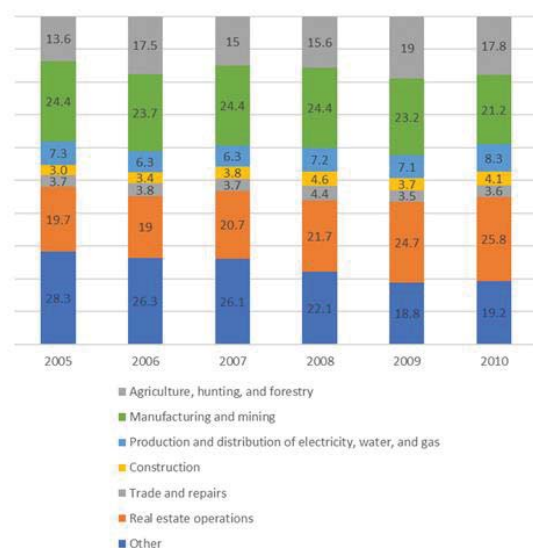
³² There is no unified system for accounting and reporting state aid, including compensated lending and fiscal support. While information on direct interest rate subsidies to SOEs as borrowers are included in the budget, there is no single line item that discloses the total amount paid, while indirect support arrangements are not disclosed.

³³ One of the first such operations was implemented in the timber sector, where about EUR 1 billion of subsidized lending was made. On June 24, 2015, the President signed an edict that specifies modes of management of “problem assets of commercial banks” accumulated as a result of loan provisions, mostly in foreign currency, to timber enterprises. The Ministry of Finance has acquired these ‘problem assets’ from commercial banks through “assignment of rights”, while the Development Bank has been appointed to manage these assets. Timber SOEs have opened special accounts in the Development Bank, which is commissioned to accumulate and transfer a fraction of revenues at the amount of debts of the current month. In its turn, the Ministry of Finance has issued government bonds at the amount of BYN 136.2 million (or US\$ 75.9), RUR 162 million (or US\$ 2.5 million), and US\$93.4 million, and EUR 567.9 million (or US\$ 613 million). Thus, the bond issuance totaled US\$784.8 million. The amount of bond issuance has exactly matched the volume of these “problem assets”. In the timber sector, SOEs have been granted relief: they were required to revise their business plans with the aim of improving performance under the conditions of prolongation of loan payments (up to five years), with a grace period for one year, and the lowering of interest rates on their loans (a half of the refinancing rate for BYR-denominated loans and a half of the original loan rate for FX-denominated loans). The interest rate difference is to be covered by the budget.

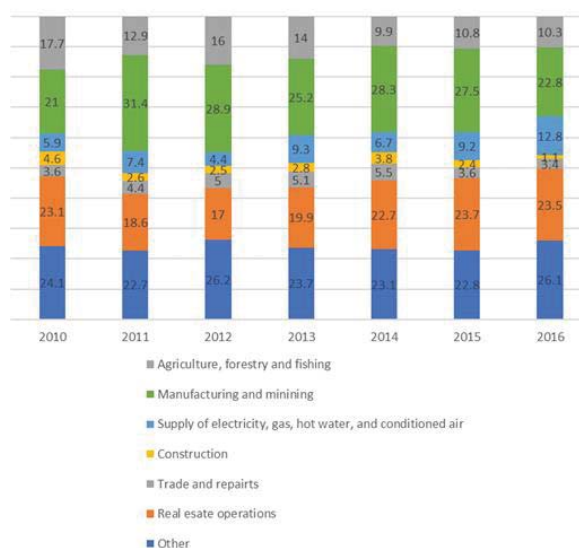
³⁴ However, there was a significant drop in the share of agriculture in total investment in the last years of the period. In parallel there was a drop in the share of employment in agriculture from 19.1 to 9.7 percent (according to Belstat).

Figure 2.9: Shares of Sectoral Investment into Total Investment, 2005-2016

A. 2005-2010 (OKONH classification)



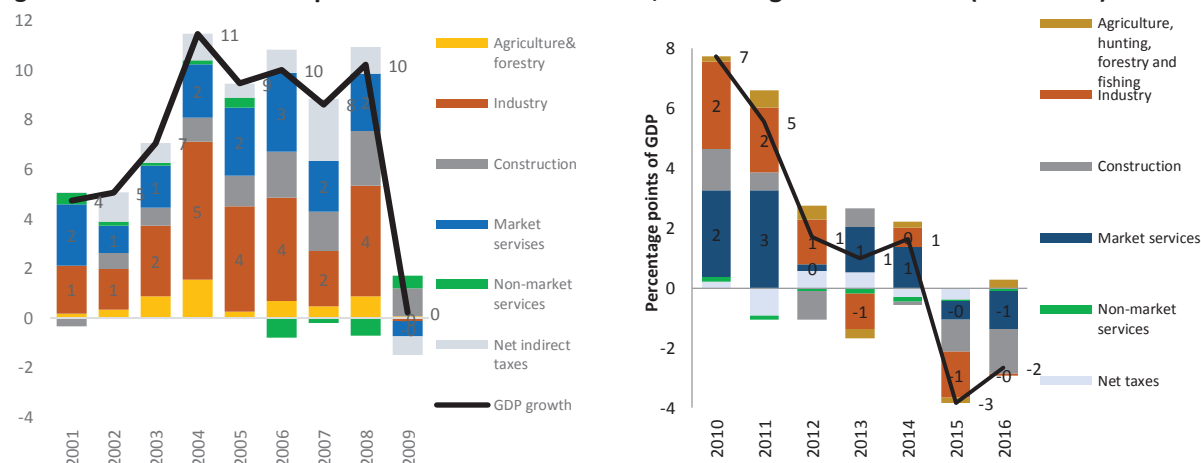
B. 2010-2016 (OKED classification)



Source: Belstat.

Over time, large debt-financed capital misallocation has contributed to the deterioration of economic activity in sectors with high-level debt. While the manufacturing industry in the past was the most important sector in determining economic growth, in recent years the manufacturing industry—which accounted for more than 20 percent of all capital investments in recent years—has been the most significant drag on economic growth (Figure 2.10).

Figure 2.10: Sectoral Decomposition of Economic Growth, Percentage Points of GDP (2001-2016)



Note: For 2001-2009, decomposition is based on an “old” classification, OKONH, or a general classification of sectors of the economy; for 2010-2016, decomposition is based on a “new” classification of sectors, OKED.

Source: World Bank Staff calculations based on Belstat data.

For instance, the growth of Belarus’s agriculture over 2005-2014 was achieved at high cost to the rest of the economy. The average rate of return on capital invested in agriculture during this period was about 6.3 percent while the rate of return on capital invested in the rest of the economy (the nonagricultural sector) was about 14.1 percent. Moreover, investment in agriculture amounted to 50 percent of the sector’s GDP. This implies that had investment in agriculture³⁵ been 10 percent of the total (rather than 13.9 percent) the annual rate of growth

³⁵ Includes agriculture, hunting and forestry.

of Belarus's GDP would have been 1.2 percent higher than it was (see Box 2.2). The nonperforming loans in the agriculture sector and the current attempt to restructure loss-making state farms are a reflection of this reality.

Box 2.2: Misallocation of Resources in Agriculture Sector

Belarus's agricultural sector is dominated by more than fourteen hundred large agricultural enterprises primarily owned by the state. Farms rent land free of charge. The average agricultural enterprise exploits more than 5000 hectares of land and employs about 230 workers (Box Table B2.2.1). Agricultural enterprises are mainly specialized in crop, dairy, and meat production. Private farmers have a negligible share of up to 2 percent of arable land and production. Subsistence farming makes up about 20 percent of total production with a large share of population depending on it. In 2016, households produced about 19 percent of the total agricultural output in Belarus (and about 34.7 percent of total crop production) and had a dominant role in the labor-intensive sectors of vegetables, potatoes, and fruits and berries production (Akhranovich et al., 2015).

Box Table B2.2.1: Selected characteristics of agricultural sector

	2006	2013	2014	2015	2016
Agricultural land area, ha, beginning of the year	9011.5	8817.3	8726.4	8632.3	8581.9
Number of agricultural enterprises, beginning of the year, thousand	1,900	1,530	1,497	1,454	1,469
Number of farming estates, beginning of the year, thousand	2,222	2,436	2,475	2,482	2,500
Number of households' plots, beginning of the year, thousand	1361.6	1022.3	1004.0	1001.3	1001.8
Number of agricultural land per agricultural enterprise, thousand ha	3.9	5.0	5.1	5.2	5.1
Number of agricultural land per farming estate, thousand ha	0.059	0.057	0.059	0.062	0.065

Source: Belstat.

Household plots exhibit exceptional productivity, with 19 percent of agricultural output produced on 9.4 percent of all agricultural land in 2016 (Belstat). Household plots have close ties with and receive transfers in the form of inputs and services from state-owned agricultural enterprises. This household subsector is therefore either exceptionally productive, or not all of these transfers are entirely accounted for in the available statistical data.

The average agricultural land area exploited by each agricultural enterprise has grown steadily during the decade (Table B2.2.1). This trend has little to do with the search for an optimal economic size but rather is the result of a government policy of increasing concentration with more-efficient absorbing loss-making enterprises.

The regulatory environment. After the breakup of the Soviet Union, Belarus began the same type of agricultural reforms as were being implemented in most other transition economies. But this reform process was later discontinued, leaving in place the key tools of the centrally planned economy, such as state-controlled management of agricultural enterprises, state production targets, state procurement and state input supply, and state lending and investment, as well as price regulation and control over wages.

The main instruments of the Belarus agro-food policy (according to World Bank, 2009) are: (i) price regulation; (ii) investment support; (iii) state supply of inputs; and (iv) state procurement.

Price regulation. Prices are generally set at a level that allows agricultural enterprises to generate "normal" profits, also taking into consideration state subsidies and compensations, and are largely considered to be performing a social function. The government of Belarus determines procurement prices for almost all agricultural products at the beginning of each agricultural season. The state fixes prices for products that are sold to the state through state procurement. For all other sales, the government sets "recommended" prices. The system of input supply is still based on state purchases made at regulated prices and distribution of key inputs to the farms.

Investment support. Every year, the government adopts a plan of direct state investments on a grant basis into government-selected enterprises. These investments are funded by the national budget and until 2010 was funded by the Agricultural Producer Support Fund and guided by the government's state program for rural development. In addition to these direct investments, the state provides loans financed from the budget and budget-financed guarantees for bank loans to agricultural enterprises, provides funds for occasional debt write-offs, provides interest rate subsidies, and provides additional support through direct regulation of banks. The state can (and does) provide preferential financial services to agricultural enterprises by directly regulating the terms of lending of the state-owned banks.

State supply of inputs. Input supply programs comprise the financially largest part of state support to agriculture. These programs include governmental coverage of mineral fertilizer and pesticide costs, the cost of machinery and machinery

maintenance and repair, energy costs, the cost of seeds and livestock breeding material, the cost of livestock feed, and the cost of land amelioration. The state procures inputs that it selects and provides them at preferential prices to the producers.

State procurement. State procurement of grains and flax is carried out by procurement organizations of the Ministry of Agriculture and Food, and for rape and sugar beet, by procurement organizations of the corporate “Belgospisheprom” group. State-fixed production targets, state procurement prices, and fixed orders to deliver to pre-identified procurement agencies complement the system of state procurement. Since the state-set prices do not necessarily cover the cost of production, farm enterprises receive considerable state support.

Agricultural producers often get lower prices for fuel, machinery, electricity, and other goods and services; on the other hand, the government sets up ceiling prices for many agricultural products. Authorities reduce costs by subsidizing inputs and introducing agricultural producer price regulation to stimulate the food processing industry and to subsidize final consumers. This phenomenal accumulation of distortions alters incentives, generates market inefficiencies, and often has unexpected beneficiaries.

In addition to large misallocation of capital, agriculture and forestry sectors are the most vulnerable sectors to climate change in Belarus. Over 40 percent of Belarus’s GDP is weather sensitive, with weather-related disasters causing average annual losses of at least 1 percent of GDP. This occurs primarily in the agriculture, forestry, fuel, energy, construction, transport, communications, housing, and utilities sectors (WBG, 2006 and 2008). On average about 100,000 people are affected and about 1 percent of GDP is lost to flooding every year (WBG and Global Facility for Disaster Reduction and Recovery, 2016). Atmospheric extremes including wind, localized rain, hail, and extreme temperatures cause about 0.4 percent of GDP in losses every year (WBG 2006 and 2008). A 100-year return period flood event would currently cause losses on the order of 4 percent of GDP or US\$2 billion, and if climate changes are taken into consideration, a similar frequency event would cause losses in the range of US\$5 to US\$8 billion in 2080.

Overall, sizable capital investments have not been able to improve SOE performance. In particular, the incentive structure governing SOEs imposes enormous obstacles to the introduction of organizational and technical innovations to adapt them to compete in the world market (See discussion in Box 2.3). Finding new and cheaper ways to produce goods and services are the main source of productivity gains and economic growth. It is here that the current organization of production in Belarus exhibits its weakest aspects. For instance, since suppliers of inputs to a final production stage are often part of the same conglomerate, management discretion to decide on whether to buy inputs or not, in what amounts and from which source, is seriously compromised. Easy access to investment and working capital finance provided by state-owned banks creates disincentives for SOEs to invest efficiently.

Box 2.3: SOEs in Belarus

Belarus has maintained extensive state ownership in both non-financial and financial sectors. The SOE sector consists of more than 3,700 companies (of which around 1,900 are joint stock companies and a further 1,800 are unitary enterprises), generating about a half of gross value added. Some SOEs are large, employing more than 10,000 workers (such as producers of tractors and vehicles), and many manufacturing companies, including producers of chemicals and construction companies, provide jobs for 5,000 to 6,000 workers. In 2016, the SOE sector in Belarus—companies either fully or partially owned by the state—generated about 46.7 percent of GDP.

In industry, SOEs continue to dominate on both many domestic and export markets. Many SOEs were designed back in the 1950s-1970s. The Soviet planners had a vision then that was very different from the “fast business process transformation” and/or “international competitiveness” realities of today, when strategic positioning within global value chains, serial strategic partnering, and investment in intellectual property matter more than the scale of production. Belarusian SOEs have been heavily oriented towards traditional markets, which are currently becoming smaller in scale. Accordingly, their inherited, large-scale production can be maintained only by a drastic expansion of exports to new markets, which are increasingly competitive. However, inflexible industrial strategies and the inability to rebalance capital/labor trade-offs prevent SOEs from increasing exports, revenues, and profits.

Scale biases resulted from a business model that was based on growth targets because many enterprises were performing various non-core and social functions. Currently, the business models of Belarus’s SOE sector center on minimizing long-term production costs by striving for full productive capacity utilization given targeted production volumes, while sacrificing competitive flexibility, market responsiveness, and new product innovation. Business models are designed for very long production runs, for large production lots, for vendor supply dependence relative to other specific SOEs, and for the realization of economies of scale through preferential access to wide markets. At least before 2014-2015, the largest of these SOEs used

to schedule production based on central forecasts, and had break even points which exceeded actual production volumes. Even in this context, they were unable to segment the markets they served and differentially price into these segments. Instead, they offered fixed terms of sale to all of the channels they served and thus consistently failed to reach break-even points. When ambitious sales fail to materialize, the result is inventory accumulation at the point of final manufacture. In turn, inventory level becomes a new economic target, which enterprises seek to fulfill, being constrained by the inability to sell below marginal production costs.

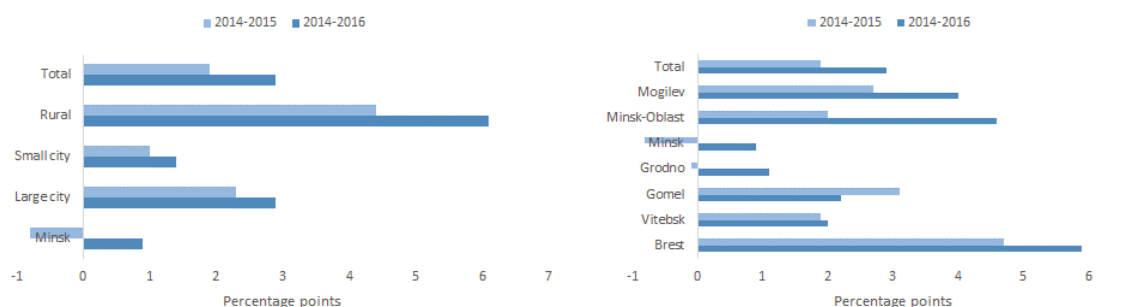
The data show that an increasing number of SOEs continue to make losses and incur debts to suppliers and commercial banks. For instance, according to Belstat data between Q1 2013 and Q1 2016, net profits turned negative, from 5.2 percent of GDP to net losses of 1.9 percent of GDP, while loan arrears increased from 1 percent of GDP in Q1 2013 to 6.5 percent three years later and then almost double a year later to 12.1 percent of GDP. This suggests that SOEs have been accumulating large accounts receivables and payables to one another as well as to their other suppliers and state-owned and private banks. While in Q1 2013, the share of loss-making SOEs in their total number was 10.6 percent, it almost doubled two years later to 18.5 percent, growing to 26.3 percent in Q1 2016. According to the IMF estimates, about one-fourth of the largest 560 companies, fully or partially owned by the state, with liabilities equal to 55 percent of GDP, were making losses in 2015.

Performance problems are partially caused by existing ownership and oversight architecture. The SOE sector is governed by a complex and fragmented system maintained by several bodies exercising parallel and overlapping functions. The State Property Committee (SPC) is the designated owner of the national government's shares in joint stock companies (JSC), but it does not have the power to exert ownership rights over these JSCs, except those directly subordinated to it. The key ministries perform simultaneously as owners, policy-makers, and regulators of the SOEs under their respective portfolios.³⁶ The execution of policy and regulatory functions by the line ministries and regional governments weakens the goal of shareholder profit maximization and blurs SOEs' profit objectives. Moreover, existing arrangements permit supervisory boards to be made up of representatives of the company's management (except for the CEO) and officials from their supervising entity. These practices are far from efficient corporate governance arrangements of today.

B. Strengthening sustainability of the social contract

The recent economic downturn has made households more vulnerable. In 2015, the poverty headcount at PPP US\$10/day increased by 2 percentage points at the national level, with rural areas being more affected, where the poverty headcount increased by 4.4 percentage points (that is, by 24 percent) in just one year (Figure 2.11). Across regions, there are also notable differences, such as, for instance, a stable poverty level in Grodno and a large increase in the poverty headcount in the Brest region. In addition, there is a large share of population just above the US\$10/day threshold, which means that any further deterioration in welfare can have important implications in terms of the incidences of poverty.

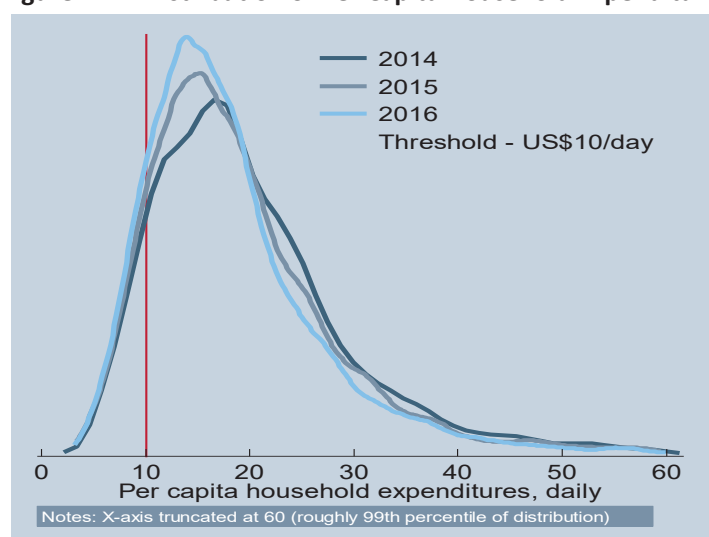
Figure 2.11: Percentage Points Increase in the US\$10/day Poverty Headcount between 2014 and 2016



Source: Staff estimates based on HBS data.

³⁶ Until 2010, the Ministry of Industry alone had 300 SOEs under its supervision. It consolidated them into 234 SOEs while merging 170 into 17 holding companies.

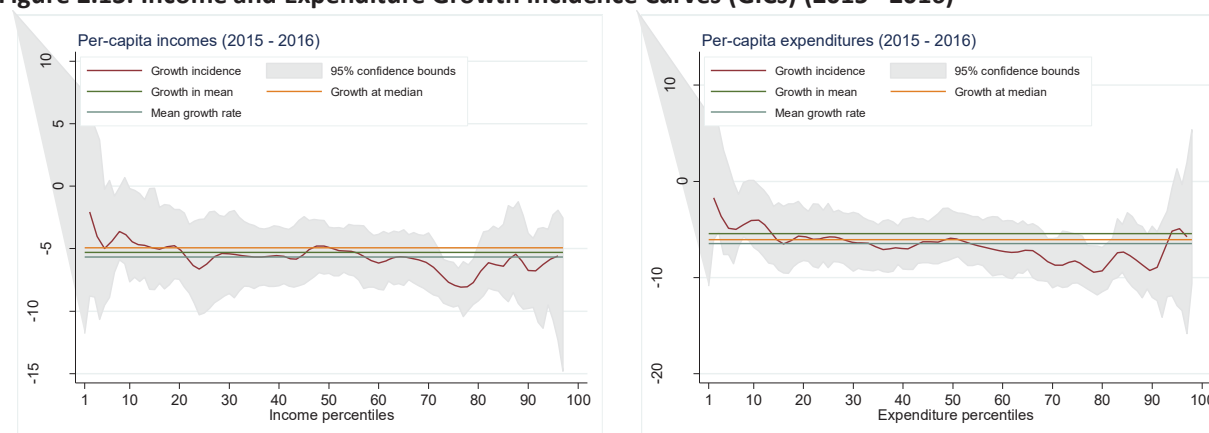
Figure 2.12: Distribution of Per Capita Household Expenditure (2014-2016)



Source: Staff estimates based on HBS data.

Household welfare deteriorated further in 2016. Following the economic contraction of 3.8 percent in 2015, the GDP fell again by an estimated 2.6 percent in 2016. The income growth incidence curve (Figure 2.13) shows that disposable incomes fell in real terms with 95 percent confidence for a large share of the population of Belarus. The dynamics of per capita consumption, which normally allow for some smoothing and tend not to be as volatile as incomes, actually show a fall in household expenditures of a comparable or even slightly larger magnitude, concentrated among the better-off). During 2016, the poverty incidence at the \$10/day threshold increased by a further 1 percentage point, again with a larger absolute increase in the poverty headcount in rural areas (Figure 2.12). The continued recession was also felt in Minsk and its surrounding areas, as well as in Grodno. In both areas, there were no recorded increases in poverty in 2015, but poverty incidence increased in 2016 (for example, increasing in Minsk Oblast by 2.6 percentage points).

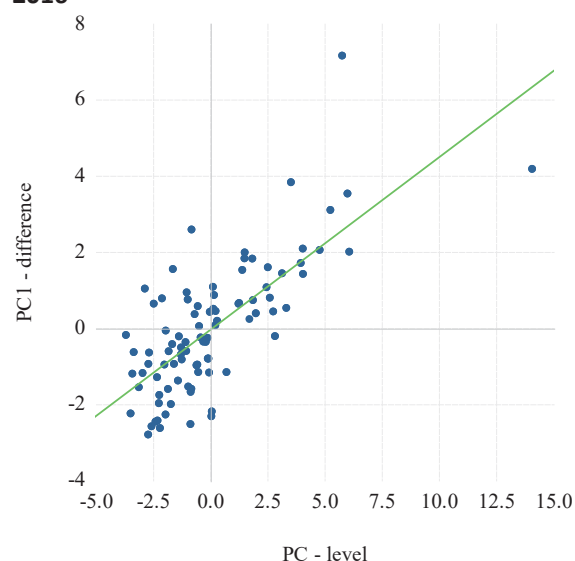
Figure 2.13: Income and Expenditure Growth Incidence Curves (GICs) (2015– 2016)



Source: Staff estimates based on HBS survey data.

The recession has also accentuated spatial disparities across regions (see Box 2.4). A recent analysis of regional (*rayon*) performance in recent years (Chubrik, 2017) showed that, based on a composite indicator of regional economic well-being (principal components aggregated based on a set of variables as dynamics in real wages, real fixed capital investment, employment, and real industrial output), the *rayons* that had better initial conditions prior to the downturn also displayed better performance through the recession (Figure 2.14). In other words, the downturn caused strong divergence between *rayons* in terms of social and economic performance.

Figure 2.14: Correlation between *Rayon*-level Pre-downturn Initial Conditions and Performance through 2016



Source: Chubrik (2017).

Notes: The X-axis shows the PCA value of the pre-downturn initial conditions index. The Y-axis shows the PCA index based on first logarithmic differences in the set of indicators between their value in the last year in the sample to their benchmark value.

Box 2.4: Spatial Economic Developments in Belarus

Belarus has kept economic development relatively even across its six regions, except for the capital city. In 2016, Minsk city alone accounted for 27 percent of Belarus's GDP, while gross regional product (GRP) of Minsk exceed the national average level by 2.2 times. Moreover, Minsk is increasingly becoming a services cluster: since 2014, the share of those employed in services has been rising faster than in other oblast centers to exceed 70 percent of total employment in 2016. The capital city area is the major agglomeration node in the economy; other nodes around large cities lag behind. During the 2015-2016 recession, the disparities between the central region and other oblasts have widened—the gap between GRPs of Minsk and Mogilev oblasts increased by one-fourth between 2010 and 2016. Quantitative analysis confirms that the location explains more than 80 percent of the variation in key regional indicators, including output, investment, employment, and incomes observed between 2005 and 2016. In addition, economic density is highly correlated with the distance from the capital city with more distant areas showing weaker economic activity.

Within oblasts, the economic activity tends to be concentrated in urban, densely populated rayons. In 2016, about 75 percent of Belarus's industrial output was produced in just 20 of 138 regions; the population of these regions constituted 60 percent of Belarus's population. The current economic landscape is in part inherited from the Soviet central planning when during the 1960s-1970s planners selected 19 geographic areas—each comprising several rayons (excluding Minsk City)—to develop specific industries. The relative significance of these industries is still having an impact on cross-regional variations in per capita incomes, value-added per employed and the share of value-added of industry in GRP. However, the concentration of enterprises makes certain rayons vulnerable to exogenous external shocks. In 2003-2004, the UNDP Office in Belarus and the Ministry of Labor and Social Protection estimated that Belarus had at least 44 such “mono-towns” with more than 25 percent employed working for a single company. The total population of such “mono-towns” accounted for 12.1 percent of total urban population of Belarus. Over the last decade, the number of “mono-towns” has gradually declined, but vulnerabilities remain.

Since 1990s, emerging economic activities in the private sector began to reshape the economic density of Belarus. Newly created, mostly private, enterprises began to emerge. The authorities have used geographically concentrated tax preferences—including ‘free economic zones’, tax reductions for residents of small urban and rural areas—to attract business to regions other than Minsk. While these measures have helped to increase the number of small private firms, spatially neutral policies—designed with no spatial considerations in mind such as gradual, economy-wide liberalization of economic activities—have had more significant impact to encourage regional growth of micro-, and small-sized enterprises (MSEs). Panel data econometric analysis (2006–2013, rayon-level data) shows that the liberalization of the business environment—captured by improvements in the *Doing Business* ratings—has had a significant and positive impact on the private sector development throughout all Belarus's regions both in the short and the long run.

The private sector growth has also been geographically uneven, with a tendency of economic activities to gravitate to the industrialized urban centers. Data shows strong evidence of so called clustering effect—growth in the number of micro- and small-sized enterprises is positively correlated with growth in the number of larger firms at the rayon level. At the same time,

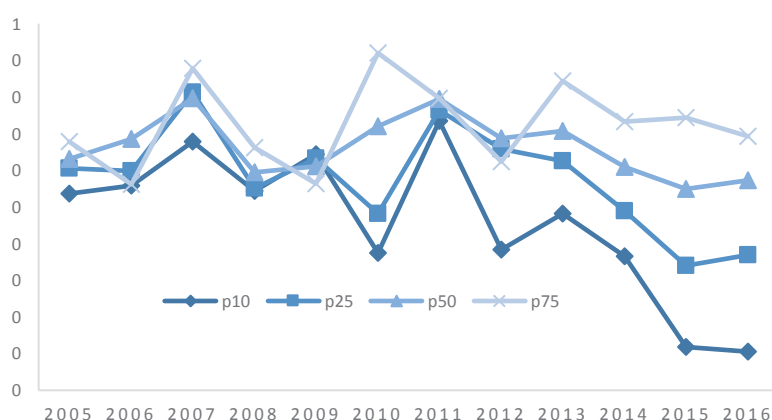
rayons with sizable rural population have seen less growth in MSEs than those with large towns. In addition, the number of MSEs has remained low in depressed areas with high levels of registered unemployment and areas affected by the Chernobyl accident.

Going forward, Belarus's economic development would continue to be uneven across different regions. The appropriate policy response will be to help people that experience job losses rather than try to counteract the forces of economic agglomeration. Instead, minimizing the economic distance among regions should be addressed mainly with spatially blind or universal policies, such as ensuring the delivery of high quality public goods across the country. Instead of deployment of high-cost targeted interventions to save regional jobs, universal programs are needed to support transition to more productive employment, preferably in the private sector. Currently, inadequate income support for the unemployed undermines the ongoing economic restructuring in regions.

Source: Belarus Regional Development Policy Notes: Spatial Dimension of Structural Change, The World Bank, 2015.

The smaller magnitude of the fall in household expenditures in 2015 relative to the decline in household incomes may be due to some consumption smoothing, in part through reliance on savings, but this conclusion has its limits. Cross-sectional elasticities of household expenditures with respect to income were quite high during the 2005-2009 years (elasticity was higher than 0.9), whereas in 2010 (following low growth in 2009) and in 2012 (following high inflation in 2011), the relationship between income and expenditures weakened, particularly at the bottom level of welfare distribution. In 2013-2015, the expenditure elasticity with respect to income exhibited a downward trend, particularly at the 10th and 25th percentiles of the distribution, and to a much smaller degree at higher points in the distribution. Because the economy posted a second consecutive year of negative growth in 2016, and because growth is estimated to remain moderate during 2017-2019, the ability of households to run down savings will reach its limits, which can lead to further declines in household welfare. Indeed, the elasticity estimates for 2016 showed that the trend in falling elasticities at the bottom has been halted, showing that falling incomes are associated with falling household expenditures (Figure 2.15).

Figure 2.15: Elasticity of Household Expenditures with Respect to Household Income (2005-2016)

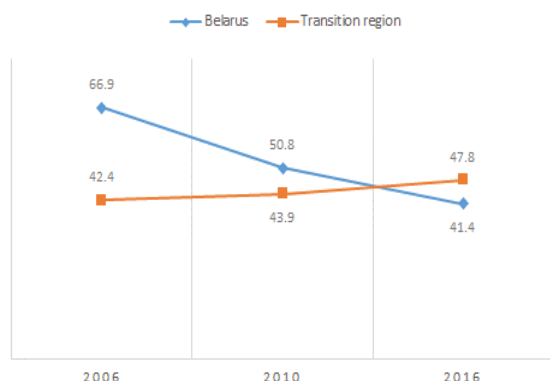


Notes: estimates based on cross-sectional quintile regressions estimated at different percentiles of the distribution.

Source: Staff estimates based on HBS data.

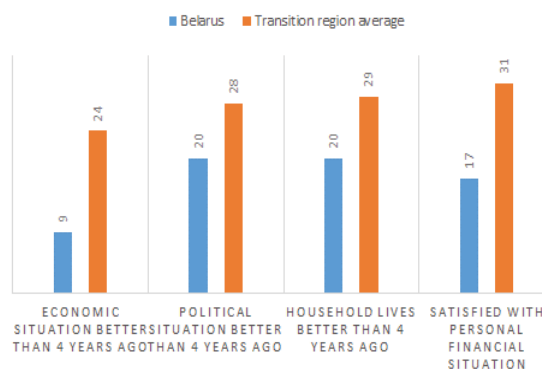
The objective measures of deteriorating household welfare are also mirrored by subjective measures of well-being. According to the Life in Transition Survey (LiTS), between 2006 and 2016 Belarus recorded the largest deterioration of reported well-being among all ECA countries (EBRD, 2016). In the survey, the share of adults reporting to be satisfied with life fell from 66 percent in 2006 (one of the highest in the ECA region at that time, and significantly higher than the transition region average) to 50 percent in 2010, and to 41 percent in 2016, below the transition region average (Figure 2.16).

Figure 2.16: Share of Adults Satisfied with Life (2006-2016)



Source: LiTS 2006-2016 data.

Figure 2.17: Share of Adults Satisfied with Economic / Political Situation in 2016



Source: LiTS 2016 data.

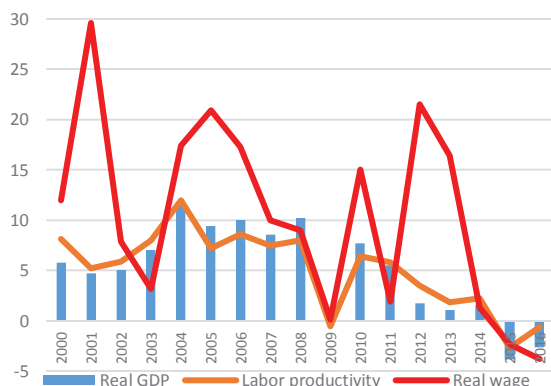
The decline in overall satisfaction of life is also reflected in the broader discontent with both the economic and political situation in the country, as well as the perception of adequacy of household finances. Belarusians were more pessimistic, on average, than the respondents in the transition region as a whole about the economic and political evolution of their country over the past four years, or indeed about their own situation with respect to the recent past. Only 17 percent of adults in Belarus were satisfied with their personal financial situation in 2016, compared to 31 percent of adults in the transition region as a whole (Figure 2.17).

Ongoing energy sector reforms—especially the announced full cost recovery across all utilities except heating by the end of 2018—will have further important welfare implications. Reforms aimed at increasing utility tariffs to cost-recovery levels are expected to have significant negative welfare impact, especially for low-income households. The share of household budgets spent on utilities is projected to increase for the bottom decile from 11.6 percent in Q1 2016 to 15.5 percent by the end of 2017. In the absence of compensatory measures, or substitution away from energy consumption, such an adjustment would imply that poor households would have to cut back on other consumption lines or increase their debts.

Real wages have periodically been exceeding productivity because of administrative increases, but this trend was reversed as the growth began to slow down. During the recession, the growth of real wages was less than the increase of productivity, and was affected by the economic downturn and declining decline in working-age and employed population. However, cross-sectoral wage differentiation has been low, because the span between the lowest average wage (agriculture) and the highest average wage (financial activities) is estimated to be about 93 percentage points (in 2014), compared, for example, to 168 percentage points in Russia.³⁷ However, while accelerated wage increases improved household welfare and kept inequality low, there were periodic gaps between real wage growth and productivity, which had implications for the cost competitiveness of Belarusian enterprises (Figures 2.18 and 2.19).

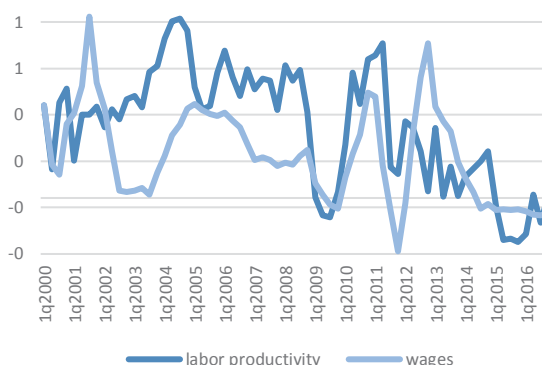
³⁷ According Belstat data, the ratio of average wages in agriculture to average national wages increased from 69 percent in 2010 to 76 percent in 2014; the ratio of financial sector wages to the average fell from 175.8 percent in 2010 to 169.5 percent in 2014 (164 percent in 2013).

Figure 2.18: Real Wage and Labor Productivity Growth (2000-2016), Annual Data



Source: Staff estimates based on Belstat data.

Figure 2.19: Real Wage and Labor Productivity Growth (2000-2016), Quarterly Data (Index Q1 2000=1)



Incomes of the elderly rose as pensions kept up with wage increases, but this had the effect of undermining the fiscal sustainability of the pension system. The pay-as-you-go (PAYG) pension system in Belarus benefited from a favorable environment due to low birth rates and survival rates for the 1940-1946 cohorts, resulting in low numbers of pensioners in recent years (Zvinienne and Biletsky, 2011). Individuals who reach retirement age in Belarus can continue working while receiving pensions. During the five years of post-retirement age (55-59 for women and 60-64 for men), 45 percent of men and 56 percent of women are found to be employed at the end of 2015 (Bornukova, Lisenkova, and Luzghina, 2015). Because pensions in Belarus are indexed to average wages and not inflation, incomes of the elderly grew accordingly over the past decade and a half. However, pensions remained flat in real terms during the 2012-2015 period. Furthermore, the aging of the population threatens the fiscal sustainability of the existing PAYG system. Recent parametric reforms, including the gradual increase of the retirement age, should help to improve fiscal sustainability of the pension system. However, estimates suggest there could be a pension fund deficit of over 4 percent of GDP by 2050, even with these new policy changes in place (IMF, 2016).

An emerging concern is the ability of the elderly to continue benefiting from shared prosperity in the future. Household survey data reveal that while the share of wage recipients has remained constant over the past decade, the share of pension recipients increased both in the B40 population (from 19 percent in 2003 to 24 percent in 2015) and in the T60 population (from 51 to 57 percent). As the population-aging process continues, the share of pension income in overall disposable income will increase for an increasing share of the population. This shines a spotlight on the ability of pension income to support the well-being of the B40 (and beyond) population in the future.

C. Reducing Dependence on External Sources of Finance

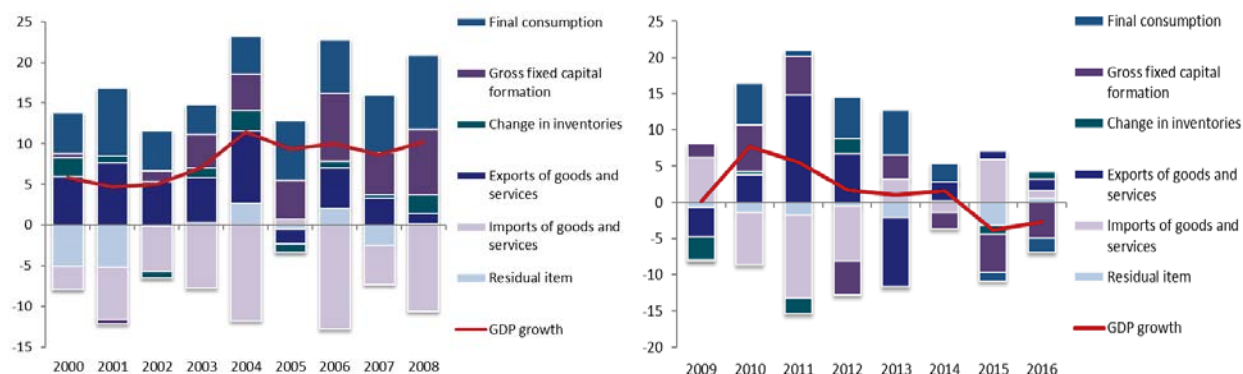
Unbalanced aggregated demand resulting in excessive dependence of external sources of finance has made the financial sector and the balance of payments vulnerable. Active demand management measures of the past through public investment and periodic acceleration of wage growth boosted domestic demand beyond the productive capacity and contributed to an increase in the current account deficit. It is estimated that the unit labor costs increased by about 50 percent in the period between 2010 and 2014, compared to an increase in this period of only about 10 percent in Russia and broadly no increase in the EU (estimated as an average of EU trading partners weighted by trade shares) (IMF 2014).

Since 2005, economic growth has relied increasingly on foreign savings. The current account deficit has largely been financed by external borrowing with limited foreign direct investment (FDI) (Figure 1.13). Although the existence of a sustained current account deficit does not necessarily augur problems per se, these may arise if

external savings have been used to support consumption levels above what is sustainable in the medium term and/or if they have been used to finance investments that do not have a rate of return commensurable with the cost of these external savings. A first step towards answering these questions begins with the examination of the role of components of aggregate demand in explaining past growth. Figure 2.20 shows marked differences in this regard between the periods 2000-2008 and 2009-2015. The two periods are divided by the international financial crisis. This event, totally outside the control of Belarus, was of critical importance for the growth perspectives of transition countries trying to accelerate convergence to western European income standards. Convergence required foreign capital inflows and markets for these countries' exports, and those were precisely the factors adversely affected by the financial crisis.

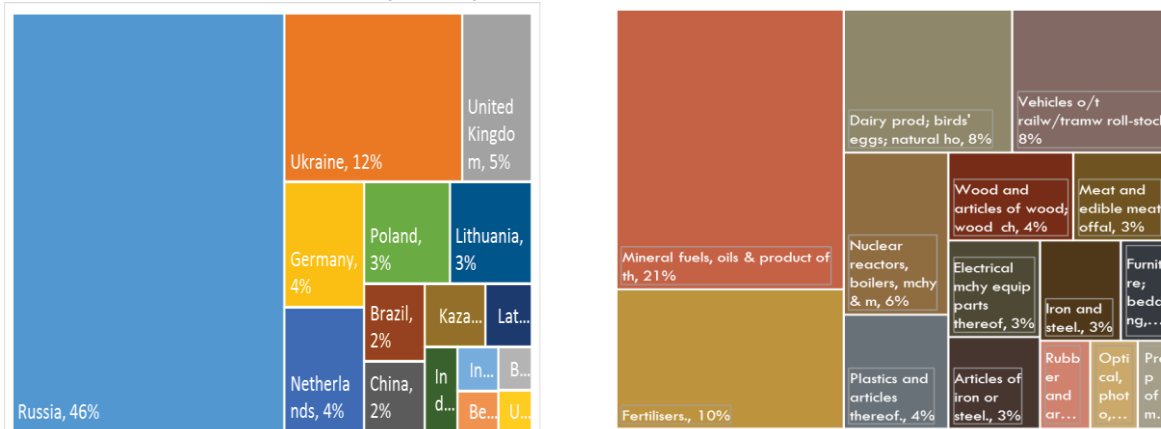
In 2000-2008 the most dynamic components of aggregate demand were consumption and exports. Consumption-led growth during this period was understandable given that Belarus was coming back from a deep recession, and thus export-led growth was, in principle, sustainable. This is because the growth of exports depended on an unsustainable regime that subsidized Belarus's oil imports and thereafter Belarus's production and exports. When Russia began revising the energy policy towards Belarus at the end of 2006, exports and growth suffered. By 2016, the Belarus export structure had deteriorated, and its product mix became dominated by a low-value added, and narrow range of products and by dependence on a single market (Figure 2.21).

Figure 2.20: Sources of Aggregate Demand (2000-2016)



Source: Staff estimates based on Belstat data.

Figure 2.21: Structure of Belarus's Exports by Markets and Products in 2016, Percent in Total



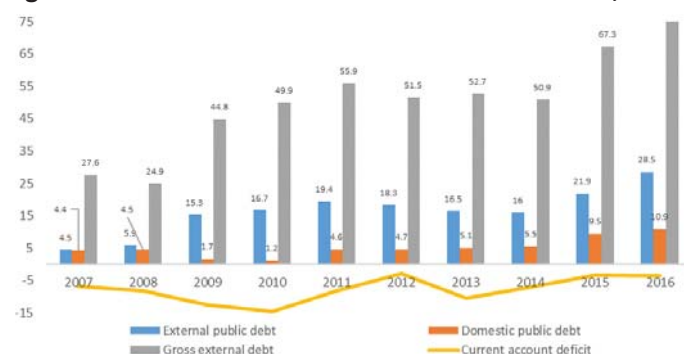
Source: Staff estimates based on WITS/Comtrade data. The Common Commodity Nomenclature of Foreign Economic Activity of the Customs Union is used.

In the second period, 2009-2014, two external factors had a big influence: a reassessment of credit risk (along with an unwillingness to lend on the part of international banks), and Russia's increasing reluctance to continue the oil transfer system. Because of these factors the role of external demand on growth diminished. Against this background, the government stimulated domestic demand policies through subsidies on credit to SOEs—

especially in the manufacturing and agricultural sectors—and administrative wage increases unassociated with productivity gains. The impact of expansionary domestic policies on economic growth in the small open economy of Belarus was short-lived: higher demand translated into higher consumption and gross capital formation, and into higher imports and pressures on international reserves, and ultimately forced the enactment of three exchange rate adjustments—in 2009, 2011, and 2014.

The mirror image of large and protracted current account deficits was the increase in the domestic and external public debt from 8.9 percent of GDP in 2007 to 39.4 percent in 2016. Additional issuance of FX-denominated bonds on the domestic market also contributed to the accumulation of the public and publicly-guaranteed debt (Figure 2.22). In 2016, public and publicly-guaranteed debt had reached almost 40 percent of GDP, an increase of 15 percentage points in five years, while gross external debt increased from 56 percent in 2011 to 78.5 percent of GDP in 2016. Belarus is facing substantial refinancing needs since the redemption profile for public debt reveals a sizeable maturity concentration in the medium and long-term due to Eurobonds maturing in 2018 and repayments due to Russia, China, and the Eurasian Fund for Stabilization and Development (EFSD). In June 2017, Belarus issued new Eurobonds worth a total of US\$1.4 billion in two tranches with relatively high annual interest rates of 6.875 percent (5.5-year maturity)³⁸ and 7.625 percent (10-year maturity). In 2017, the Government will need to allocate US\$3.26 billion—or 6.9 percent of its projected GDP—on public debt repayment and payment of interest in foreign currency (including US\$1.7 billion, or 3.6 percent of GDP for external public debt, and US\$1.56 billion, or 3.3 percent of GDP – for domestic public debt denominated in foreign currency).

Figure 2.22: Debt Ratios and Current Account Deficit, Percent of GDP (2007-2016)



Source: Ministry of Finance, National Bank of Belarus.

Public debt sustainability risks have increased substantially, reflecting a weakening of Belarus's fiscal position, particularly with its increase in quasi-fiscal deficits and contingent liabilities. In 2015-2016 a sharp decline in fiscal revenues prompted the Government to tighten spending to achieve a headline fiscal surplus. However, officially-reported data on the budget surplus—against a background of contracting economy and rising public debt—do not reflect certain quasi-fiscal activities, most notably recapitalizations of state-owned banks and called guarantees of central and local governments. If these activities are properly accounted for, a deficit emerges. This deficit puts additional pressures on the sustainability of Belarus's external accounts because a sizable share of bank loans and government guarantees are dominated in foreign currency, making them vulnerable to the effects of large exchange fluctuations. The ongoing post-recessionary and low-growth environment also poses significant challenges for meeting large gross-financing needs.

The ongoing adjustment has considerably narrowed down the room to stimulate domestic demand through credit and wage growth. Falling real wages and disposable incomes (by 3.8 and 6.9 percent in 2016) put a downward pressure on household consumption. In 2016, household consumption dropped by 3.2 percent in real terms (according to National Accounts data), and households lowered their consumption of food items by 2.6 percent and non-food items by 5.2 percent. Reduction of directed lending and lower public capital

³⁸ Bonds of 5.5-year maturity were placed below face value, making returns 7.125 percent per year

expenditures depressed investment of enterprises and organizations under the management of national and especially local governments—by 17.2 and 24.7 percent, respectively, while gross fixed investment fell by almost 17.4 percent year over year in real terms.

Chapter 3 Opportunities: Transition towards Competitive, Inclusive and Dynamic Belarus

Based on the diagnostic in Chapter 2, maintaining shared prosperity and restarting sustainable economic growth depends on whether Belarus will seize emerging opportunities and manage critical challenges. On the one hand, stagnant total-factor productivity growth, declining competitiveness, and increased reliance on foreign savings, including the need to service foreign currency-denominated debt, continue to pose a risk that Belarus will fall into a low growth trap. On the other hand, key opportunities exist to restart the growth engine by creating favorable conditions for private sector growth and domestic and foreign private investments. Moreover, Belarus endowments—a highly educated work force and a favorable geographical location at a crossroads between East and West—can help to facilitate the integration into a more globalized regional and world economy.

Over the last two years, the government has turned its attention to structural weaknesses in the economy. It has taken a number of macroeconomic stabilization measures and adopted policies to support private sector development (see Box 3.1 for a summary of key measures), with more measures expected in 2017-2018. A special focus is given to reducing the regulatory burden for businesses and adopting measures to relax product and services markets. According to the Government Action Plan for 2016-2020, the agenda for reforms is also more comprehensive than before and is internally consistent with the long-term economic development goals. There is enhanced understanding about benefits and risks of reforms.

Box 3.1: Progress on Structural Reforms in Belarus: 2015–2016.

Area 1: Transformation of the System of State Support to Reduce Losses and Enhance Incentives for Achieving Productivity Growth

- Beginning in early 2015, the National Bank of Belarus shifted its monetary policy stance towards one consistent with reducing inflation—monetary targeting where changes in the money supply become the key instrument in maintaining price stability. The key objective of this policy was to reduce the inflation rate—consumer price inflation declined to 12 percent by December 2015 (year on year).
- .
- On June 1, 2015, the National Bank of Belarus introduced a new mode of currency trading at the Currency and Stock Exchange, moving away from fixing daily rates. The double-auction system matches buy and sell orders on a continuing live basis, allowing for the market determination of currency trades and exchange rates. Although this mechanism results in greater exchange rate volatility, the National Bank operates as an ordinary market participant and does not readily intervene in the market.
- Laws on long-term state support were passed, including a regulation to mandate the DBB to finance all new investment projects under the state programs.

Area 2: Financial Sector Development

- A regulation on mandating the National Bank as a supervisor of the Development Bank of the Republic of Belarus was passed.
- A ceiling on annual directed lending under government programs was set for 2015-2016.
- Independent asset quality reviews of the largest commercial banks were completed in 2016.

Area 3: Efficient Product and Service Markets

- In July 2014, the Council of Ministers adopted a resolution linking nominal wage increases to labor productivity at state-owned enterprises.
- On January 15, 2016, the government abolished permanent controls over prices of socially important goods and services. The prices of these goods and services may only be regulated in exceptional cases “to smoothen price fluctuations” for less than 90 days in a calendar year.

Area 4: Utility Tariff Reform and Mitigation Measures

- On December 1, 2015, the tariffs for electricity, heating and natural gas were raised by 3.8 percent.
- From January 2016, the government further increased tariffs for electricity and gas by reintroducing a 20 percent value-added tax (VAT) for these services. Tariffs for residential heating were increased by 30 percent. Tariffs for water and sewerage increased by 1.85 times in Minsk alone.
- On October 1, 2016, the government introduced non-cash subsidies for households spending more than 20 and 15 percent of their incomes on utilities (for urban and rural areas, respectively). A better-targeted program is currently in preparation to be implemented.

Source: World Bank staff summary of government's policy documents.

Recent improvements in the external environment—a tentative recovery of the global economy and stabilization of growth in neighboring countries—offer Belarus many opportunities. But they also give rise to many risks if policies are not adjusted in time. There is a strong case for Belarus to continue reforms and adjust its policies for two major reasons. First, in the past, opportunities—including energy subsidies from Russia and growing external demand—were not used by Belarus to restructure its domestic economy, reorient export patterns strategically, and lay down foundations for sustainable export-driven growth. Moreover, recent episodes of growth volatility have demonstrated that cyclical volatilities in the external environment are amplified by structural rigidities remaining in the domestic economy. Second, the drivers of global economic growth are changing and thus the *status quo* will not work. Growth of global commodity prices is moderating, trade liberalization is slowing, there is elevated global policy uncertainty, and China is rebalancing its economy. All these factors will have significant implications for countries that are trying to integrate into global manufacturing value chains—it will be much harder than before. It is also clear that Belarus is unlikely to benefit as much as in the past from growth in Russia (Figure 3.1) and from increases in commodity prices. The convergence of incomes between Belarus and Russia is also expected to be more gradual (Figure 3.2). A realistic appreciation of these changing external factors is a huge incentive to reform. Maintaining the current *status quo* is not an option.

Figure 3.1: Average Annual GDP Growth Rates in Russia and Belarus, Projections for 2017-2022

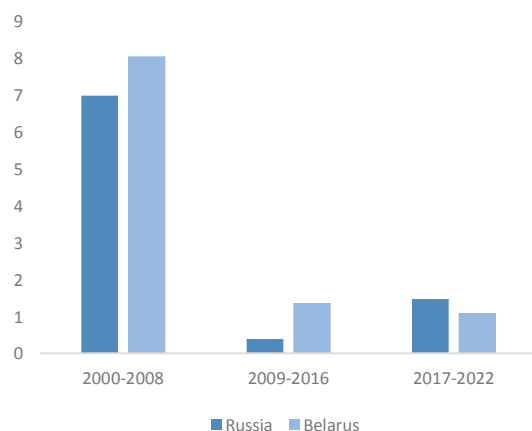
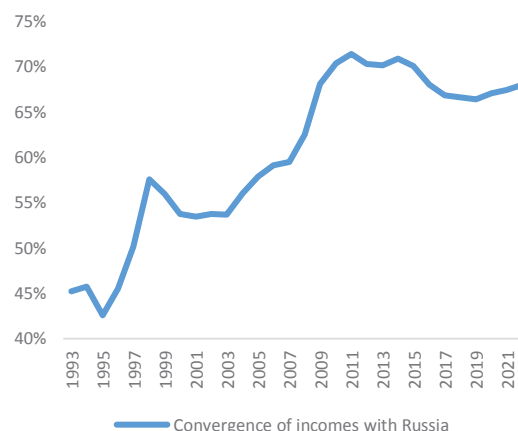


Figure 3.2: Ratio of GDP per Capita of Belarus to Russia



Source: World Bank staff projections.

Today there is a window of opportunity to proactively lay down foundations towards a new vision of a competitive, inclusive, and dynamic Belarus. At the core of this new vision is managing a transition to a new growth path that is more sustainable. Seizing this opportunity and achieving this vision will require Belarus to complete its economic, social, and institutional transformation by:

- Increasing the economy's competitiveness by expanding the role of market forces in both real and financial sectors and by increasing public sector efficiency;

- (ii) Safeguarding social inclusion by strengthening social safety nets and aligning labor market policies with the increased role of markets; and
- (iii) Upgrading the institutional framework to make Belarus's business environment more dynamic and market-oriented.

Undertaking this economic, social, and institutional transformation will have costs, but these costs can be mitigated. Today there is a broad consensus among policy makers for this direction of change, but there are diverging views about the pace and timeline of the needed changes. The cost of transformation is likely not to be trivial; for example, there could be an increase in budget outlays for social safety nets, and there could be a decline in real incomes as energy and utility tariffs are aligned to costs. In addition, tightening of budget constraints for state-owned enterprises could potentially have an adverse social impact, such as resulting in an increase in unemployment. However, the *status quo* path would also have its costs, which would be much higher—risking reversal of the progress Belarus achieved over the last decades. (See Box 3.2 for a specific discussion of the cost of nonreform in the agriculture sector). It is inevitable that tightening Belarus's external financing constraints if market conditions worsen again in the future will force structural changes and an adjustment in allocation of factors of production. Low international reserves—equivalent to just a few months of imports—offer a limited buffer to potential external shocks. Creation of a rigorous private sector, a more efficient public sector, robust social safety-nets, and upgrading economic institutions, can help to significantly lower the costs associated with the transformation.

Box 3.2: The Cost of Nonreform in Agriculture Sector

Structural adjustment is never automatic or painless for everybody involved. There is a cost associated with structural reform which is direct for the losers from such a reform and indirect for the economy as a whole to the extent that there are often transaction costs associated with the restructuring of the economy. Even so, what is often unsaid is that there are costs for not undertaking reforms. In the case of Belarusian agriculture these costs are already visible in the following ways:

- **The fact that capital is less than one-half as productive in agriculture as in the rest of the economy.** This suggests that government policies that have channeled large amounts of capital into agriculture have led to an inefficient allocation of resources from an economic perspective. This development was aggravated by the sharp increase in the share of agriculture in fixed capital investment in recent years. Policies such as investment subsidies and directed state investments that encouraged this trend effectively drew capital away from alternative uses that had been on average twice as productive. In addition, the increase in public debt resulting from the failure of these policies now has to be serviced and repaid. This will be a dampening factor on consumption in the next decade.
- **The absence of mechanisms to automatically correct misalignments.** This is shown, for instance, by the fact that many farms in Belarus are too big and are not able to scale down their operations to make the best possible use of available technologies. Under more market-oriented conditions, competitive forces would incentivize downsizing of some of the large commercial farms. The result would be more manageable units in which it is easier to monitor complex operations (such as field work and herd management) and motivate workers, with the ultimate effect of increased efficiency. At the same time, restructuring might also lead to more specialization. If a large crop farm is encouraged or even obliged to maintain a dairy herd, for example, because local authorities are eager to maintain a supply of milk for the local dairy processing plant, the result can be a loss of overall efficiency as resources are taken from one area (for instance, crop production) to support another area (for instance, milk production). In this case, the freedom to specialize in crop production alone could lead to increased scale efficiency, not because the farm in question moves closer to its optimal scale of operations by becoming smaller in hectare terms, but because the optimal scale of specialized crop production is larger and closer to the farm's current size.
- **The high costs the command and control regime has on the state budget.** Budgetary expenditures for agriculture accounted for 7.48 percent of the total state budget in 2016 and have grown faster than gross agricultural output and agricultural value-added. Against the background of the current fiscal situation the current nature and level of support can only be maintained at the expense of other budget expenditure categories, which might become socio-politically undesirable.
- **Tensions between Belarus' trade and other regulations and those agreed within the Eurasian Economic Union.** Establishment of the Customs Union (CU) and the Common Economic Area of Belarus, Kazakhstan and Russia (CEA) have limited the scope of Belarus foreign trade regulations. First, member-states apply unified measures of customs and tariff regulation. When some of the members are also members of the WTO, countries like Belarus are obliged to reduce its level of tariff protection and apply almost all the regulations that Russia negotiated with the WTO. Second, the Customs Union and the Common Economic Area implies a common system of nontariff regulation, including

veterinary, sanitary and phytosanitary controls. WTO obligations of Russia imply improved transparency in application of these norms within the CU and the CEA. However, WTO regulations of sanitary and phytosanitary norms allow for flexibility.

A. Becoming More Competitive by Increasing the Role of Market Forces

A return to sustainable economic growth would require increasing the *competitiveness* of the economy by expanding exports to traditional markets and, more importantly by also diversifying into new markets. Belarus had preserved state-owned and state-controlled enterprises—this approach helped Belarus avoid social costs associated with economic restructuring—but it led to serious vulnerabilities, including stagnant productivity growth, loss of competitiveness, and reliance on underpriced energy imports from Russia. In 2017, after a two-year recession, tepid economic growth returned, supported by low base effect and recovery in commodity exports. However, the foundations of economic growth remain fragile. Without change, it is unlikely that growth could return to its pre-2008 impressive numbers, because without needed reforms, the potential output of Belarus is estimated to be at about 2 percent per year.

Increasing external competitiveness would require taking advantage of the opportunity of completing an economic transformation by letting market signals play a more important role in allocation and pricing (costing) of factors of production, products, and services. What is necessary is to restructure the organization of production by expanding the role of the private sector in production of goods and services while assigning a subsidiary role to the state in this area. This transformation will imply profound changes in the structure of the economy, including the phase-out of inefficient economic activities and the emergence of new and more productive sectors. Some of these deep changes are already occurring, and the expansion of employment in the services sector is a clear indication of these trends. But other changes, not so easy to predict, will come with the advent of reforms. As a result of these changes, key drivers of the economic transformation would be (i) increasing operational and commercial efficiency of state-owned enterprises, (ii) letting market forces play a more decisive role in allocation of resources by phasing out price controls, strengthening product market competition, and improving the investment climate, and (iii) increasing the efficiency of the financial system to optimally allocate capital.

The guiding principle underlying the economic transformation is to stay the course of the reform path already begun and to implement ambitious measures outlined in the 2016-2020 Government Action Plan (Table 3.1). Because Belarus has already been gradually widening the role of the private sector, it only needs to accelerate the pace of change and to address more forcefully the problem of legacy to accomplish the transformation goals. However, while laws and decrees may be enacted, results may (and have been) held back by a bureaucratic apparatus of controls that remains largely unmodified.

Table 3.1: Belarus 2016-2020 Government Action Plan: Policy Measures

Areas	Policies priorities and measures
<i>Macroeconomic management</i>	Annual inflation down to 5 percent by 2020; inflation targeting regime and exchange rate flexibility; Indicative forecasts and KPIs (exports, profitability, inventories, cost levels) replace direct production targets;
<i>Public finance</i>	Reduction of interest rate subsidies, channeling of all new directed loans to the DB; competitive procedures for public investment bids accessible by private companies; PPPs in infrastructure and public services; Results-oriented, medium-term (three year) budgeting; broadening the tax base by reducing tax benefits; tax burden not to exceed 26-27 percent of GDP;
<i>State property and SOEs</i>	Separation of regulatory and ownership functions; SPC to manage a number of SOEs by introducing contemporary corporate governance practices; Local authorities to manage a large number of (non-strategic) SOEs;
<i>Private sector development</i>	Improvement of business climate by strengthening property rights protection, reducing controls and inspections, applying RIA to all business-related legislation; Better lending conditions for SMEs (SMEs' share in new lending to reach 30 percent); Clear rules for acquiring premises and facilities by private firms;
<i>Energy and utilities</i>	Facilities modernization, energy efficiency and cost-reduction measures; reduction of public and cross-subsidies to reach full cost recovery of household utility tariffs by end-2018, except for heating;
<i>Human and social development</i>	Improved targeting of social support; Housing and Utility subsidy to cushion the impact of utility tariff increases for vulnerable households; Unemployment insurance and retraining mechanisms for unemployed; Greater role of general practitioners instead of reliance on polyclinic care

Source: Belarus 2016-2020 Government Action Plan.

Measures to improve the efficiency of SOEs should be aimed at supporting the overall Belarus growth strategy to make its economy more competitive and more connected to the global market by exposing SOEs to market signals and constraints that lead to better use of the factors of production. While a substantial SOE reform is a tall order politically—reflecting the influence of vested interests—bold and successful implementation of SOE reforms are important to instill confidence, facilitate other structural reforms, and unleash new sources of growth that Belarus needs. Specifically, by fostering the efficient and orderly reallocation of capital and labor, Belarus can exploit the significant productivity differences that persist across sectors and firms. The reallocation of labor and capital towards more productive sectors is essential for achieving the objective of inclusive and sustainable growth in Belarus. Key elements of such SOE efficiency improvement should include:

- *Identifying clear SOE objectives.* Noncore objectives of SOEs can be removed, while some social functions (for instance, maintaining in-house healthcare and recreation facilities) can be performed through government agencies rather than SOEs. For natural monopolies and strategic sectors, the objectives of SOEs would be to support Belarus economic and social development goals.
- *Introducing modifications in structures and processes for the direction and supervision of SOEs.* Arms-length relationships should be maintained between shareholders and directors to ensure that SOE interference is limited. At the same time, the supervisory framework of SOEs can properly align rights and responsibilities among government agencies.
- *Gradual tightening of budget constraints.* Key lessons from other transition countries suggest that as long as SOEs continue to have easy access to various forms of financial support through the state-owned financial institutions and directly from central and local governments, there will not be sufficient incentives on the part of management of these companies, and the line ministries involved, to make their operations more efficient.
- *Introducing greater competition by continuing to improve the investment climate and limiting entry barriers and implicit support to SOEs so that enterprises can compete fairly.* SOEs that effectively compete in contestable markets can remain, while those that cannot compete can be scaled back, with better use of resources, while the nonviable ones exit the markets.
- *Introducing corrective mechanisms—accompanied by measures to mitigate the social, fiscal and financial impact.* Mechanisms should be implemented that (i) facilitate an orderly and gradual

reallocation of resources away from inefficient, nonviable, and non-strategic SOEs; and (ii) mitigate the most immediate social, financial, and fiscal pressures associated with weak SOE performance.

Promoting an inviting environment for private sector and foreign direct investment has the potential to unleash a new growth engine and mitigate costs associated with restructuring in the SOE sector. Sound private sector development is a foundation for sustainable employment growth that would strengthen social resilience (See Box 3.3). Since 2008, Belarus has advanced dramatically in reforming its basic business regulations. This progress is reflected in the Doing Business (DB) rankings for Belarus that show the most progress in the areas of business and property registration, licensing and inspections, and the costs of tax administration. Nevertheless, these improvements have not led to a significant increase in foreign investment, while domestic investments continue to be suppressed due to high market interest rates. The cumulative improvement on standard international indicators, such as the Doing Business index, is still not considered to be sufficient to overcome concerns about overall macroeconomic vulnerabilities or other core issues, such as protection of property rights, affecting the country's attractiveness as an investment destination. Continued efforts are needed to ensure consistent, predictable, and efficient enforcement. Maintaining secure property rights and the rule of law are paramount to creating a level playing field for all enterprises in the economy.

Box 3.3: Private Sector Developments in Belarus

Although the public sector still dominates in the economy and employment, the private sector has gradually been expanding. During 2011-2016,³⁹ the number of registered private companies⁴⁰ grew on average by 3.4 percent per year to account for 82.2 percent of all legal entities in 2016. In contrast, during that period the number of SOEs fell by 1.3 percent per year. Despite these trends, the share of the private sector in GDP accounts for only 42.8 percent in 2016, almost the same as in 2011 (42.2 percent), decreasing from its maximum value of 43.2 percent in 2013. At the same time, over the 2010-2016 period, the share of private sector employment grew by 1.9 percentage points annually to reach 31.6 percent in 2016⁴¹ (Table box 1).

Table box 3.3.1 The Role of the Private Sector, 2011-2016

	2011	2012	2013	2014	2015	2016
Share in GDP, percent	42.2	42.3	43.2	43.1	42.6	42.8
Share in industrial output, percent	23.6	24.9	23.6	25.1	24.5	26.0
Share in total revenue, percent	48.8	45.8	47.5	46.5	43.4	48.2
Share in total capital investment, percent	26.5	31.3	31.8	36.6	33.7	35.5
Share in total employment, percent	29.8	30.8	32.1	29.5	28.5	31.6
Average monthly wage, US\$ (domestic private companies)	318.1	417.3	546.1	610.3	442.5	386.8
Annual revenues per employee, US\$ thousand	63.04	66.63	69.34	73.19	51.24	47.35

Source: World Bank Staff calculations based on Belstat data.

In terms of revenues, the private sector dominates specific sectors, such as information technology (IT), domestic trade, wood processing, and plastic and rubber production. Despite the existence of a significant number of private companies in the chemical industry, machinery and equipment, construction materials, and food processing, they make up a small fraction of respective sectoral outputs. In these sectors, large SOEs continue to dominate. However, in these SOE-dominated sectors, the role of private companies as investors is growing. For example, in 2016, the share of private investments in machinery and equipment grew to reach 65 percent of sector's investment. In the whole economy, the share of private investment also increased from 26.5 percent in 2010 to 35.5 percent in 2016.

The role of private companies has been most notable in the services sector. Domestic trade is heavily dominated by private firms: 70.6 percent of total revenue and 82 percent of sector's employment. While these numbers are made up primarily of SMEs and petty entrepreneurs, there are several large companies, including, for example, "Evro-torg". Also, private sector penetration is significant in the hotel and restaurant business. Although most hotels – if measured by quantity and room stock – are in state hands, there is a large number of private hotel operators (including international brands) as well as private catering companies.⁴² In addition to hospitality and catering, the private sector is active in real estate, accounting and audit, advocacy,

³⁹ The 2011-2016 period contains comparable data because the national classification of economic activities has been revised.

⁴⁰ Private companies include 100 percent privately-owned firms, without mixed ownership enterprises. However, it includes foreign companies and mixed private-foreign ownership companies. Accordingly, the public sector includes companies fully and partially owned by the state.

⁴¹ This figure excludes individual entrepreneurs.

⁴² During the 2011-2016 period, private actors invested heavily in the hotel and restaurant business, beginning with just US\$31.9 million in 2011, increasing to US\$251.1 million in 2011, and then reaching US\$70.8 million in 2016. On the contrary, public investment declined, from US\$79 million

advertisement and marketing, and automobile and freight transportation. In contrast, public sector companies focus on research and development (R&D) activities (performed by a network of state research institutions, including the Academy of Sciences), architecture and urban planning, and air and railway transportation (which are both state monopolies).

A gradual phasing out of price controls, and strengthening product market competition, would also require adjusting household utility tariff pricing. In water sector, existing single tariff for the whole country removes incentives for efficiency between utilities. In the energy sector, the economy of Belarus heavily depends on energy imports, with about 95 percent of power and 80 percent of heat being produced from imported Russian natural gas. The sector once was characterized by a complicated system of direct subsidies to households and cross-subsidies between nonresidential and residential consumers, as well as between energy services, which undermined industrial competitiveness by requiring industrial consumers to pay an almost 50 percent premium for electricity. Similarly, significant cross-subsidization that exist in water utility sector, where less than 2 percent of customers account for 30 percent of consumption and 77 percent of revenue, represents a vulnerability for the entire sector. In the past, annual subsidies drained fiscal resources to the tune of about 2 percent of GDP annually. However, the government is committed to reach cost recovery in tariffs by the end of 2018, at least for residential consumers⁴³.

Overall, a more diversified and deeper financial sector is needed to support the development of the private sector and to transition to a market-based economic growth model. The governance and risk management of large state-owned banks must be improved to prepare for eventual partial or possibly full privatization. The growth of nonbank intermediaries needs to be encouraged to increase the level of savings and to channel them into long-term productive investments. The financial market infrastructure needs further upgrading, including a greater use of noncash payments. Finally, further strengthening of the financial safety net would bring the framework for emergency liquidity assistance, bank resolution and deposit insurance in line with international best practice.

The transition to a market-based growth model will require a more diversified and deeper financial sector. Accordingly, the growth of nonbank intermediaries should be encouraged, and regulatory and supervisory framework for non-bank financial institutions, including insurance and securities markets, should be upgraded.

B. Maintaining Inclusive Growth by Strengthening Sustainability of Social Service Delivery Mechanisms

Maintaining inclusive growth would require social services delivery mechanisms capable of sustainably delivering high quality services, and providing effective safety nets to mitigate the impact that both structural change and the business cycle can have on affected households. The key drivers of social transformation would be: (i) strengthening targeting efficiency of social safety-nets to protect the most vulnerable, and (ii) improving sustainability and quality of social service delivery systems (particularly, education and health).

The existing labor market and social protection systems are inadequate to support a reallocation of labor from less productive to more productive sectors and firms. Specifically, existing unemployment benefits, active labor market policies and social protection systems are not sufficient to provide adequate safeguards while enterprise restructuring is being implemented or to meet cost-recovery targets for public utility service delivery. While 63 percent of the bottom quintile were covered by social assistance programs in Belarus, leakage rates are high—about 42 percent of the top quintile were also covered by social assistance, compared to only 20 percent, on average, for ECA and for high-income countries. In 2016, Belarus spent 12.3 percent of GDP on social

in 2011 to US\$15 million in 2016. As a result, the share of private sector investment in total sectoral investment reached 83 percent in 2016. This was partially related to increased activity of international investors in the hotel industry and, to a lesser extent, the domestic investors in public catering.

⁴³ The Program of Socio-economic Development of the Republic of Belarus for 2016 - 2020, approved by Edict of the President of the Republic of Belarus No. 466 dated December 15, 2016, provides that in 2018 households will be paying full-cost based prices for the entire range of housing and communal services, this transition being closely connected with the reduction of costs associated with the provision of these services, increase of personal incomes and the use of non-cash housing subsidies. Starting from 2019, the tariff policy will provide for maintaining the 100% cost recovery level for households.

protection, an average amount by ECA standards, with more than three-quarters of that amount being absorbed by social insurance programs, mainly pensions (9.6 percent of GDP in 2016). Social assistance programs consist mainly of various categorical benefits.

While in Belarus there are a variety of labor market support programs—including unemployment benefits and active labor market policies—the country is not prepared to counter the effects of sizeable unemployment that is likely to result during enterprise restructuring. In the past, SOEs were seen as “employers of last resort”, so the unemployment assistance used to be very weak: about 9.5 percent of the minimum wage in 2016 and 9.8 percent in 2017, provided to about 60 percent of officially registered unemployed in the course of a maximum 6.5 months.

Another challenge in labor markets remains high level of informal employment. In April 2015 a tax on social dependency⁴⁴—a levy on residents without a formal employment for less than 183 days a year—was introduced to encourage formal employment and fund public service delivery. The tax office identified about half a million Belarusians to pay an equivalent of about US\$190 and around 50,000 paid. However, the levy was introduced during the economic recession and public discontents erupted in the form of a series of public protests in Minsk and other cities, and the collection of the tax was suspended. The Government has been working on revisions of the policy to address the identified deficiencies. On January 24, 2018, a new Decree on Promotion of Employment cancelled the levy and focused on measures to encourage formal employment.

Furthermore, realignment of tariffs with cost-recovery levels would result in notable welfare costs, without well-targeted mitigation measures in place. Subsidized tariffs have disproportionately benefited richer households. For example, the top two income quintiles received 42.1 percent of the overall heat subsidy, while the lowest two only received 24 percent. Tariff increases will increase the fiscal sustainability of the sector. However, simulations suggest that increasing heating tariffs to cost-recovery levels could increase the share of utilities payments in total household budgets from 8 percent to 16 percent in the bottom decile, while the share of households spending more than 20 percent of household budget could increase from 2 percent to over a quarter in the bottom decile. Well-targeted mitigation measures for the poor households need to be put in place to prevent substantial deterioration of their welfare. However, the need to address the impacts of rising housing utilities tariffs should not be a stand-alone effort. Rather, a common targeting platform for various benefits is needed, along with having a sufficient state capacity for means-testing and asset-testing, as well as utilizing an integrated approach for each stage of the delivery chain, including identification, eligibility, error and fraud control, and payment.

Belarus’s demographic structure is shifting, with important implications for demand in education and health sectors. The population dependency ratio (the number of old age people for 100 working people) is projected to double from 57 in 2008 to 115 in 2050⁴⁵. The number of citizens above the age of 60 will increase by 14 percent in the next decade alone. In the health sector, the aging will amplify spending pressures and change the demands placed on the health system (for example, requiring more long-term preventive and curative care). In education, the system will need to adapt to the sharp decline in the student population.

In addition to the changing aging profile, Belarus has experienced significant internal migration, intensifying demand pressures for public services in cities while reducing them in rural areas. Over the last decade about one million people have moved to cities, increasing the share of Belarus’s urbanization rate from 67 to about 75 percent, a trend that is likely to intensify if structural change of the economy accelerates.

Adjusting to demographic and migration trends, Belarus has already implemented school network optimization, yet the pupil-teacher ratio remains low. Under the National Development Program for General Secondary Education (GSE) in 2007-2016, 873 GSE schools were closed and 1,115 reorganized across all six oblasts of Belarus and the city of Minsk, reducing by nearly one-third the number of institutions in rural areas. Yet, at 15 pupils per teacher, the pupil-teacher ratio in Belarus is lower than in high HDI countries or in Russia, although

⁴⁴ The Presidential Decree #3 as of April 2, 2015 ‘On Preventing Social Dependency’.

⁴⁵ UN populations Statistics.

it is comparable to the value for “very high” HDI countries. Nevertheless, the success of the consolidation program is not fully realized, in part, because expenditures on salaries, utilities, and school meals leave limited room for quality improvements.

In addition, the management of the educational sector requires enhancement. Data issues are pressing. While general aggregate data are available, such as basic statistics, there is little information on areas such as learning outcomes and financing. As a result, strategic planning is weak, while the sector is managed “manually”, reacting to specific demands. It is difficult to assess the quality of secondary education because Belarus has not yet taken part in international programs for student assessment, such as PISA, PIRLS, and TIMSS (although plans are in place to take part in the OECD’s PISA assessment program in 2018). Similarly, national sample-based assessments are underdeveloped, and do not focus on rigorous measuring of students’ competencies. To gain better knowledge about the relevance of graduates’ skills, analytical work needs to be conducted, given the absence of any systematic tracer studies of university graduates.

The supply and demand of skills across different categories and educational levels should be aligned to support private sector development. According to 2013 Enterprise Survey data by the International Finance Corporation (IFC), more than 20 percent of private firms reported that an inadequately educated workforce was a significant obstacle to doing business in Belarus—the second highest obstacle after high and changing tax rates, especially for medium-sized companies. About 68 percent of students of higher education study social science and humanities, while the remaining part specialize in various scientific and technical disciplines, including medicine. The vocational training institutions are less popular than the institutions of higher education. Overall, there is a need to modernize the methods and content of education at the general secondary, vocational, and university levels, with more focus on socioemotional (“soft”) skills and transversal skills.

Finally, Belarus’s health care system needs to embrace a paradigm shift, specifically, a shift from in-patient curative to preventive health care and from input-based to output-based financing system. Currently the system (see Box 3.4) lacks a strong primary care system that will be necessary to address major health challenges in a cost-effective manner. The current level of public health spending at 4.19 percent of GDP in 2016 is in line with the spending in other middle-income countries in the region (2.7 percent on average for CIS countries, 4 percent for ECA), but it remains below the level of public health spending in the EU and the OECD countries. For its population size, Belarus has many hospitals, hospital beds, doctors, nurses, and other personnel. Belarus has the highest number of hospital beds per capita in the WHO European region—10.9 per 1,000 population in 2014, which is well above the average for both the CIS (7.2 per 1,000 in 2014) and the EU (5.2 per 1,000 in 2014). As a result, scarce resources are spread too thin to maintain existing facilities, preventing new and more cost-effective use of funds. Overcoming these inefficiencies is critical for containing health care costs and increasing cost effectiveness, especially since further pressures are likely to arise from increased treatment costs and an aging population.

Box 3.4: Health Care System in Belarus

The current Belarussian health care system is based on a hierarchical and nationally controlled system staffed by state employees. Incremental change, rather than radical reform, has been the landmark of the health care policy. The Ministry of Health (MoH) has overall responsibility for the health care system, although the funding and purchasing of primary and secondary care is devolved to the regional level, which includes six regions including the capital city of Minsk. Highly specialized tertiary care hospitals are funded directly from the MoH budget. There are very few privately owned service providers in the country. Planning for capital investments has been based on legal minimum requirements that have focused on the required inputs. The Budget Law, approved each year, stipulates a minimum amount of public financing per capita. The MoH is responsible for planning and management functions which are largely integrated. The MoH plays the main regulatory role at all levels of the health system, although regional and district governments are also key stakeholders given that they are responsible for financing the system at their level.

Provision of services involves an extensive network of health care providers throughout Belarus. The PHC network has two forms of service provision: traditional polyclinics in the cities and rural outpatient clinics led by general practitioners (GPs) and small *feldsher*-midwife points in the remote rural areas. Primary care in Minsk and in the six other regional centers is provided through a network of adult and pediatric polyclinics, where many preventive, diagnostic, consultative, and referral services are offered.

There have been concerted efforts to introduce GPs who provide primary care services to both adults and children in rural areas.

Secondary-level care is provided by district and regional hospitals. While district hospitals provide general secondary care services, regional hospitals deal with more complex cases and offer a wider range of care. Each district and region also has an outpatient polyclinic, which delivers specialized care for the patients in the community. A significant direction for health policy in Belarus has been the growth in the volume of high-tech services (for example, hip replacement, complex heart surgery, and organ transplants) available in the health system.

This has come about because of a specific policy push. Most of these high-tech procedures take place in highly specialized national centers, which have the best human and material resources. These procedures are also offered in high-tech centers located in some of the regional hospitals.

Source: Belarus: Public expenditure review: enhancing public services in times of austerity, The World Bank, 2013.

C. Upgrading Institutional Framework to Make Belarus's Business Environment More Dynamic

Going forward, various agencies of the government must adjust their roles in transitioning from direct to indirect economic involvement. In Belarus, the share of general government expenditures in GDP (43.5 percent in 2015) is large, but not as large as Sweden's 49.3 percent of GDP.⁴⁶ These high shares of government expenditures in GDP suggest that in both countries income distribution and poverty reduction objectives have a high priority. Where Belarus and Sweden differ radically is in how production of goods and services are organized. In Belarus, most production of goods and services is done by a sector of state-owned enterprises that operate under command and control economy rules, and most social programs are the responsibility of the SOEs. In Sweden production of goods and services is the responsibility of the private sector which operates under free market rules which have facilitated innovation and capacity to adapt to change. At the same time, in Sweden social programs are the responsibility of the state.

Changes in the economic model will require rethinking of the role of the state and migrating from a producer of goods and services to a regulatory role. These changes will require better domestic resource mobilization based on the direct taxation of individuals and small businesses, especially in the private sector. In the past, strong economic growth translated into buoyant general government budget revenue growth (coming from VAT, customs duties, and corporate/personal incomes), exceeding 50 percent of GDP in 2008 (including revenues of an off-budget social security fund)³⁷. Expenditures expanded pro-cyclically, driven by subsidies and transfers, followed by capital expenditures and increases in public sector wages. However, when growth weakened, expenditures were contained to meet declining tax revenues and rising debt service. Planned changes in SOE governance will require a new approach to management of fiscal risks and the managerial role of the state.

Advancing economic and social transformations requires upgrading Belarus's institutional framework to make the business climate *dynamic*. Today, private sector development is constrained by a lack of commitment to reforms, frequent legislative changes, and to private enterprise itself—signals meant to spur more investment are not perceived as credible—as well as by a lack of policy and regulatory coordination between different agencies and levels of government. Hence, in Belarus managing a transition to the new growth trajectory would require its institutions to (i) make a strong commitment to private property, contract rights and direction of reform, (ii) strengthen coordination among all levels of government and private sector actors, and (iii) increase cooperation between various stakeholders towards a shared vision, including strong ownership of general public of the proposed reform process.⁴⁷

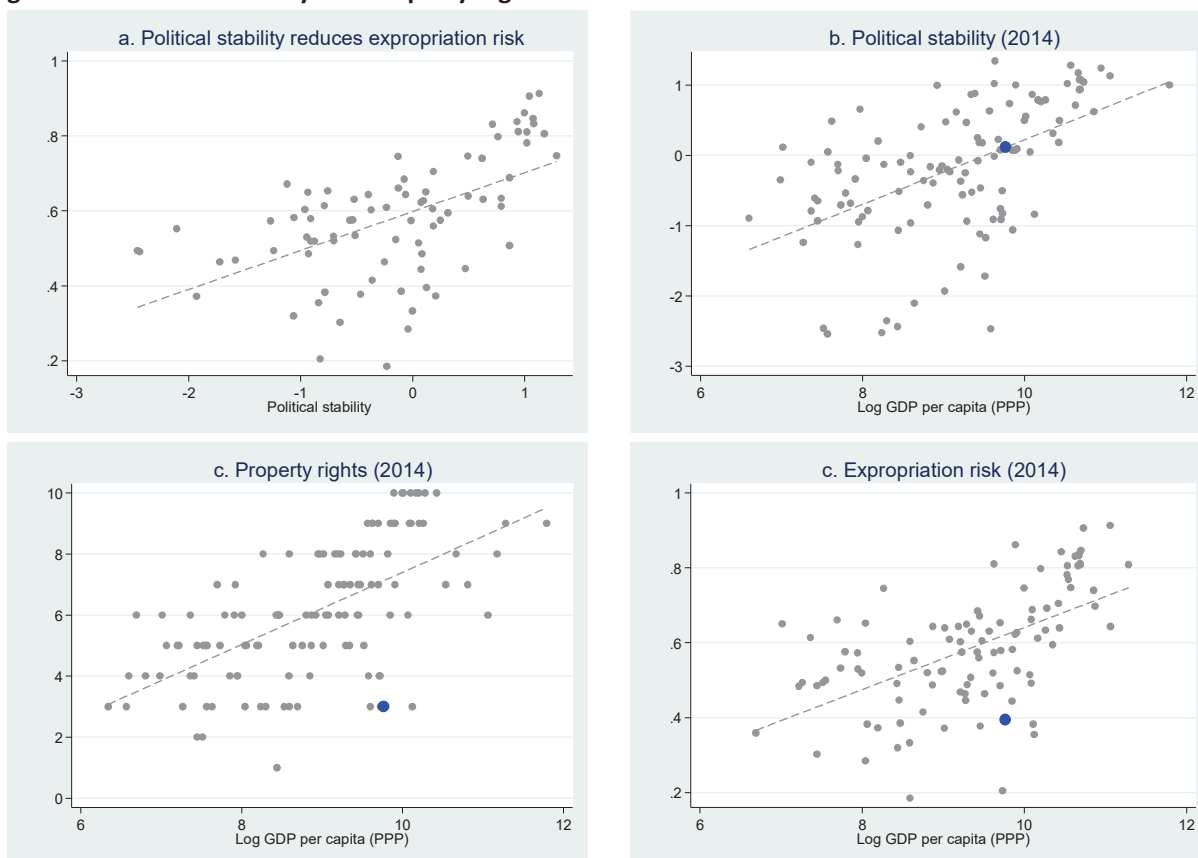
The largest barrier to development of the private sector in Belarus is the lack of a credible commitment to private property rights. Given the stability of centralized political power in Belarus, the country should be able to

⁴⁶ The data corresponds to WEO October 2017.

⁴⁷ This would also include (i) institution building for good enterprise governance and improved accountability and transparency, (ii) improved infrastructure for doing business, including creating better business support systems with which to attract strategic investors, (iii) strengthened markets for managerial and entrepreneurship talents, company control, and enterprise strength building services and transformation of the risk-taking culture within SOEs.

maintain a commitment to private property and prevent expropriation, since expropriation risks tend to rise in countries with less stable political power (Figure 3.3a). Yet while political stability in Belarus is relatively high (Figure 3.3b), respect for private property is not as strong as Belarus's income per capita would suggest (Figure 3.3c) and risk of government expropriation without adequate compensation is elevated (Figure 3.3d), especially given the levels of income in Belarus. Private investment depends on this baseline protection of private property.

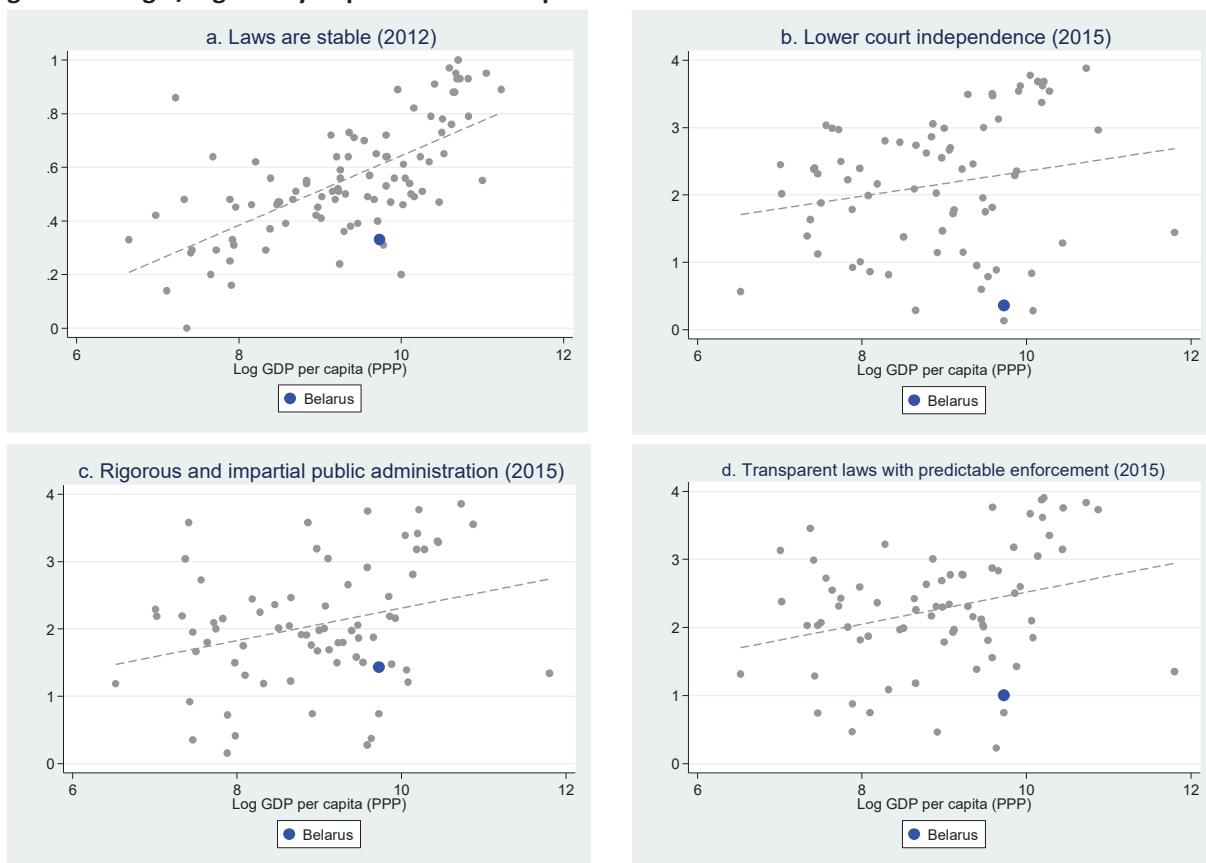
Figure 3.3: Political Stability and Property Rights



Source: World Bank Staff estimates on the basis of World Governance Indicators.

The formal legal and regulatory framework supporting property rights and private enterprise development have improved, but commitment breaks down in implementation and enforcement. While Belarus in 2017 ranked 37th in the world for ease of doing business, up from 44th in 2016, regulators sometimes take “arbitrary” actions. Judicial independence is also lacking. Laws are not perceived as stable (Figure 3.4a) and lower courts (which handle most commercial disputes) are not independent (Figure 3.4b). Moreover, public administration is not seen as rigorous and impartial (Figure 3.4c). A weak and partial judiciary and public administration undermine efforts to create transparent laws with predictable enforcement (Figure 3.4d).

Figure 3.4: Legal/regulatory Implementation Gaps



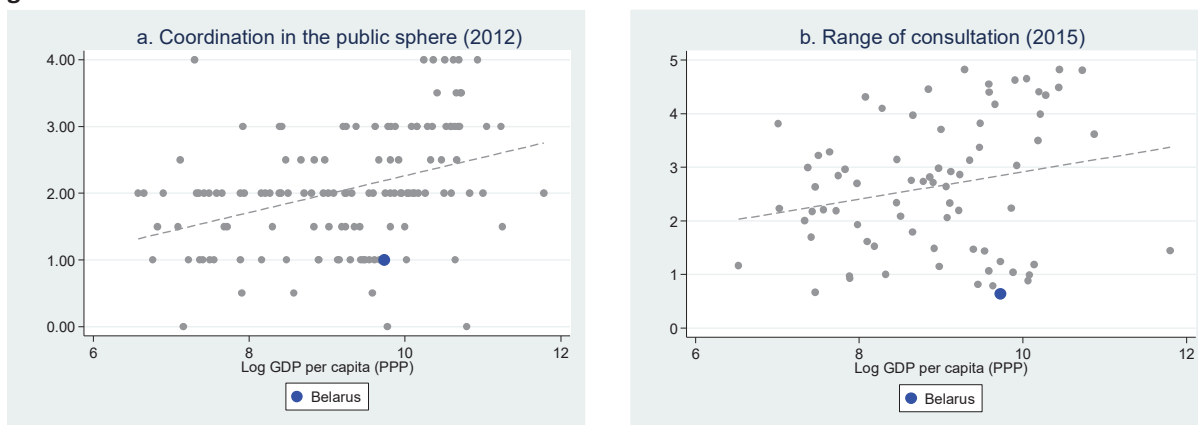
Source: World Bank Staff estimates based on World Governance Indicators.

As demonstrated by the implementation gap between *de jure* rules and the *de facto* experience of these rules, generating a credible commitment to the private sector requires a shift in behavior of public sector actors. This is a challenge that is not easily overcome, because it is based not only on rules but also on norms and beliefs. Societal bias against private entrepreneurs makes credible reforms challenging. This lack of support is seen even in formal laws, such as the lack of limited liability, whereby business owners can be held personally liable in bankruptcy.

Problems of coordination, in turn, undermine efforts to credibly commit to reform. Coordination challenges should be understood in terms of policy coordination among government ministries and levels of governments, as well as in terms of the role of the market in coordinating expectations of private sector actors.

Cross-ministerial coordination is extremely challenging. Private firms relate how promises by one regulator are undermined by other regulators. Line ministries still control SOEs, so their incentives to coordinate with other ministries are distorted, implying a need to break up production and regulatory functions. Despite low levels of public coordination (Figure 3.5a), the state still attempts to coordinate too much economic activity, for instance by setting output prices and subsidizing inputs in agriculture. Here, lack of coordination can lead to economically irrational outcomes. Additionally, the state does not sufficiently coordinate with enterprises themselves and has very low levels of consultation (Figure 3.5b). Only about 10 percent of SMEs participate in business associations, which are not perceived as very helpful given these low degrees of consultation.

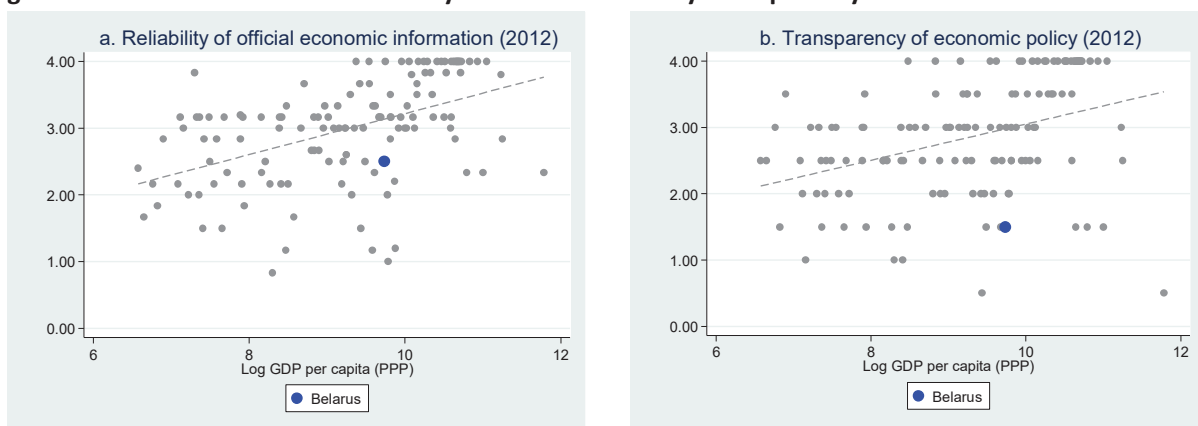
Figure 3.5: Lack of Public Sector Coordination and Consultation with Private Actors



Source: World Bank Staff estimates on the basis of World Governance Indicators.

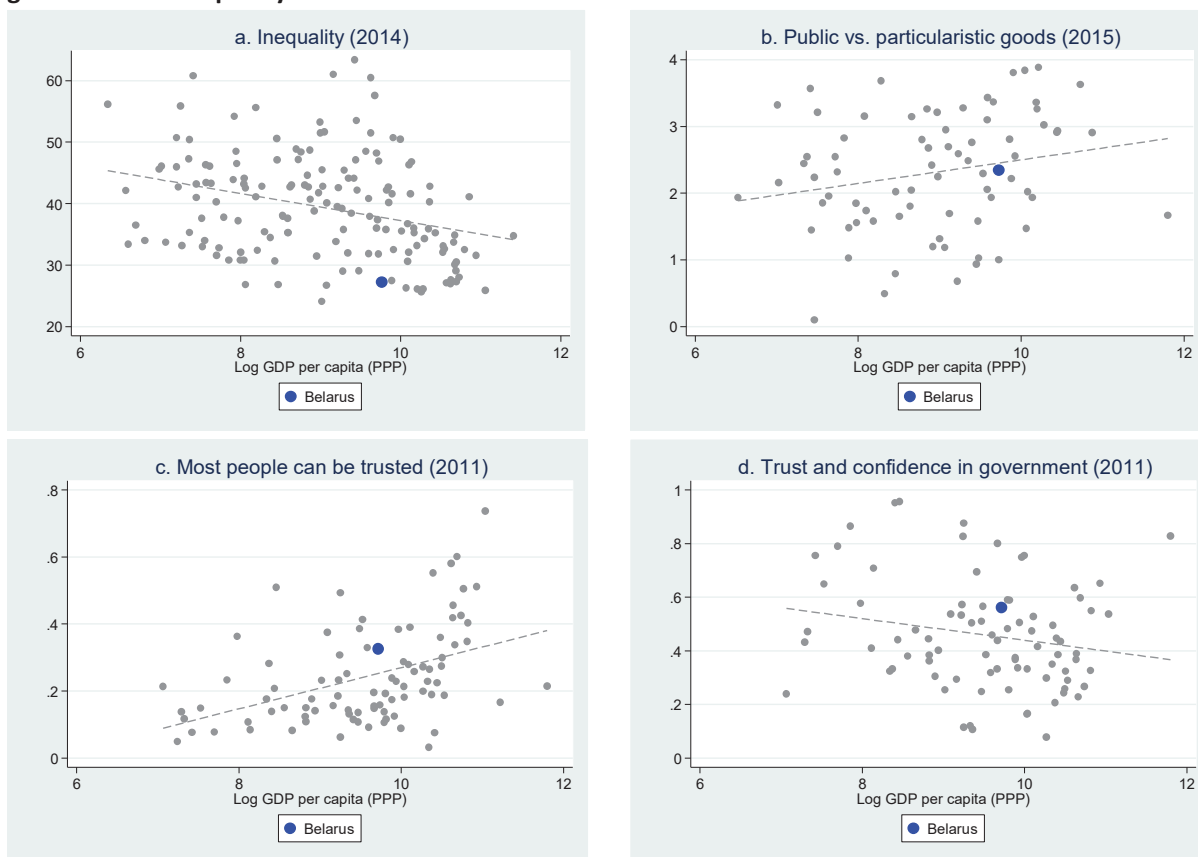
Markets can efficiently coordinate expectations, but this coordination function depends upon low transaction costs, reliable and available information, and deep/broad financial markets. These conditions are unmet. Lack of transparency of data and of economic policy decisions prevent private actors from making well-informed decisions. Private actors do not trust official economic information (Figure 3.6a) and find government economic policies to be nontransparent (Figure 3.6b), making it difficult for government policies and data releases to coordinate expectations of private actors. Among private actors themselves, norms and rules for data disclosure are poor, preventing companies from accessing information about each other and limiting opportunities and incentives for mergers, acquisitions, and partnerships.

Figure 3.6: Low Levels of Data Reliability and Economic Policy Transparency



Source: World Bank Staff estimates on the basis of World Governance Indicators.

Figure 3.7: Low Inequality and Levels of Public Goods Provision



Source: World Bank Staff estimates on the basis of World Governance Indicators.

Finally, policy effectiveness relies on cooperation, including the willingness of citizens to voluntarily comply with laws, to contribute to public goods, and to not free-ride on others. Belarus has achieved high levels of cooperation by maintaining low levels of inequality (Figure 3.7a) and providing public goods (Figure 3.7b), resulting in relatively high levels of interpersonal trust (Figure 3.7c) and trust in government (Figure 3.7d). The high degree of state legitimacy that has enabled cooperation is based on the fulfillment of a social contract in which state firms provide employment and social services. In 2016, about 40 percent of employed people worked at state-owned enterprises (Belstat 2017). Rapidly privatizing or radically reforming these firms without an alternative arrangement would undermine the social contract and could lead to a cooperation breakdown. Yet increasing wages at SOEs through administrative fiat, which has kept the social contract intact, is increasingly unsustainable given mounting fiscal pressures, growing debt, and declining export competitiveness. In this sense, new sources of state legitimacy and a new basis for a social contract through alternative means of service provision and employment will be necessary.

Chapter 4 Priorities for Shared Prosperity

A. Prioritization Criteria

The SCD shows that achieving lasting poverty reduction and shared prosperity in Belarus will require a new economic strategy that takes advantage of emerging opportunities. Equitable, export-driven growth is likely to generate long-term economic and employment gains, but will require sustained macroeconomic stability and comprehensive structural and institutional reforms. The diagnostic presented in this SCD identifies an array of constraints for effectively increasing shared prosperity and for reducing risks of an increase in poverty in Belarus. The SCD has identified seven key priorities for achieving further progress towards achieving in Belarus the twin goals of reducing extreme poverty and boosting shared prosperity. Six priorities are aimed at making the most of opportunities to implement a new vision of a comprehensive, inclusive, and dynamic Belarus, while mitigating identified challenges. Finally, there is one cross-cutting priority related to mitigating the impact of climate change and disaster risk. The seven identified priorities are shown in Table 4.1. The judgments relating to the application of these criteria are set out in the narrative below.

Articulation of policy priorities—and subsequently to concrete policy actions—was done in consultations and discussions among SCD team, Country team and development partners. The SCD core team then identified the top policy priorities (and later the policy actions) by applying filters to narrow down the extensive list of constraints. At this point four filters were applied:

- *Impact*: areas with expected substantial (medium to large) impacts on the twin goals, assessed via the pathways—economic, social and institutional transformation—towards reducing poverty and boosting shared prosperity.
- *Preconditions*: areas that address certain constraints which are an essential precondition for progress in other areas. To ensure credibility of a gradual approach for accelerating progress toward sustainable economic growth and achievement of the twin goals, it is important to commit to and make significant progress in a number of strong, frontloaded priority measures. In essence the preconditions are designed to address Belarus’s legacy of an unfinished transition from a planned economy to a market economy.
- *Complementarities*: areas that have large or important complementary effects.
- *Feasibility*: areas that can be implemented in the medium term given cost and capacity requirements.

The SCD team also built on internal and external consultation process. The objective was to get advice from key experts in Belarus and the World Bank on areas of emphasis and, as the work progressed on the emerging storyline and main messages. This process identified several major knowledge gaps (Box 4.1).

Box 4.1: Knowledge gaps

There are some major knowledge gaps in terms of both World Bank sector expertise, access to data and more generally of topics not well covered in the academic or policy research literature. Of these four emerged as the most important areas:

- **The real sector, particularly agriculture sector.** The absence of firm-level financial data, even anonymized (except for open joint-stock companies), to analyze competitiveness at the firm level. The analysis of geotagged firm-level data in industry and agriculture would make possible to construct a detailed picture of resource allocation and a calculation of the efficiency of factor use. Access to such data would also give a better view of production networks among enterprises within the Belarus economy. In addition, agriculture sector knowledge gaps are significant. A thorough diagnostic study is needed to

identify key issues in the sector such as the interplay between the levels of public support, the impact of state purchases and sales of agriculture products and management of state directives.








- **The financial sector.** Lack of data on the volumes and maturities of subsidized loans, preventing to estimate the expected impact of various scenarios of direct lending reduction on SOEs, commercial banks, including potential fiscal costs of bank recapitalization and SOE labor retrenchment.
- **Social outcomes.** Labor Force Survey (LFS) results remain classified. Moreover, poverty is not recorded at the rayon level, making it difficult to conduct spatial welfare analysis.
- **Social infrastructure (education and health).** Differences in quality of access to public services are poorly captured. Quality of education is not rigorously measured, and there is no systematic *tracer* studies of university graduates.

Addressing legacy issues is at the core of the transformation process. Three identified priorities focus on legacy issues. A blend of traditional controls, a legacy from central planning, and innovative, forward-looking market processes create a tension. Legacy of central planning is holding the economy back while the market forces are trying to propel it forward. At the core of it is to let market forces a more decisive role in allocation of capital and labor. A more efficient allocation of capital is needed to ensure macroeconomic and financial sector stability.

Against this background one of the most important legacy challenges facing Belarus is to improve economic governance by gradually modify state institutions previously associated with command and control rules and procedures. With the shift in the role of government from direct to indirect economic involvement, the social protection and labor market policies will also have to shift away from protecting jobs to protecting income of workers and their ability to earn income, as well as providing adequate support to the unemployed. The presence of these bureaucratic institutions implies a legacy burden that works against the modernization of the SOEs and the development of the private sector. The costs associated with this legacy are augmented by the fact that the resistance to change is very difficult to anticipate and that the resulting uncertainty deters more productive investment and required transformation. After addressing legacy issues, unlocking Belarus's growth potential would require unleashing private sector growth potential, maintaining human capital edge and enhancing connectivity. The progress of implementing the Government's reform program is heavily tilted towards measures focused on unlocking these growth catalysts, however, without first addressing the legacy challenges there is a risk that these measures will not be sufficient. Addressing legacy challenges is particularly important for the following identified priorities: (i) maintaining macroeconomic and financial stability, (ii) strengthening social resilience, and (iii) strengthening economic governance. Ensuring sustainable progress in these areas is critical for establishing a sound foundation for Belarus to realize its opportunities while managing the most important risks.

Identified priorities are mutually reinforcing, leading to a lasting and sustainable economic, social, and institutional transformation of Belarus. Because of these linkages, the impact of partial and isolated measures in individual policy areas would likely be limited. A pragmatic and sequenced reform approach could be built on the piloting of reforms in selected priority areas. This would not only allow regular assessment of the impact of implemented reforms (and adjustment of reform measures as needed), but would also help to mitigate the risks associated with rapid and wholesale reforms. At the same time, there is a risk that gradual and partial reforms could lead to slow and inconsistent implementation and therefore undermine the credibility and ultimate impact of reforms. In this context, the selected priority actions should be viewed as a package of country-specific, interrelated policies designed to unleash the growth potential of the Belarussian economy, which is currently being suppressed.

Table 4.1: Priorities

POLICY AREAS			IMPACT ON	
			Reducing poverty	Increasing shared prosperity
PRIORITIES				
	1. Maintain macroeconomic stability	<ul style="list-style-type: none"> ▪ Maintain prudent economic policy management ▪ Address financial sector vulnerabilities ▪ Enhance fiscal and public debt sustainability 	x	x
	2. Strengthen social resilience	<ul style="list-style-type: none"> ▪ Strengthen social safety-nets ▪ Develop adequate unemployment protection mechanisms ▪ Develop active labor market policies 	x	x
	3. Improve economic governance	<ul style="list-style-type: none"> ▪ Improve efficiency of state-owned enterprises and reform the state-owned banks ▪ Improve cooperation and coordination between private and public sectors ▪ Strengthen property rights protection ▪ Strengthen the role of the market signals in allocation of capital and labor 	x	x
	4. Unleash private sector growth potential	<ul style="list-style-type: none"> ▪ Ensure competitive neutrality and deregulation of product and factor markets ▪ Eliminate cross-subsidization and Improve public utility service delivery 	x	x
	5. Maintain human capital edge	<ul style="list-style-type: none"> ▪ Increase the relevance, responsiveness, and quality of the higher education, research, and innovation systems in accordance with labor market needs and international trends ▪ Promote active and healthy aging 		x
	6. Enhance connectivity	<ul style="list-style-type: none"> ▪ Transition to rules-based trading system (World Trade Organization accession) ▪ Strengthen public investment management and management of SOEs ▪ Improve logistics potential and offer competitive transport services 		x
CROSS-CUTTING PRIORITIES				
	7. Climate change adaptation and disaster risks mitigation	<ul style="list-style-type: none"> ▪ Increase energy efficiency ▪ Assess systematic needs and risk financing strategies ▪ Promote creation of resilient forests 	x	

B. Priorities

Priority 1: Maintain Macroeconomic Stability

Belarus's the most urgent priority is to maintain macroeconomic stability and reduce vulnerabilities in the external, fiscal and financial sectors. Although the economy is currently in a cyclical recovery after two years of recession, the build-up of vulnerabilities tied to past policies and several rounds of crises in recent years have left Belarus susceptible to shocks. Negative macro-financial feedback loops—low productivity growth and high levels of NPLs—are taking their toll, with implications for quasi-fiscal liabilities emanating from state-owned banks and the SOE sector.

Macroeconomic and financial sector stability is a key determinant of whether growth can be reignited and sustained, even if it is not as rapid as in the recent past. Maintaining macroeconomic stability, a major source of instability in the past, is critical to ensuring that Belarus, with a small and open economy, is able to absorb domestic and external shocks. Maintaining financial stability and creating efficient and deep financial markets is a prerequisite for improving the allocation of capital. Making progress in these areas is also critical for other priorities. Without macroeconomic and financial stability, economic agents are subject to uncertainties that undermine other priorities, including promoting private sector development and maintaining social stability.

In terms of fiscal policy, the share of general government expenditures, more than 40 percent of GDP, is large. Moreover, about half of the production of goods and services is performed by partially- and fully-owned state-owned enterprises that operate under guidance from various government agencies. A large footprint of government has become a constraint to achieving the twin goals. Maintaining fiscal and public debt sustainability would require implementing medium-term fiscal consolidation, supported by wage restraint in the public sector, pension measures, and other policies.

In the financial sector, the first priority is to strengthen stability of the financial system. During 2016, the share of bad loans more than doubled, reaching in November 2016 an amount of 15 percent of total loans and credits, and remained at high levels throughout 2017.⁴⁸ In order to further reduce negative impacts of macroeconomic shocks and to assess systemic risks in the banking sector, asset quality reviews and forward-looking analysis of banks' balance sheets are required on an ongoing basis. This will provide the basis for implementation of bank-specific restructuring plans. Moreover, the financial safety net could be enhanced by further reforms in legal and institutional framework for deposit insurance and the resolution of problem banks.

At the same time, it is important to remove distortions in the credit market through a gradual phasing-out of subsidized credits under directed lending programs in order to avoid misallocation of scarce resources and to level (and ease) credit conditions across the economy. In parallel, the development of capital markets and insurance sector, which remain relatively small, should be encouraged. The regulatory and supervisory framework for capital market participants and the insurance sector needs to be brought closer to international good practice,, including a clear separation of state ownership and regulation functions.

Implementing these priorities are feasible because Belarus has already taken important steps to maintain macroeconomic and financial sector stability and to strengthen public sector finances. Monetary and fiscal policies were tightened, while exchange rate determination was made flexible. Directed lending at subsidized interest rates was reduced, and the agency for nonperforming loans in agriculture was created to deal with bad debts of underperforming agriculture companies. Authorities have announced plans to adopt inflation targeting and to gradually remove subsidies to enterprises and in the utilities sector over the medium term. Hence, one of the key challenges in this area would be to not reverse these policy measures.

Priority 2: Strengthen Social Resilience

Together with the shift in the growth model toward more economic efficiency and market orientation, social protection and labor market policies will also have to shift away from protecting jobs to protecting income of workers and their ability to earn income, as well as providing adequate protection to the unemployed. Belarus has achieved remarkable progress in reaching the twin goals, but the recession of 2015-2016 broke this favorable trend, and projected future low growth could further undermine these achievements and put real income growth on hold. The deteriorating economic situation points to higher household vulnerability and sustainability concerns. Furthermore, disruptions to the social contract could undermine social stability and reverse significant gains in recent decades to achieving the twin goals. At the same time, the implementation of

⁴⁸ This official figure for nonperforming loans is likely to significantly underestimate the actual level of problem loans in the economy due to (i) continuing supervisory forbearance, diagnosed recently by the Financial Sector Finance Program (FSAP), and (ii) the increasing practice of transferring the most problematic borrowers from the state banks' balance sheets to the government balance sheet in exchange for government debt instruments.

structural reforms would have a negative impact on certain vulnerable segments of the population. Inadequate social safety nets currently undermine the ability to implement a comprehensive SOE and to implement utility tariff reforms because reducing cross-subsidization in the utilities sector requires effective household utility subsidy mechanisms to protect vulnerable categories of the population. Further improvement of targeting of housing and utility subsidy program is needed.⁴⁹

To mitigate the risks of adverse impact of short-term loss of income associated with the SOEs reform, there is a need to (i) strengthen the unemployment benefits to protect the population from falling into poverty and to provide adequate income replacement, and (ii) ensure that the changes are fiscally affordable and incorporate effective incentives to encourage labor force participation and to support job-search and other activation measures. Given the current fiscal pressures and a strong preference for a phased approach, in the initial phase, a limited-duration non-contributory unemployment assistance program can be introduced with financing from the government's budget. In the long-term, a contribution-based, limited-duration program of unemployment insurance should be put in place. Such an income support setup is found in the majority of OECD and transition countries. In parallel, an integrated active labor market policy could be designed by combining and aligning various tools including wage subsidies, re-training, labor intermediation or other job search/matching support. Furthermore, strengthening the system of unemployment benefits and active labor market policies would require (i) expanding eligibility for temporary benefits to, for example, those workers separating from SOEs but still searching for new employment, and (ii) upgrading the administrative system to increase the capacity to process claims, reduce administrative barriers on potential claimants, offer effective employment and retraining support, and ensure adequate monitoring of continuing eligibility.

As part of broader efforts to modernize the safety net, it would be important to strengthen targeting of the existing systems. This would facilitate addressing coverage gaps, and operating a safety net that is adequate, financially sustainable, protects from shocks, promotes labor market participation, and provides targeted poverty relief. This would include efforts to (i) expand the Belarus public targeted social assistance system (GASP), which is very small (accounting only for 3 percent of total social assistance spending or 0.06 percent of GDP), (ii) further consolidate privileges, (which perform poorly in efficiency terms on reducing poverty and inequality), (iii) invest in a common targeting platform for various benefits, and (iv) develop higher state capacity for means-testing and asset-testing. Furthermore, efforts to strengthen the targeting system need to be accompanied by efforts to strengthen the administration that would support targeted and efficient delivery of benefits, including (i) adopting an integrated approach for each stage in the delivery chain: identification, eligibility, error and fraud control, and payment, and (ii) strengthening coordination of support provided by pensions, social assistance, and social care services to eliminate safety net gaps.

Priority 3: Improve Economic Governance

Strengthening property rights, improving oversight/management of SOEs, increase data transparency and reducing policy uncertainty is a key priority area to improve economic governance. Currently, a major impediment to private sector growth and investment—both domestic and foreign—is the poor protection of investors' property rights.

Given the number, size, and role of state-owned enterprises in Belarus, structural transformation of the SOE sector will require a comprehensive strategy and strengthened institutions. These include actions geared towards improving corporate governance, hardening budget constraints, supporting privatization and/or joint ventures with foreign investors, and undertaking reforms of the insolvency regime. For example, separation of regulatory and oversight functions would require strengthening the institutional capacity of institutions such as the State Property Committee. This transformation strategy will need to be tailored to the various segments of the SOE sector and reflect differences in performance, size, commercial viability, and strategic importance. In

⁴⁹ Belarus has already begun to strengthen social safety nets, specifically by implementing a targeted social support program to offset utility reforms—a non-cash social support mechanism that is providing support for households with utility bills that exceed 20(15) percent of expenditures in urban (rural) areas—yet more can be done to improve the targeting efficiency.

addition, improving SOE performance is one of key priorities to remove distortions to development of the private sector.

At the same time, economic institutions of state support, including tax privileges, subsidized credit, and direct budget subsidies should be reviewed, rationalized, and phased out over time to ensure that SOEs are exposed to financial discipline and market incentives. Remaining state support should be extended only on a temporary basis, subject to competitive allocation utilizing procedures that ensure equal access for all enterprises regardless of ownership. Ideally, state support should be targeted to areas that meet clear public goods objectives. Reforms of State Owned Banks should focus on improving governance, and creating a level playing field with private banks.

While there is general agreement that comprehensive SOE reform is needed, there is no political agreement on the scope, scale, and timeline of such a reform. At the same time, authorities have recently turned their attention to weaknesses in the SOE sector. A system of key performance indicators (KPI) has been revised to make profitability, lower inventories, and exports dominate over physical production targets, while wages are linked to productivity. Plans for ownership and regulatory functions to be separated have been planned, and a system of fiscal risk monitoring has been designed.

Finally, lack of transparency of data and of economic policy continues to undermine the ability to make well-informed decisions. Reliability and availability of information is critical to decrease transaction costs and improve coordination of expectations. For example, micro level data related to labor market and enterprise operations are not disclosed. This is limiting opportunities and incentives for partnerships and investment.

Priority 4: Unleash private sector growth potential

A key priority in unleashing the private sector growth potential should focus on addressing misallocation of capital and labor. While Belarus has made significant progress in liberalizing product markets, factor markets remain heavily administrated and there is a lot of evidence that ineffective factor markets have contributed to inefficient allocation of resources in the economy. For example, improvements in capital allocation depend on progress in baking sector reforms as well as broader capital markets developments which remain nascent in Belarus.

At the same time, markets in Belarus are subject to numerous complicated regulations, which increase the costs of entry and of running businesses. Some sectoral regulations are burdensome—for example, in aviation services, telecommunications, private medical services, higher education, and construction—which deters many firms from entering and/or expanding their businesses. Recently, the Authorities have started simplifying regulatory framework and cutting unnecessary red tape, including reduction of the number of administrative and licensing procedures, introduction of regulatory impact assessment, and so on. .

Administrative price controls for socially important goods and other restrictions, such as local product requirements for retailers, need to be eliminated to allow price formation based on market principles. In markets with natural monopolies, such as the utility sector, tariff setting should be cost-reflective. In the medium term, independent regulators should be created to ensure sound market regulation and tariff setting based on economic principles.

Improving the sustainability and quality of public utility service delivery would require reducing cross-subsidization, with the goal of gradually reaching 100 percent cost recovery in the household utility sector. This can be achieved gradually to provide time to invest in improving utility service quality⁵⁰, organization, operational efficiency, commercialization, the energy efficiency of energy consumption, reducing production inefficiencies, and addressing risks of rising arrears.

⁵⁰For example, quality of water supply is deteriorating due to lack of investments in water supply, for example excessive iron content has been found in 26 percent of the samples taken in Gomel Oblast and Mogilev Oblast, as Belarus has only 42 percent of the required amount of drinking water deferrization stations it needs.

Addressing constraints in this area would have positive impacts not only in the energy and utility sector, but also on growth and competitiveness. First, adjustments in public utility tariffs would strengthen the role of market price signals, increase competitiveness of industry by reducing cross-subsidies, and help redirect budget resources to better target social assistance to offset utility tariff adjustments. Second, streamlining the regulatory environment would create a more competitive environment that can provide new opportunities for both existing and new companies, especially SMEs, to enter and expand.

These priorities are feasible and progress has already been made. The government intends to strengthen domestic competition and induce the development of innovative sectors, such as the information and communication technology (ICT) sector. In particular, the Ministry of Anti-Monopoly and Trade, established in mid-2016, is currently working on amendments to the Anti-Monopoly Law aimed at changing modes of regulations, including a shift from price controls to indirect regulatory mechanisms, revising the notions of dominant market position, increasing transparency of procurement, and dealing more effectively with unfair competition (also caused by actions of the government agencies and local authorities) and abuses of dominant market positions. Additional steps have included beginning to adjust utility tariffs.

Priority 5: Maintain Human Capital Edge

Human capital improvements have been a key driver of shared prosperity in Belarus. Demographic changes over the next decade will result in many challenges to maintain human capital edge. Educational endowments have increased over the past decade and a half, including tertiary enrollment rates for both men and women, and from already high levels. Overall, there is a need to modernize the methods and content of education at the general secondary, vocational, and university levels, with more focus on socioemotional (“soft”) skills and transversal skills. Yet, high educational attainment outcomes may need to be complemented with efforts to rigorously measure student’s competencies, and to assess the degree of alignment of education and training with market demands. The supply and demand of skills across different categories and educational levels must be rigorously studied.

In the health area, Belarus lacks a strong primary care system and it will thus be necessary to address major health challenges in a cost-effective manner. For its population size, Belarus has a large number of hospitals, hospital beds, doctors, nurses, and other personnel. As the result, scarce public resources are spread too thin to maintain existing facilities, preventing new and more cost-effective use of funds. Overcoming these inefficiencies is critical for containing health care costs and increasing cost effectiveness, especially since further pressures are likely to arise from increased treatment costs and an aging population.

Priority 6: Enhance Connectivity

Given its advantageous geographical location, Belarus can benefit from its improved logistics potential and more balanced and diversified trade patterns. Facilitation of customs procedures and better use of infrastructure needed for logistics services will help to improve the transit and logistics potential of Belarus. Its favorable geographic location and good physical infrastructure should provide speed and flexibility to modern producers in transporting perishables and high-value goods between Europe and Russia or China.

Developing links to neighboring countries, as well as the internal transport infrastructure needed to connect domestic producers and markets, will require rehabilitation and commercialization of transport infrastructure and stronger telecommunications connectivity.

In recent year, there has been an increase in the level of motorization, and transport investments in Belarus have targeted the road system and allowed the trucking industry to become more competitive, and some steps have been made to modernize railways. Rail transport accounts for about a third of freight transport in the country and a sizeable share of passenger traffic. Apart from improving border crossing points and the road network, Belarus currently seeks to develop an integrated railway business plan and strategy based on expected market conditions and potentials. The implementation of this plan could result in a modification of railway

market organizations to better address changing market conditions and to incorporate more formal product design functions.

A number of policy deficiencies need to be addressed to allow private sector participation in provision of public infrastructure services. Currently, private sector participation is undermined by:

- Unclear priorities for infrastructure projects
- Lack of competitive selection process; transparency and competitiveness of tendering procedures are suboptimal
- Lack of clear Government accountability for the projects in some sub-sectors (e.g. renewable energy); insufficient collaboration among parties involved
- No mechanism/methodology of selection of PPP projects vs budget financed infrastructure projects
- Some legal issues; practices not in line with best international experience (e.g. no standard power purchasing agreement (PPA); PPAs are signed upon project commissioning; PPAs can be signed for 1-10 years – the tenure is granted at discretion of the government official)

Belarus's regulatory and legislative framework in the context of its membership in the Eurasian Economic Union (EEU) has served as an important first step toward meeting WTO accession requirements because other major members of the EEU are already members of the WTO. Accession to the WTO would further facilitate rules-based international trade that would reduce international trade discrimination and trade restrictions, and improve the unpredictability of rules. More importantly, accelerating WTO accession negotiations would continue to encourage economic development and economic reform.

WTO accession could potentially spur the development of the services sector, including transport. Modeled estimates of benefits for Belarus for full-fledged WTO membership suggest that among the different policy measures, the reduction of both discriminatory and especially non-discriminatory barriers in service sectors is expected to generate the most significant welfare gains. The most substantial expansion of output would occur in the business services sectors, especially in insurance, communications, and other professional services, as well as in rail and other transportation services (more than 9 percent per year each).

Cross-cutting priority: Climate Change Adaptation and Disaster Risk Mitigation

There is no strong evidence that the current economic growth model of Belarus has undermined sustainability of environmental outcomes. However, there are significant economic, social, and fiscal challenges related to mitigating the impact of climate change and disaster risks.

Belarus will need to address the threats and opportunities created by climate change. Climate change adaptation opportunities and mitigation measures have the potential to contribute to a greener, more sustainable growth pathway for Belarus. The type and scale of investment needed to create resilient forests, and the enabling environment for investment in the sector for carbon benefits (voluntary and regulated) as well as the possible inclusion of forestry in a national emissions trading scheme (and/or international voluntary market) should be investigated. For example, forests could be a major pathway for Belarus to reduce its carbon emissions. Domestic forests have a large climate change mitigation value, with 30 million tons of carbon sequestered in 2012. In line with the National Sustainable Development Strategy, implementing measures are planned to increase the area under forest from 39.4 percent in 2013 up to 41 percent in 2030.

Belarus's Nationally Determined Contributions (NDC) document, part of the architecture of the Paris Climate Agreement, in which countries spelt out their proposed climate change adaptation and mitigation actions. Belarus's NDC lays out specific measures for adaptation to the impacts of climate change in several areas such as in forestry and agriculture (the sectors indicated as most vulnerable to climate change) and also includes the need to build resilience in transport infrastructure and urban planning.

Belarus does not have systematic needs assessment and risk financing strategies in place. Assessment of disaster damage and losses should be standardized using modern approaches and technologies to develop a

comprehensive post-disaster needs assessment system. This would enable the development of more effective recovery strategies, including financial planning. Disaster risk management is currently financed by recurrent budget allocations across national, territorial, and local authorities. These resources are dedicated primarily to emergency response and recovery and are not sufficient for medium- and large-scale disasters (MWH 2015), dis-incentivizing long-term risk reduction. Systematic risk financing informed by probabilistic risk assessments would allow the government to ensure that adequate resources are in place to minimize the impacts of disasters on society, national budgets, and development.

With the first Belarusian nuclear power plant (BelNPP) under construction, radiological and environmental monitoring and preparedness takes on a new level of importance. Modern approaches for radiation-ecological monitoring with enhanced observational technologies, data collection, processing, storage, transmission, and presentation, including for emergencies, is needed to ensure radiation safety not only in the vicinity of the BelNPP, but also for the whole country. For timely response to threats posed by radiation and nuclear accidents, including in neighboring territories, an up-to-date automated national radiation monitoring system is needed. Installation of carbon-14 and tritium air and water monitoring systems is of particular urgency.

Increasing energy efficiency is another important aspect of mitigating the impact of climate change. The buildings sector is a large potential source of energy savings for Belarus. More than 80 percent of the country's residential stock, and about 95 percent of the public building stock, was built before 1996. Building thermal protection standards were significantly strengthened in 1993 and updated in 2010. Pre-1996 buildings consume, on average, nearly twice as much energy per square meter as buildings constructed in the last four years. Deep thermal retrofits in these residential and public buildings could result in dramatic energy savings. Energy efficiency investments can significantly reduce budget outlays in the long term while also improving the physical assets and quality of energy services.

Similarly, increased use of renewable energy, particularly biomass, will contribute to mitigating the impact of climate change in Belarus. The sustainable use of biomass for renewable energy production is critically linked to sustainable forestry which is of paramount importance in Belarus given that the forests represent one of the largest natural resources in the country. Belarus has adopted a national plan on moving towards a green economy by 2020, which explicitly states the goal of increasing the potential of renewable energy sources and decreasing the energy intensity of GDP. Energy switching technologies, as with the forest sector, or specifically wood biomass could play an important role.

C. Risks

Downside risks to Belarus's medium-term outlook remain significant. Risks from external factors are coming from two sources. First, large external debt repayments pose a risk of a disorderly adjustment in external imbalances due to tightening global financing conditions. Although the headline current account deficits have narrowed (averaging around 4 percent of GDP over the last three years), external debt remains high at 76.6 percent of GDP. Majority of gross external debt pertains to the public sector and is characterized by a heavy and uneven debt service profile with repayment peaks every few years. The recent agreement between Belarus and Russia provides temporary relief to balance of payment pressures; but a more durable solution is needed. Second, Belarus remains vulnerable to changes in global commodity prices and in terms of its energy trade policy with Russia. Either of these developments would make it harder for the government to generate the foreign currency needed to service its debt.

Downside risks from domestic factors relate to a possibility of a disorderly unwinding of financial sector imbalances if mechanisms for addressing insolvent SOEs and NPL resolution are not put in place. Large historic lending at subsidized rates, especially in foreign currency to insufficiently-hedged borrowers, has contributed to rising shares of bad loans in the banking system and exposed banks to currency-induced credit risks. In addition, there are risks to fiscal sustainability arising from sizable quasi-fiscal deficits related to the excesses of the expansionary policies of the past. Lack of considerable improvements in the management of SOEs, reform of

energy subsidies, prudent wage policy, careful scrutiny of all planned investments, and efforts to improve tax collection could significantly undermine Belarus's fiscal and debt sustainability.

There is also a risk that recently introduced macroeconomic stabilization measures—the introduction of a more flexible exchange rate regime and reduction of government direct lending—are reversed. In such a scenario, economic resource misallocations, particularly in the financial sector, would continue to reduce the productivity of firms, the strength of financial institutions, and the confidence of consumers. In these circumstances monetary policy loses its effectiveness as even lower interest rates would not be able to trigger highly indebted companies to invest more resulting in a prolonged period of stagnation.

Upside risks could be associated with faster than projected growth of commodity prices (oil and potash) and stronger recovery of main trading partners, especially of Russia. In addition, a swift implementation of structural reforms and diversification of production and exports can directly contribute to higher medium-term growth.

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Appendix 1: Key Macro-fiscal variables, 2010-2019(F)

	2010	2011	2012	2013	2014	2015	2016	2017	2018F	2019F
	Actuals								Projections	
National Accounts										
Real GDP, % change	7.7	5.5	1.7	1.0	1.7	-3.8	-2.6	2.4	2.1	2.4
GDP per capita, US\$	6,000	6,427	6,913	7,898	8,239	5,289	4,497	5,451	6235.3	6837.3
Consumer prices, % change (December to December)	9.9	108.7	21.8	16.5	16.2	12.0	10.6	4.6	6.0	6.5
General Government Operations										
General Government budget revenues, % GDP /1	40.1	37.4	37.3	39.0	38.9	41.3	40.9	42.1	42.5	42.8
General Government budget expenditures, % GDP/1	41.8	34.7	36.5	38.8	37.8	39.9	39.4	38.9	41.9	42.0
General Government fiscal balance, % GDP /2	-1.7	2.7	0.8	0.2	1.0	1.4	1.5	3.2	0.6	0.8
Public and Guaranteed Debt, % GDP	39.5	46.0	39.1	37.6	38.8	53.0	53.9	55.3	58.1	58.9
External Sector										
Current account balance, % of GDP	-15.0	-8.5	-2.9	-10.4	-6.9	-3.7	-3.6	1.5*	-3.1	-3.0
Exports of goods and services, % change	7.7	30.4	11.2	-14.6	4.6	2.1	2.6	8.1*	5.0	6.1
Imports of goods and services, % change	12.2	18.5	10.9	-4.2	2	-10.6	-1.4	15.9*	5.4	6.3

* - data for three quarters of 2017

/1 According to Special Data Dissemination Standard

/2 Excluding quasi-fiscal activities

Source: Official statistics and World Bank Staff Projections.