The 2009 IMF Stand-By Arrangement with Belarus – why not a success?

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Abstract

The thesis analyses the 2009 IMF Stand-By Arrangement with Belarus – how successful it has been in assisting the balance of payments adjustment and how appropriate the program was in its design. By tracking the evolution of the balance of payments concept and the IMF role in its adjustment, together with the recent economic developments in Belarus, the thesis reveals the structural character of the country's balance of payments crisis and answers the questions of to what extent the characteristic features of Belarus' balance of payments crisis were factored into the program design and how proposed by the Fund macroeconomic adjustment and structural reform were intended to achieve the stated goal. By scrutinizing the Fund's statements, reviews and reports, analyzing statistical data on Belarus' macroeconomic performance and juxtaposing it with the initially programmed outcomes, the thesis answers the questions of how successful was the IMF program and what external and domestic factors determined the ambiguous progress Belarus made towards its external sustainability. It appears that despite generally positive tone of the official declarations, the SBA under review was quite far from being successful, while Belarus' current account deficit – the initial focus of the program and therefore the main assessment criterion of its effectiveness – widened further. Moreover, despite promising initiatives Belarus has not met several structural reform benchmarks, in particular, for privatization, financial sector reform and price liberalization, which are essential for the country's long term external sustainability and competitiveness. These can be explained by both stronger than expected influence of external shocks and disregarded by the Fund specifics of Belarus' economic model and political regime.

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Introduction

The topic of the thesis is a country's external sustainability in the presence of external shocks. An increasing number of countries in different parts of the world, including Central Eastern Europe (CEE) region, have been hit hard by the global crisis, which exposed them to external vulnerabilities. The world economic recession and contraction of the global demand, coupled with reversal of capital flows and restricted access to international finances, have posed the most significant threats for a country's balance of payments stability. Many of these hard-hit by the crisis countries, including Belarus, have attempted to resolve their problems by signing for external financial assistance, provided by the International Monetary Fund (IMF). After about a decade of relative inactivity following the 1997-1998 Asian financial crisis, the IMF regained its importance as an international lender of last resort, as the new round of large state loans with attached conditionality was initiated in late 2008 and early 2009.

Up until the recent crisis, the main instrument of the balance of payments adjustment mechanism for emerging markets was an exchange rate devaluation, which combined with provision of external financing allowed a country to stabilize both the current and the capital accounts in relatively short terms. The global nature of the recent economic crisis and the consequent global contraction of demand conditioned that the previous stabilization mechanism might not be feasible anymore. Against the background of globally synchronized recessions, the series of competitive devaluations might threat the financial system stability of individual countries and deepen the world economic crisis. Therefore, given the global nature of the recent economic crisis, the IMF has had to come up with a more sophisticated conditionality – mix of macroeconomic policies and structural reform developed with the aim of reducing external vulnerabilities and promoting medium-term growth in a crisis-hit country.

While Belarus had not been deeply integrated into the international financial system, the country's participation in the global economy remained mostly limited to participation in international trade. Therefore, Belarus' external balance crisis, in contrast to many countries in the CEE region (e.g. Hungary and Latvia), was mainly caused not by a sudden reversal of international capital flows, but by the contraction of external demand due to the recent world crisis and sharp terms of trade shock due to a significant reduction of the energy subsidies from Russia, preceding the global recession. Moreover, Belarus represents a specific post-Communist country in terms of both its economic model and political regime. All mentioned above facts make Belarus an interesting case study for the Fund's lending conditionality in the wider context of the IMF programs during the recent global economic crisis.

Belarus, as many other emerging economies faced a substantial external disbalance already in the pre-crisis period, however, in its case the constant current account deficit was rather a structural problem. The 'marketization' of relations with Russia started in 2006/2007, which resulted in sharp terms of trade shock for Belarus, just exposed existing structural disbalance. Therefore, Belarus needed a complex solution, which would ensure the country's external sustainability and improve its competitiveness and economic potential in the longer run.

Against this background the IMF's 2009 Stand-By Arrangement (SBA) for

Belarus will be put in the center of analysis. Within the scope of my thesis I would like to assess how successful was the IMF program for Belarus in assisting the country's balance of payments adjustment. More precisely, the purpose of the thesis is to investigate how proposed by the IMF macroeconomic adjustment and structural reform were intended to ensure Belarus' external sustainability and whether they could achieve the goal given the specifics of the country's economic model and domestic political context. Among the intermediate research questions to be answered are: (i) what were the national characteristics of Belarus' balance of payments crisis and to what extent they determined proposed by the Fund program of macroeconomic adjustment and structural reform?; (ii) what were the projections and the ultimate outcomes of the IMF program and what external and domestic factors determined the ambiguous progress Belarus made towards its external sustainability?

For the purposes of my thesis I will employ data from both domestic (National Statistical Committee and National Bank of Belarus) and external (IMF and the World Bank) sources. While the recent economic development of Belarus, the country's foreign trade patterns, and use of monetary policy instruments will be traced from mentioned domestic sources, the country's current account trends will be presented based on data from the World Bank due to the differences in methodology. Also, the comparison of the program's projections and outcomes will be based on the IMF's estimates and calculations due the lack of availability and transparency from domestic sources regarding performance criteria. The post-program developments will be also considered in order to assess the effectiveness of the IMF program.

The thesis will proceed as follows. The first chapter of the thesis will present the evolution of the balance of payments concept and the views on its adjustment mechanisms. Also it will discuss the emergence of the IMF, its mission and role in the world financial order. The second chapter will describe the recent economic development of Belarus – from the 'economic miracle' to the current balance of payments crisis – in order to reveal the the structural character and underlying causes of the recent external balance difficulties. The following chapter will present in details the 2009 IMF Stand-By Arrangement with Belarus, describing its rationale and design, following its implementation process and intermediate performance results, and assessing its effectiveness by juxtaposing the program's projections and ultimate outcomes. It will also briefly describe the post-program developments and the 2011 financial crisis in Belarus and its underlying causes. The thesis will conclude with an evaluation of the program's overall success in assisting the country's balance of payments adjustment, while appropriateness of the program's conditionality will be also assessed in light of specifics of Belarus' economic model and domestic context.

Chapter 1 – International monetary system and balance of payments adjustment mechanisms

All countries in the world, to varying degrees, are participants in the modern global economy. The intensity of this participation, the degree of integration of an individual country into the world economy may vary a lot, but there is no such a country that would not be linked with the outside world through economic interactions. The increased scale and diversity of the world economic relations are expressed, in particular, in a greater number and volume of economic transactions between the countries, and a greater impact of those transactions on the economies of individual countries and the entire world economy. The whole range of international economic and implicitly political relations of a country with the rest of the world, the nature of which depends on both domestic and external factors, is reflected in a country's balance of payments. And the international monetary system with its role in ensuring exchange rates stability and balancing external accounts, as Barry Eichengreen eloquently put it, is "the glue that binds national economies together."[1]

Following the widely popular Eichengreen's periodization of the international monetary system, in the modern era of international relations we have witnessed several periods of financial globalization and disintegration: during the classical gold standard era, since the second half of the XIX century to the beginning of the World War I, international capital mobility reached high levels; the interwar period saw the collapse of established financial system and severe decline of international capital

1 Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System*, 2nd edition (Princeton University Press, 2008), 1.

flows with the widespread imposition of capital controls and trade restrictions; the decades following the end of the World war II were marked with gradual recovery of international capital flows under the Bretton Woods monetary system, continued after its collapse in 1971 and consequent shift from fixed to flexible exchange rates, reaching the peak of international capital mobility in the early XXI century up until the recent global crisis[2].

For the purpose of my thesis, dealing with the recent balance of payments crisis in Belarus and the IMF role in solving it, below I will briefly introduce the context: the evolution of views on external balance adjustment mechanism, paying closer attention to the post war period, relevant Bretton Woods arrangements, the creation of the IMF, its role in balancing and stabilizing the world economy.

1.1. Evolution of the international monetary system and balance of payments concept

The general equilibrium model and the mechanism of setting external balances under the classical gold standard was described for the first time by David Hume in the mid XVIII century[3]. According to his price-specie flow model, gold was to flow in a country, having positive trade balance, and conversely – out of a country, having negative balance, assuming that gold or a particular currency fully convertible into gold are the only mean of international payments. In addition, it predicted the existence of self-correction adjustment mechanism, as the specie flow would result in a gradual change in relative prices, which in turn would put pressure on a country's export and import volumes. While under the gold standard, financial

2 Ibid., 1-6.
3 Ibid., 24-25.

transactions were also conducted in gold or in fully convertible currencies, the Hume's model might be applied to the entire country's balance of payments.

While the Hume's price-specie model remains to be the dominant model in thinking of the gold standard up until today, however, in light of financial globalization trend started in the late XIX century and resulted in a rapid growth of the international lending and capital flows, the central bank's interest rate policy tool should be taken into the model's consideration. Thus, the neoclassical description of the international adjustment mechanism under fixed exchange rates puts an emphasis on the interest rate's role in influencing both capital and current accounts[4].

In a general equilibrium model, described by John M. Keynes in his work "A Treatise on Money" of 1930, a particular country may balance both capital and current accounts under certain combination of price level and interest rate[5]. However, the model also predicts, that given the international capital market conditions, achieving the required for external balance price level might have very unpleasant consequences, such as e.g. high rate of unemployment for unacceptably long period of time. While the central bank of a country in deficit may increase interest rate in order to prevent gold outflow, such a movement would increase the cost of financing investment and servicing debt. Therefore, Keynes stressed the dual role of the interest rate, which influence directly the capital account and indirectly the current account through investment, employment and price level[6].

It is worth to notice here, that there was also a certain conflict between

4 Ibid.
5 M. June Flanders, *International monetary economics, 1870 – 1960. Between the classical and the new classical* (Cambridge University Press, 1989), 185.
6 Ibid.

external balance of payments and internal balance of the labour market, which, given the specifics of political systems in times of classical gold standard, was determined not in favour of the latter. As Barry Eichengreen pointed out, the fact of limited to men of property voting rights and exclusion of working class form political process, inclined the governments to unconditionally commit to fixed exchange rates and gold convertibility and maintaining external balance under existing rules of game, even at price of high unemployment. Such a tendency started to change only in the XX century with the extension of voting right to the working class men and the rise of the welfare state after the World war II[7].

As a response to the mentioned above politically sensitive tradeoff, on the eve of the Bretton Woods conference, Keynes proposed the external balance adjustment mechanism to be based rather on regulating the effective demand, than on price changes[8]. The presented by him mechanism of adjustment would work in the following way: a contraction of domestic demand in a deficit country decreases the volume of imports and increases the volume of available for export output, while domestic demand expansion is prescribed for a surplus country. In this way the external balance might be adjusted at relatively lower social costs in contrast to the painful price adjustments. As it will be discussed in the subsequent part of the thesis, presenting the conditions of the IMF stand-by Arrangement with Belarus, the Keynes' suggestion remains to be popular.

In order to understand the fundamentals of the modern international monetary system, which is still based heavily on the principles of the Bretton Woods, it is

7 Barry Eichengreen, *Globalizing Capital*..., 30.
8 M. June Flanders, *International monetary economics*..., 190-192.

necessary to briefly mention the context of its development. While after the World War I there were no multilateral efforts taken to ensure mutually beneficial peaceful cooperation, each country followed a policies what it considered to be in line with its own interests, such as e.g. competitive deflations and devaluation, which ultimately led to a global disorder and an economic hardship. As the US Secretary of the Treasury Hans J. Morgenthau stated in his opening address to the Bretton Woods conference in July 1944: “All of us have seen the great economic tragedy of our time. We saw the worldwide depression of the 1930s. We saw currency disorders develop and spread from land to land, destroying the basis for international trade and international investment and even international faith. In their wake, we saw unemployment and wretchedness – idle tools, wasted wealth.”[9]

It is worth to notice, that given the perception of inevitable reformation of the post WWII international monetary order, the Bretton Woods system was initially developed with the aim to avoid the mistakes of the post Versailles international system, however, was not the first proposition on coping with the chaos in the interwar international monetary relations. Thus, in July 1940, Walther Funk, German Minister for Economic Affairs and President of the Reichsbank, outlined a plan for the reconstruction and reorganization of the post war European economy, called the “New Order”[10]. The New Order would stabilize the European currencies' exchange rates in relation to the Reichsmark, while the old laissez-faire currency arrangements, prevailed under the gold standard, would be eliminated. According to the German plan, the existing at that time method of bilateral economic relations

9 Cited in Armand Van Dormael, *Bretton Woods: Birth of a Monetary System* (London: The Macmillan Press LTD, 1978), 1.
10 Ibid., 5-11.

would be substituted by a system of multilateral trade, with external balances to be settled through the foreign exchange clearing.

The "New Order" plan, proposed by Nazi Germany, constituted a certain challenge for the Allies plans of the post war economic reconstruction. Thus, already in April 1941, John M. Keynes, the head of the British delegation to the Bretton Woods conference, proposed a plan, which would restrict international capital movements unless the country from which capital was moving having a favourable balance with the country to which the capital was moved, while the ultimate goal of a plan would be "trading goods against goods"[11]. This meant that each trading transaction must necessarily find its counterpart in the reverse trading transaction within a given period, and at the same time, central banks of an individual countries were required to adjust their exchange rates in accordance with their balance of payments position, while the surplus would be transferred to the reserve fund of the international clearing bank. The International Currency Union, proposed by Keynes, would be based on international bank money, called "bancor", to be accepted as the gold equivalent by all member states for the purposes of ensuring external balances[12].

At that time, the Keynes' plan for the post war international economic reorganization, despite its apparent goodwill and solid theoretical foundation, was perceived to be too ambitious and sometimes even utopian, while its aims and purposes were much broader and more comprehensive than those finally accepted in the Bretton Woods[13]. For example, described above mechanism of international

11 Ibid., 8-9.
12 Ibid., 36.
13 Ibid., 34-35.

balance adjustment was based on unlikely assumption, that the surplus countries would be willing to continuously subsidize the deficit ones, transferring their unspent surpluses to the international clearing bank, especially taking into account the fact than the biggest surplus country was the US. Nevertheless, towards the end of the Bretton Woods conference the strong awareness of its significance prevailed, while John M. Keynes formulated in his closing remarks the general feeling of confidence in the post-war future: “We have shown that a concourse of 44 nations are actually able to work together at a constructive task in amity and unbroken concord. Few believed it possible. If we continue in a larger task as we have begun in this limited task, there is hope for the world.”[14]

1.2. International Monetary Fund and its role

The IMF was created as a part of the Bretton Woods arrangements in 1944 with the original aims to facilitate international trade, provide a forum on international monetary cooperation, stabilize the system of fixed but adjustable exchange rates and ensure stability of international payments system in the aftermath of the World War II[15]. By setting up a stable international monetary system, participating countries were intending to eliminate mutual distrust and enmity, and thus, to foster peaceful coexistence and cooperation between them in the post war reality[16]. While under the classical gold standard a country with external deficit might increase interest rate, which would ultimately decrease demand for imports, but at the expense of growth and employment, under the Bretton Woods system, this was not feasible anymore,

14 Ibid., 2.
15 International Monetary Fund, What We Do, http://www.imf.org/external/about/whatwedo.htm
16 Armand Van Dormael, *Bretton Woods*..., op. cit.

as growth and employment were much desired in the post war reality.

Upon entering the Fund, in accordance with the relative size of the economies, each country's quota was alloted, 25 percent of which to be paid in gold and 75 percent – in own currency. The initial amount of quotas was about USD 8 billion, which amounted to approximately 20 percent of world reserves. In this way countries contribute to a pool fund, from which countries with external payment imbalances can borrow in case of need. The size of a particular country's quota determined the borrowing limit of that country.

The prime function of the IMF was to provide a hard-currency loans to governments with external imbalances, that might otherwise have to devalue its currency in order to restore the balance or have put their economies temporarily into recession to maintain a fixed exchange rate[17]. With the collapse of the Bretton Woods system, however, the scope of Fund's aims dispersed significantly and shifted towards fostering global monetary cooperation, securing financial stability, facilitating international trade, promoting high employment and sustainable economic growth, and reducing poverty around the world[18].

Nowadays the IMF consists of 188 member states, which are contributing finances to the Fund's pool, from which in case of need countries can borrow, as it was initially envisaged. The quota system determines also distribution of voting powers among nations. Due to the size and strength of their economies, the G-5 group of countries – France, Germany, Japan, the United Kingdom, and the United

17 Maurice Obstfeld, Alan M. Taylor, *Globalization in Historical Perspective* (University of Chicago Press, 2003), 132.
18 International Monetary Fund, About the IMF, http://www.imf.org/external/about.htm

States – have been the most influential ones as regards the Fund's policy decision-making process. However, recently, the IMF started to implement set of reforms in its quota system, gradually shifting voting powers to under-represented emerging market and developing countries[19].

Even though that relative to the size of world economy, the IMF has shrunk significantly since 1945, the Fund acquired certain important lender of last resort functions for many developing countries tn the post Bretton Woods international financial system[20]. The IMF's lender of last resort function, by analogy with national financial system generally means, that it can offer a credit to a country in times, when no other lender is either capable of lending or willing to lend. The existence of the lender of last resort in the international financial system, however, implies a 'moral hazard' problem – availability of the IMF's financial resources and its technical assistance in case of balance of payments crisis makes such a financial crisis more likely to happen. However, given that nearly all the IMF loans were repaid in full, the importance of the moral hazard element seems to be overestimated by many scholars[21].

The primary function of the International Monetary Fund in today's world financial system is to provide loans to the countries, facing external payments imbalances. However, in order to make the IMF program successful, financing itself is not enough – it must be accompanied by the recipient country's efforts to cope the

19 International Monetary Fund, “IMF Executive Board Approves Major Overhaul of Quotas and Governance”, Press Release No. 10/418, 5 November 2010.
20 Stanley Fischer, “*On the Need for an International Lender of Last Resort*”, The Journal of Economic Perspectives, Vol. 13, No. 4, Autumn 1999.
21 Kenneth S. Rogoff, “*Moral Hazard in IMF Loans. How Big a Concern?*”, Finance & Development, A quarterly magazine of the IMF, 39/3, September 2002.

underlying causes of its balance of payments problem. Thus, the IMF loans go with set of conditions attached and can be provided only if the recipient country's authorities commit to necessary policy changes and structural reforms[22]. While the fund is not a charity organization, such conditionality serves as a safeguard, that the lent money are used for the initial purpose of structural adjustment, and that the recipient country consequently will be able to repay its debt.

While initially the IMF conditionality was largely limited to policies affecting macroeconomic aggregates, such as controlling domestic credit expansion and reducing government deficits, since the 1980s the range of structural policy conditions attached to the Fund's loans have become much broader[23]. Among the most unpopular structural adjustment measures imposed by the IMF are: cuts in government spending, domestic currency devaluation, decrease in real wages, reduction of subsidies, privatization of state-run enterprises and elimination of trade barriers, which involve direct or indirect harm for certain groups of the society.

Given the distribution of voting powers in the Fund, one can state, that the IMF conditionality allows the wealthier developed countries to dictate economic development programs for the poorer developing countries through controlling the lending policies and conditions attached to the loans. Certain stringent conditions imposed by the Fund have become a source of criticism by many developing countries, while the required structural reforms may cause a short-term economic hardships coupled with social and political instability[24]. However, despite the

22 Masood Ahmet, Timothy Lane, Marianne Schulze-Ghattas, "*Refocusing IMF Conditionality*", Finance & Development, A quarterly magazine of the IMF, 38/4, December 2001.
23 Ibid.
24 John T. Rourke, *International Politics on the World Stage*, 10th edition (Mcgraw-Hill

criticism, developing countries, facing the balance of payments problem, continue to apply for the IMF's programs, as there are very few alternatives for obtaining external funding available, especially in times of global credit crunch.

After about a decade of relative inactivity following the 1997-1998 Asian financial crisis, the IMF regained its importance as an international lender of last resort in light of increased external vulnerabilities and constrained access to the international capital due to the recent global economic crisis. Since the new round of large state loans initiated in late 2008 and early 2009, the IMF has developed a more flexible approach to crisis management in particular borrowing member states[25].

Higher Education, 2004).

25 Andre Broome, "*The International Monetary Fund, crisis management and the credit crunch*", Australian Journal of International Affairs Vol. 64, No. 1 (February 2010), 37-54.

Chapter 2 – Belarus' recent economic developments and the nature of external payments crisis

Since the very beginning of its independent existence, Belarusian have remained greatly dependent on Russian market and, most importantly, energy supplies. As Belarus posses very limited amount of domestic primary energy resources, it relies heavily on imported energy resources. Up until the recent tensions in relations with Russia, the price of natural gas for Belarus was equal to the European-part regions of Russian Federation and the export duties for Russian oil were not applied to Belarus. Consequently, under such preferential mode of energy supplies, throughout the second half of the 1990s and the late 2000s, Belarus achieved what is called the 'economic miracle', providing its citizens with constantly growing incomes, but at the same time the country's external stability became unsustainably dependent on energy supplies from Russia. Therefore, as it became apparent, for a long time Belarus have used to live above its means, relaying excessively on the implicit subsidies.

The energy-political model of relations with Russia, discussed below, provided Belarus with exceptionally beneficial terms of energy supplies from Russia, compared to any other country – the level of economic preferences was unprecedented for an independent state. Customs Union, as a part of broader political arrangements, allowed Belarus to get preferential access to huge Russian market, to purchase Russian energy resources at prices considerably lower than other neighbouring countries.

Until the recent economic crisis, Belarus has been considered as a example of successfully developing post-Soviet economy. Such assessment could be argued by high and stable economic growth since 1996[26] and by relatively high living standard of the majority of the population comparing to other CIS countries. At the same time, according to the UNDP reports, Belarus have been leading among the CIS member states in terms of the human development index[27]. After the collapse of the Soviet Union, Belarusian authorities decided not to follow the widely accepted path of shock therapy and mass privatization and chose the path of evolutionary economic reforms, preserving administrative control over the country's economy. Thereby, the Belarusian economic model proved that there are at least few possible ways of progressive economic development on the post-Soviet area. However, as the recent economic and external balance crisis shows, the necessary steps for ensuring economic sustainability were not taken during the boom years.

2.1. The fall of the Soviet economy. Dependence on Russia

Prior the World War II Belarus was largely agrarian and relatively poor country on the periphery of the Russian Empire and consequently the Soviet Union. However, in the period from 1960 through 1985, industrialization in Belarus proceeded much more rapidly than in any other Soviet republic – hundreds of large factories were built. Having become one of the Soviet Union's main industrial centers, Belarus was known as the 'assembly plant of the USSR'. Transport and agricultural machine-building, production of chemicals and light industrial goods were the most developed branch of the country's industry, in addition to strong

26 Over the last 15 years, Belarus has redoubled its GDP and was the first among the CIS countries to reach up the GDP level of 1990.
27 Ministry of Foreign Affairs of the Republic of Belarus, http://www.mfa.gov.by/en/organizations/un/hdi/

microelectronics and high-tech sectors[28].

Only a small part of the economy was oriented toward domestic needs, while the majority of the goods produced in Belarus were distributed on the huge Union's common market[29]. Thus, the GDP per capita growth rates in Belarus were higher than of most other Soviet republics, while positive external trade balance of Belarus with the rest of the Soviet Union was estimated at USD 2.5 billion in 1991 alone[30].

The payments system in the USSR was not base on market discipline, as the political system implied vertical fiscal redistribution between the Union's budget and the budgets of particular republics – apart from the direct financial transfers, an implicit trade subsidies existed in a sense that importers of overpriced goods subsidized exporting republics while the exporters of underpriced goods subsidized importing republics[31]. According to the 1990 study by the Central Statistical Office of the USSR, shortly before the collapse of the Soviet Union, the Belorussian an SSR had a privileged net recipient position with the rest of the Union, benefiting both from underpriced imports of oil and gas and overpriced exports of non-oil and gas products[32]. Given that for a certain sectors the domestic and world price levels differed by some 300 percent, with the Soviet Union disintegration and foreign trade liberalization the mentioned above solid trade surplus of Belarus turned out to be a

28 Leonid Zlotnikov, "*The Belarusian 'economic miracle' – illusions and reality*", in ed. Sabine Fischer, *Back from the cold? The EU and Belarus in 2009*, the European Union Institute for Security Studies, Chaillot Paper No 119 (Paris: November 2009), 66-67.
29 E.g. according to Zlotnikov, 60 percent of the computers sold in the Soviet Union were manufactured in Belarus.
30 Leonid Zlotnikov, The Belarusian 'economic miracle'..., op. cit., 66-67.
31 The comparison of the inter-Union and the world prices might be quite incorrect in case of manufactured goods, however, it might be very useful in case of energy and natural resources, agricultural products and food.
32 Marek Dąbrowski and Rafał Antczak, *Economic transition in Russia, the Ukraine and Belarus in comparative perspective* (Warsaw: CASE, 1995), 8-13.

factual deficit[33].

Relative prosperity of Belarus and effectiveness of its economy were possible to achieve due to the republic's economy integration into the common Soviet market. Thus, not only a huge common market for Belarusian industrial goods was essential, but also Belarusian industrial complex was greatly dependent on regular deliveries of raw materials and energy resources from different parts of the Union by the central plan at non-market terms. Therefore, with the dissolution of the Soviet Union and marketization of relations within the post Soviet area, Belarus lost its preferential access to the huge common market and to the abundant raw materials and energy resources base.

After the disintegration of the Soviet Union and and the liberalization of foreign trade, it became apparent that competitiveness of Belarusian economy in world market was remarkably low, given the extreme level of the economy's energy intensity. The energy inefficiency was inherited from the Soviet times, when this issue was obviously out of consideration, given the Union's abundance in energy resources. While most of the old-generation Belarusian leadership's efforts were put in obtaining of energy concessions from Russia and restoration of favourable conditions of market access, the issues of the economy's energy efficiency, modernization and attracting foreign direct investments were left without enough attention. As it will be discussed below, the Belarusian economy's energy inefficiency will be among the main reasons contributing to negative external balance of Belarus in the late 2000s, when the preferential model of relations with Russia have started to collapse.

33 Leonid Zlotnikov, The Belarusian 'economic miracle'..., op. cit., 66-67.

The loss of well-established economic ties, liberalization of foreign trade and slow pace of market reforms caused significant economic downturn during the early transformation stage in Belarus: throughout the 1991-1995 period GDP per capita dropped by 35 percent, industrial and agricultural output – by 39 and 45 percent respectively[34] (see also the Belarusian GDP growth chart below for the dynamics of slowdown). At the same time external debt of Belarus started to accumulate intensively, even though Russia assumed full responsibility for external assets and liabilities of the former Soviet Union. At the end of 1995, the total country's external public debt amounted to almost USD 2 billion, 24 percent of which Russia, 49 percent – to individual OECD creditors, 27 percent – to the IMF[35]. However, if to consider USD 900 million of Belarusian enterprise payment arrears for energy imports from Russia, which were transformed into long term public debt, Russia alone held nearly half of the Belarus' external debt[36].

Shortly after the disintegration of the Soviet Union, Russia, being net creditor country with all the others republics, began to use the settlement system to manage its external payments imbalances, however, overdrafts of other post Soviet republics were so high, that in the mid 1992 the Central Bank of Russian Federation established limits on payments imbalances. The so-called technical credits were supposed to be repaid through deliveries of goods, but already in 1993 rapidly growing amount of technical credits convinced the Russian authorities to halt further financing and convert technical credits into the official debt of newly independent

34 Leonid Zlotnikov, The Belarusian 'economic miracle'..., op. cit., 66-67.
35 Sergei Shatalov, "*The Sustainability of External Debt*", in A World Bank Country Study. *Belarus: Prices, Markets, and Enterprise reform* (Washington: 1997), 211.
36 Ibid.

states[37].

In the light of severe terms of trade shock, Belarus accumulated also a substantial amount of debt on commercial terms to the mentioned above IMF and bilateral OECD creditors (in particular, Germany)[38]. However, given the magnitude of the economic downturn of the early 1990s, Belarus' ability to service needed amount of external debt on commercial terms might be questionable. Therefore, preferential terms of financial support from Russia (such as e.g. consolidation of enterprise arrears into long term public debt at zero interest rate in 1993 and allowing debt servicing in kind[39]) somehow softened the economic hardship in Belarus and allowed it to go through those vulnerable times with less losses that most of the other post Soviet republics.

Belarus inherited from the Soviet Union a highly industrialized economy, which at the very beginning of independent existence became a drag on the country's economy, as more and more factories and the entire industrial sectors ceased being profitable in light of the new post Soviet reality. With the liberalization of foreign trade, many Belarusian industrial goods appeared to be uncompetitive on the European market, while even gradual increase in energy prices was unaffordable for a highly energy-intensive Belarusian enterprises. Facing the need of much painful economic restructuring and taking into account the fact of absence of essential stocks of natural and energy resources and importance of Russian market for the country's industrial sector, newly elected independent Belarusian authorities decided to re-

37 Marek Dabrowski and Rafal Antczak, Economic transition in Russia..., op. cit., 13.
38 Sergei Shatalov, The Sustainability of External Debt, op.cit., 211-214.
39 Ibid.

establish close political and economic ties with Russia[40].

2.2. The Belarusian 'economic miracle'

Immediately after the disintegration of the Soviet Union the goal was to escape from imposing barriers in trade with its main trading partner, thus, in November 1992 Russia and Belarus signed the Free Trade Agreement, which in January 1995 was completed by two new deals – protocol on the implementation of free trade principles without exceptions and restraints and the Agreement on the Customs Union. Since 2002 Belarus and Russia have been engaged in an effort to build a common economic space, both bilaterally and multilaterally, while the latter path proved to be more successful[41].

Creation of the Customs Union in 1995 enabled Belarusian goods to enter Russian market duty-free and to receive gas and oil supplies at the Russian internal market prices. This allowed Belarus to avoid (or rather postpone) a painful but inevitable otherwise restructuring of the economy, with possible deindustrialization process in some sectors. Also the share of Russian gas in the country's total primary energy supply increased from 37 to 61 percent during 1992-2005[42], which posed a threat to the country's energy sustainability. While cheap natural gas supplies from

40 It is worth to notice here, that this strategic decision was determined by Belarusion people's will, as the result of the first 1994 presidential elections in Belarus, regarded by international observers and the OECD as free and fair, just reflected electorate's great disappointment with the new post Soviet reality, while candidate Lukashenka in his program promised restoration of the Soviet times stability through Belarus-Russia integration.

41 Common Economic Space of Belarus, Kazakhstan and Russia was launched in 2010.

42 Source: International Energy Agency, in Alexander Zaborovskiy, "*Belarusian Energy Strategy Today: Improving Energy Efficiency, Reducing Energy Dependence and Insuring Gas Transit to the EU*", International Association for Energy Economics, 2011, 31-35.

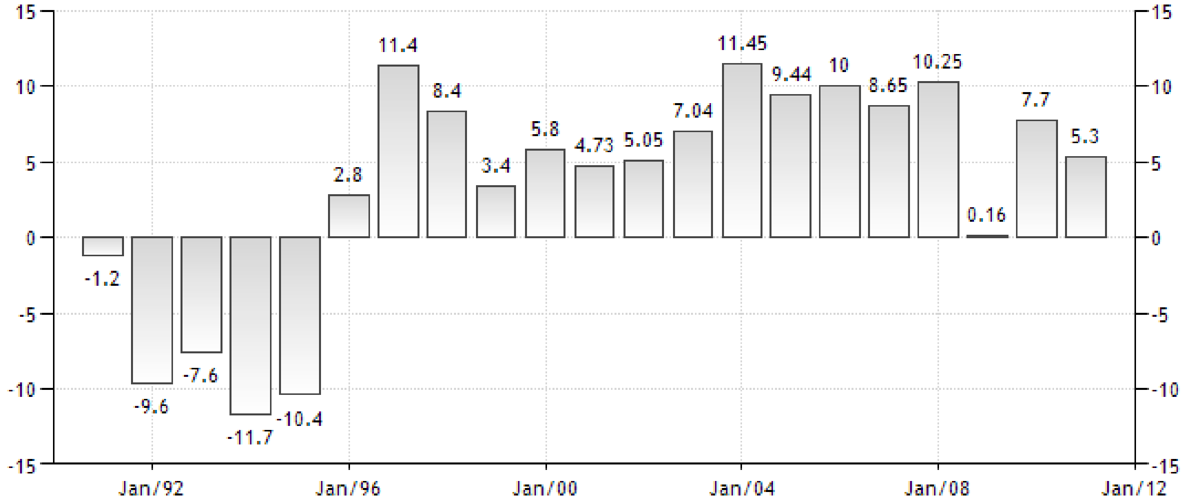
Russia guaranteed the vital level of competitiveness for obsolete Soviet- time Belarusian enterprises, crude oil after processing at Mazyr and Navapolatsk oil refineries was re-exported with high profits to the West. Up until recent tensions in Belarus-Russia relations, described below, the re-export of petroleum products to the Western European countries become one the main export position of Belarus – e.g. in the peak 2006 year out of 21 million tons of imported crude oil, only 6 million tons were consumed domestically and the remaining 15 million tons were reexported mainly to Western Europe. This allowed Belarus to balance its external payments, given constant trade deficit with Russian Federation[43].

Moreover, when Belarus repeatedly failed to pay its gas bills on time, those disputes usually ended by Russia making concessions to Belarus by regularly clearing its gas debts. Thus, in February 1996 Russia virtually wrote off Belarusian arrears for energy imports worth of USD 1.37 billion, which were equivalent to about 8 percent of the country's GDP at the moment[44]. The year 1996 became also the turning point in the dynamics of Belarusian GDP growth.

43 National Statistical Committee of the Republic of Belarus, http://belstat.gov.by/homep/en/indicators/ftrade1.php

44 Sergei Shatalov, The Sustainability of External Debt, op.cit., 211-214.

Chart 1: annual GDP growth in Belarus as % to the previous year[45]:



As we can see from the chart, the major factor influencing economic growth in independent Belarus was the country's preferential relations with Russia, especially after the creation of the Customs Union in 1995. After a slowdown of the growth rates during 1999-2002, reflected the 1998 financial crisis in Russia, economic growth continued to increase at impressive average 10% throughout 2004-2008, up until the recent economic crisis, discussed below. Thus, one can state, that Russia's energy supply subsidies enabled Belarus to emerge from recession of the first half of the 1990s and to a large degree stimulated its sizable and stable economic growth during 2000s, making a substantial contribution to the so-called Belarusian 'economic miracle' up until the recent economic crisis.

According to the 1997 calculation, Russian implicit subsidies to Belarus amounted to some USD 1.5–2 billion, or the equivalent of 9-12 per cent of Belarus' GDP at that time[46]. Taking into account the concessions on the price of natural gas

45 Source: World Bank data, in Trading Economics, http://www.tradingeconomics.com/belarus/gdp-growth-annual
46 Andrej Illarionov, "*Kak nam reorganizovat Rosbel?*", Ekspert no. 41 (Moscow: October

and duty on oil exports for Belarus, Vladimir Putin estimated the scale of subsidizing of Belarusian economy at the level of USD 5.8 billion in 2007, including USD 3.3 billion – due to the supplies of natural gas at prices below world level, and USD 2.5 billion – by reducing the export oil duty[47]. Earlier the IMF's report estimated the figure at the same level, stating that in 2004 preferential prices of Russian energy resources subsidized Belarusian economy to the effect of 10 percent of the country's GDP[48].

While it is quite difficult to accurately estimate the amount of money that flowed into Belarus due to the Russian gas and oil subsidies within the "Union State" framework due to some loopholes in the Customs Union, it is reasonable to say, that preferential economic relations with Russia enabled Belarus to emerge from the early 1990s recession and to a large degree stimulated its sizable and stable economic growth since the creation of the Customs Union, while ensuring its external stability, allowing to live above the country's means up until the recent crisis.

At the same it is important to see the negative impact of the Russian preferences, emphasized by the ex head of the National Bank of Belarus Stanislau Bohdankevich[49]. While shortly after the fall of communism in Europe, the pressure of external competition put other Central and Eastern European countries on the path of liberal transformation, preferential relations with Russia delayed the necessary reformation of the Belarusian economy. The country's authorities concentrated most

1997), 26.

47 Elena Novozhilova, "*Putin podschital ubytki Rossii*", BelaPAN, 9 January 2007.

48 International Monetary Fund, "*Republic of Belarus: Selected Issues*", Country Report no. 05/217, June 2005.

49 Stanislau Bohdankevich, "*Belarus-Russia: Independence and Economic Interests*", Paper presented at the Conference "*Belarus and the 'Big Europe': problems and perspectives*", March 2007.

of the efforts on obtaining cheap Russian energy resources and on distribution not enough competitive products on the large growing Russian market, rather than on a restructuring of the economy, attracting foreign direct investments and technological modernization, including reduction of energy intensity of the economy.

The huge Russian subventions (amounted to roughly 10 percent of the Belarusian GDP) were mostly directed towards social and non-production aims, increasing disproportionately the real incomes of the country's population, which grew almost 2 times faster than labour productivity[50]. Excessive, relatively to the economy's rate of growth, real income growth resulted in an increased demand for imports and foreign exchange, needed both to finance the imports and to hold private savings. While enormous energy subventions guaranteed the stable economic growth and growing real incomes in Belarus, the external sustainability of the country's economy were not regarded with a proper caution and respect. In this way the illusion of economic miracle was created.

While with gaining independence, Belarus, as any other post communist country, faced a choice between the strategy of radical market reforms and preserving the administrative methods of economic management, the latter strategy required external support, which came in the form of preferences from Russia. This very specific energy- political model of relations, which Belarus and Russia developed within the Union State and the Customs Union framework, is ironically and eloquently characterized by commentators as “gas and oil in exchange for kisses”[51]. It provided Belarus with a serious economic concessions (primarily

50 Ibid.
51 Aleksandr Klaskovskiy, BELAPAN (Minsk, December 2010).

preferential terms of gas and oil supplies), while Russia gained Belarusian geopolitical loyalty and promises of further integration. Belarusian authorities were able to maintain such an advantageous model of relations with Russia due to unique political and military-strategic significance of the country, as Belarus found itself in the position of "Moscow's last ally"[52].

Thus, Belarusian authorities were able to ensure the fulfillment of the social contract and to avoid a painful restructuring of the country's economy by re-establishing lapsed economic ties and obtaining energy preferences from Russia, but did it at the expense of technological and productivity gap and inefficient allocation of resources. Therefore, tempo of transformation process of Belarusian economy was much more slower than of other countries with economies in transition, especially in comparison with Central European and Baltic States[53]. The low price of energy supplies from Russia and profitable resale of refined petroleum products for a long time allowed Belarusian authorities to maintain low production costs, ensure stable and sizable economic growth and allocate considerable money for the social obligations of the state, and what is more important from the perspective of the thesis, maintain the country's external balance at sustainable level.

52 Margarita M. Balmaceda, "*At a crossroads: the Belarusian- Russian energy-political model in crisis"*, in *Back from the cold? The EU and Belarus in 2009*, edited by Sabine Fischer, The European Union Institute for Security Studies, Chaillot Paper No 119 (Paris, November 2009).

53 Stanislau Bohdankevich, *Belarus-Russia*..., op. cit.

2.3. The balance of payments crisis and its causes

The status quo, preserved up until the end of 2006, when Russian authorities, not seeing any greater commitment from the Belarusian side to deepen the integration within the Union State framework[54], decided to use their most powerful lever of influence over Belarus, namely increase in the price of energy supplies. In November 2006 the Russian ambassador in Minsk, Alexander Surikov, expressed the quintessence of announced before by Vladimir Putin redefinition of Russian-Belarusian relations: "when a Union State is created, all such questions like gas prices increase will be taken off the agenda. We do not intend to pay only for a Belarusian promise to join the common state"[55]. It is worth to stress, that as one of the conditions for joining the WTO, Russian authorities undertook the obligation to gradually increase domestic energy prices, as well as marketize its economic relations with the post-Soviet countries[56]. Therefore, the terms of trade shock was rather inevitable.

The marketization of relations implied elimination of implicit subsidizing of Belarusian economy and also prevention of duty free petroleum products re-export. According to the deals, since 2007 the gas price would rise steadily until it would reach average market rate for the region in 2011 with a lowering factor of 0.67, 0.8 and 0.9 in the years in between respectively, while at the same time a duty on oil

54 At the time creation of monetary union controlled by Moscow and issue of privatization in Belarus were on the table, as Belarus was one of the few post Soviet countries awaiting large scale privatization.

55 Cited in Wojciech Konończuk, *Belarusian-Russian Energy Conflict: The Game Is Not Over*, Batory Foundation (Warsaw: January 2007).

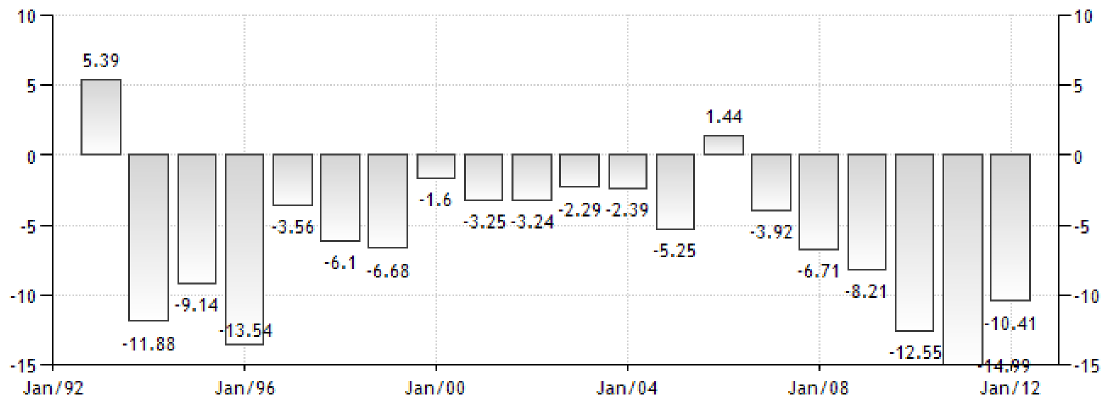
56 Stanislau Bohdankevich, *Belarus-Russia*..., op. cit.

exports to Belarus, diminished from initially proposed USD 180.7 to USD 53 per ton of crude oil, was imposed[57]. Despite the fact, that two countries found the way to somehow soften and delay the economic shock (as Belarus was the only post-Soviet state to be offered a gradual transition to European gas prices set in advance), such new Russian approach significantly undermined the factors of economic growth and external stability in Belarus.

However, rapid destabilization of the economic situation in Belarus, caused by the mentioned terms of trade shock, could threat political stability in the country, which may have uncertain consequences for the Russian long-term interests in Belarus. Therefore, in order to refrain from contracting the living standard in Belarus, and thus, to prevent an eventual situation of uncontrolled political change in the country, in the same year of 2007 Russia and Belarus signed an intergovernmental agreement to grant the latter a USD 1.5 billion stabilization loan and a USD 2 billion loan in the next two years[58].

57 Tatiana Manenok, "*Belarus – Russia: Dependency or Addiction?"*, Heinrich Böll Stiftung (Warsaw: 2010).
58 Wojciech Konończuk, *Difficult Ally: Belarus in Russia's foreign policy* (Warsaw: CES, September 2008).

Chart 2: Belarus' current account as % of GDP[59]:



As the chart illustrates, Belarus run constant current account deficit since the very beginning of its independent existence, while the positive balance in the years 1992-1993 may be explained by the lag between political and economic disintegration. Following the early 1990s difficulties, caused by the disintegration of the common Soviet market, and increased current account deficit, caused by the 1998 financial crisis in Russia, Belarus achieved relative sustainability of the current account during the first half of the 2000s. After achieving a surplus of 1.4 percent of GDP in 2006, the country's current account went into significant deficit, as the discussed above 2007 energy deal with Russia and the consequent worsening of terms of trade for Belarus – lost competitiveness due to higher gas prices and lost profit by introducing an oil export duty – were immediately reflected in the country's current account dynamics. As it will be discussed below, despite the 2009-2010 IMF stand-by program for Belarus, the trend remained unchanged and the current account deficit increased to 15 percent of the country's GDP in 2011 due to a number of domestic factors and deeper than expected recession in the main trade

59 Source: World Bank data, in Trading Economics, http://www.tradingeconomics.com/belarus/current-account-to-gdp

partners of Belarus – Russia and the EU.

Given the level of energy intensity of Belarusian economy – e.g. in 2008 Belarusian economy used 2.5 times more than Lithuania and almost 3 times more than Poland tons of oil equivalent to produce the same given amount of GDP[60] – preferential price for Russian natural gas ensured the vital level of the Belarusian economy's competitiveness, being the main determinant of the economy's stable performance. While taking into account the structure of Belarusian exports – e.g. in 2007 resale of oil and petroleum products accounted to over 35% of total exports[61] – difference between price of Russian crude oil for Belarus and European price for petroleum products was the main source of the country's external stability, providing also foreign exchange to cover growing import expenditures. In this way the dynamics of Belarus' current account deficit since 2007 illustrates the importance of the Russian preferential terms of energy resources supply for Belarus' external payments stability.

The analysis of the Central-Eastern European countries in transition, which are mostly comparable to Belarus, shows that the deeper a country was integrated into the world economy both via trade and capital flows, the harder it was hit by the recent global financial crisis. As Belarus until recently remained relatively uninvolved into the global financial order, its dependence on the global economy was mostly determined by participation in the world trade[62]. Given the rigid demand for imports,

60 International Energy Agency, *Key World energy statistics 2010*, cited in Mykhaylo Salnykov, "*A Multidimensional Approach to Energy Security in Belarus*", Policy Brief, Forum for Research on Eastern Europe and Emerging Economies (BEROC, 2011).

61 Source: National Statistical Committee of the Republic of Belarus, in Stanislau Bohdankevich, *Belarus-Russia...*, op. cit.

62 Dzmitry Kruk, Robert Kirchner, Ricardo Giucci, "*The international financial crisis and Belarus: Risks and policy implications*", IPM Research Center, German Economic Team,

increased disproportionately during the preceding boom years in Belarus, and taking into account the economy's reliance on cheap energy and its export structure, the variation in the country's current account are to a great extent determined by the trend of its external trade balance.

As the National Bank of Belarus and the World Bank statistics prove – the data differs somehow due to different methodological approach, but the trend is clear – the external trade account of Belarus was moving together with the current account in response to the same factors, while a somehow higher external trade deficit since early 2000s was compensated by services trade surplus, primary and secondary income surpluses in the current account in a different proportion depending on the year[63]. After achieving an external trade balance in 2005, the total external deficit grew rapidly throughout 2006-2010, reaching enormous level of 13.6 percent of the country's GDP (about USD 9.6 billion) in 2010.

If to take a closer look at the recent years Belarusian external trade deficit, i.e. to compare the total balance of payments of Belarus with the country's balance of payments with Russia alone, an interesting tendency becomes apparent: in the period under consideration, trade deficit with Russian Federation alone was constantly higher, than the total external trade deficit[64]. This fact proves the suggestion, that the major factor influencing the country's stable economic performance and external balance stability was a specific energy-political model of

Policy Paper Series PP/03/2008 (Minsk, July 2008).

63 National Bank of the Republic of Belarus, External sector statistics.

64 National Bank of the Republic of Belarus, *Balance of Payments of the Republic of Belarus for 2006 – 2011*, *Balance of Payments of the Republic of Belarus with the Russian Federation 2005 – 2011*. http://nbrb.by/engl/statistics/BalPay/; http://nbrb.by/engl/statistics/BalPayBelRus/

relations with Russia, started to collapse since the year 2007.

Thus, the main reason for the extreme level of Belarus' external balance deficit since 2007 have been worsening of terms of energy supplies from Russia, due to the new approach in bilateral relations, discussed above. While this negative impact was further reinforced by decrease in global demand mainly for Belarusian petroleum products and industrial goods on European and Russian markets respectively, caused by the recent global economic crisis and the consequent contraction of global demand.

Chapter 3 – The IMF Stand-by Arrangement with Belarus

3.1. The program's rationale and design

During the boom years of impressive economic growth the Belarusian authorities did not take appropriate steps to address external vulnerabilities, hoping that a favourable external conditions will last forever. The main reason for Belarus' balance of payments crisis started in 2007 was the new approach in Belarus-Russia relations, resulted in worsening of terms of trade for Belarus due to increased prices of energy supplies and introduction of export duties on petroleum products. The negative impact of the lost preferences was further reinforced by contraction of global demand, especially for Belarusian petroleum products on European market and industrial goods on Russian market, caused by the recent world economic crisis.

Therefore, the country's authorities faced an urgent need to attract huge amounts of external capital to absorb the energy shock and to restore the external payments balance in the longer run. Consequently, in November 2008, Belarus reached an agreement with Russia for USD 2 billion stabilization loan and received a state loan of USD 500 million from Venezuela in the next month. At the same time negotiations with the International Monetary Fund were initiated with the aim to cover the external financing gap, projected for the following few years and to ensure external sustainability and economic growth in the longer run.

Already on October 22, 2008 the IMF Managing Director Strauss-Kahn stated that the Fund mission will begin discussions with the authorities in the next few days on a program, while the amount of Fund financing under a Stand-By Arrangement has yet to be determined.*[65]*

Initially Belarus requested USD 2.5 billion (about SDR 1.6 billion or 419 percent of the country's quota) stand-by loan, involving exceptional access procedure, i.e. fulfilling the criteria of (i) exceptional balance of payments pressure, (ii) sustainable debt position, (iii) access to private capital markets and (iv) strong policy reform program[66]. Consequently, as soon as in January 2009, the IMF Executive Board gave final approval to a stand-by arrangement of USD 2.46 billion, which was issued to finance a 15-month program in support of the effort to reform the country's economy[67]. Getting ahead, in June 2009 the IMF, following the first review of Belarus' performance under the program, increased the amount of the stand-by arrangement by additional USD 1 billion to the total amount of USD 3.52 billion[68].

In line with the conventional procedure, at first the Belarusian authorities outlined its program of economic reforms, which incorporated an exchange rate adjustment, fiscal and incomes policy adjustments, transformation and modernization of the state banking sector and policies to improve the country's business climate, while the key program's objectives were to facilitate an orderly adjustment of the country's economy to external shocks and to reduce its exposure to those external vulnerabilities[69]. Also the Belarusian authorities agreed on a need of a broad-based structural reforms in order to liberalize the country's economy, and

65 International Monetary Fund, Press Release No. 08/255 (IMF, 22 October 2008).
66 International Monetary Fund, "*Republic of Belarus: Request for Stand-By Arrangement - Staff Report*", Country Report 09/109 (Washington: IMF,April 2009), 26.
67 International Monetary Fund, Press Release No. 09/05 (IMF, 12 January 2009).
68 International Monetary Fund, Press Release No. 09/241 (IMF, 29 June 2009).
69 International Monetary Fund, Country Report 09/109, op.cit., 1.

thus, strengthen its competitiveness and ensure the medium-term growth[70].

The IMF stand-by program provided Belarus with relatively cheap money at LIBOR+0.75% interest rate[71], however, Belarusian authorities in turn agreed on implementation of a set of economic reforms – the IMF's conditionality, which contained a number of macroeconomic adjustment measures and addressed a number of structural issues.

According to the IMF officials, strong liberalization and structural reform efforts, together with greater availability of external finance, would help Belarusian authorities to cope with balance of payment crisis and increase the country's growth potential[72]. While the full scope of proposed liberal structural reforms would be possible to implement within the next several years, achievement of macroeconomic stability and reduction of the country's exposure to external vulnerabilities should be given priority.

The strategy of adjustment to external shocks and of restoring the external stability in the first place implied exchange rate realignment, combined with wage restraint and demand management measures[73]. While devaluing the Belarusian ruble would help to restore the capital account stability by preventing mass conversion of ruble deposits into foreign currency deposits[74], wage and demand restraints would help to restore the current account stability by reducing consumption imports. Given that at the end of 2008 foreign reserves of Belarus dropped to around

70 Ibid., 12.
71 For comparison, the mentioned above stabilization loan from allied Russia was provided at LIBOR+3% interest rate.
72 International Monetary Fund, Country Report 09/109, op.cit., 12.
73 Ibid., 14.
74 This was a serious issue given that at the end of 2008 foreign reserves of Belarus dropped to USD 3.2 billion – less than 1 month imports of the country.

USD 3 billion[75] (less than 1 month imports of the country), mentioned efforts were of primary importance. In addition, both measures would also improve the country's competitiveness position in the longer run. At the same time, the strategy to reduce vulnerabilities was based on a new more flexible exchange rate regime, allowing wider fluctuations to absorb further external shocks[76].

With Russia and the European Union being the main trading partners and growing volume of financial transactions in Russian rubles and Euros, Belarus' factual peg to the US dollar implied the country's balance of payments unjustified exposure to the US dollar exchange rate volatility. In this way, adoption of new currency basket – consisted of Euro, US Dollar and Russian ruble in equal weights – instead of dollar peg, had to better reflect the structure of the country's trade and financial flows, thus reducing eventual balance of payments vulnerabilities. While implemented on January 1, 2009 as a program's prior action, devaluation of the Belarusian ruble by 20% and widening of the exchange rate band to ±5% (widened later to ±10%) were to correct the estimated misalignment, support exports and improve the economy's competitiveness, thus working towards restoration of external balance.

The increase in interest rates, preceded the shift in the exchange rate regime coupled with a firm control of inflation expectations were intended to support the exchange rate realignment, consistent with the inflation target of 11.5%[77]. While during the year 2008 the Belarusian monetary authorities had already increased the

75 National Bank of the Republic of Belarus, External sector statistics, http://nbrb.by/engl/statistics/ReserveAssets/assets.asp
76 International Monetary Fund, Country Report 09/109, op. cit., 14.
77 Ibid., 16-17.

refinancing rate by almost 4 percentage points[78], the stand-by agreement envisaged further gradual increase if necessary. Besides supporting the new exchange rate regime and preventing financial outflow, the increase in interest rates and elimination of the ceiling on corporate loans had also to ensure that capital would flow towards the most efficient enterprises on market terms and promote better risk management[79].

The findings of the Financial System Stability Assessment, prepared jointly by the IMF and the World Bank, noted significant improvements since the previous 2004 assessment, while provided further recommendations on strengthening the country's financial system, emphasizing a need for overhaul of the government-directed lending mechanisms in the context of the Stand-By Arrangement in order to ensure the long-term viability of Belarus' banking sector, shift its operations towards commercial principles.

Structural reform in the financial sector was another cornerstone of the IMF stand-by arrangement, aiming at ensuring financial sector liquidity and solvency. The blanket deposit guarantee was already enacted, while in December 2008 a large USD 1.5 billion injection to state-owned banks was implemented to provide them with necessary liquidity. In addition, Belarusian authorities were required to develop adequate risk assessment and management in banking sector and purge the country's banking system (primarily state-owned) of directed lending. Given that directed loans in reality often become non-performing loans and that banks in turn use to apply higher rate on non-favoured loans, it created a significant threat for the

78 National Bank of the Republic of Belarus, Monetary policy instruments, *Refinancing Rate Statistics*, http://nbrb.by/engl/statistics/refrate.asp
79 International Monetary Fund, Country Report 09/109, op. cit., 17.

banking system stability and undermines the market mechanism.

Created intentionally for this purpose the Development Bank should relieve commercial banks from lending under government programs (with those loans reported above the budget line). By eliminating the obligation to allocate a certain share of their capital for directed loans to priority sectors at preferential rates, banks would strengthen their capital positions. Such a movement towards commercial banking principles would transform banks into more market-oriented entities and establish precondition for planned bank sector privatization[80].

Fiscal tightening was another priority of the IMF program for Belarus, aiming at bringing domestic demand and investment in line with external financing constraints and projected slowdown of growth rate[81]. The overhaul of the government's directed lending programs alone was projected to result in 3 percent of the GDP reduction in state support to the economy relative to the previous year[82]. Furthermore, the budget balance for 2009 implied rolling back certain social programs and reduction of housing, utility tariffs, agricultural and food subsidies, restraining of public investment, maintenance of a prudent wage policy in public sector. While reduction in subsidies alone was calculated to reduce public budget by about 1 percent of GDP, the restraining of public investment had even bigger potential, as the level of public investment at more than 10 percent of GDP in 2008 was enormous for the whole CEE region[83]. Furthermore, the IMF program for Belarus had a structural condition to refrain from establishing any new extra-

80 International Monetary Fund, Country Report 09/109, op. cit., 18.
81 International Monetary Fund, Press Release No. 09/05, op.cit.
82 International Monetary Fund, Country Report 09/109, op. cit., 20.
83 Source: International Monetary Fund.

budgetary funds in order to ensure greater transparency of fiscal policies.

While the possibility of rapid and efficient response of the Belarusian economy to shocks was impeded by a range of price and wage controls, the rationale behind price liberalization (by eliminating the ceilings on monthly price increase) and reduction in real wages (by eliminating the targets of nominal wage increase) measures was to allow the country's economy adjust to shocks and reduce the fiscal risks. Wage restraint policy – in 2009 projected nominal wage increase of at most 10% was below projected inflation level instead of 57% wage increase according to the initial budget plan – was calculated to deliver further 0.6 percent of GDP in fiscal adjustment compared to the previous year[84]. The benefits of this structural adjustment measure, in addition to restricting domestic demand, would also reduce current account pressures and improve competitiveness through the unit labour cost channel in the longer run.

The program also envisaged the Belarusian authorities' efforts to enhance the role of private sector in the country's economy. Broader measures to support private sector development included reduction in the size of government, further deregulation, privatization of state owned enterprises, elimination of distorting taxes (e.g. taxes on profits were anticipated to fall from 24 to 20 percent) and excessive regulatory burden on private companies, which should be undertaken “as fast as market conditions allow” in order to create conditions for the medium-term growth in Belarus[85].

Combined effect of the above mentioned structural reforms, intended to be

84 International Monetary Fund, Country Report 09/109, op. cit., 20.
85 Ibid., 22.

implemented within several years, had to bring about macroeconomic stability, reduce the economy's vulnerability to possible external shocks and to create a conductive environment for sustainable economic growth in the medium-run. However, in the short run many of the mentioned reforms (in particular exchange rate downward adjustments, fiscal austerity measures, contracting social obligations of the state, price liberalization and wage restraints) were extremely unpopular within the Belarusian society. Given the nature of the specific Belarusian political regime, economic liberalization might implicitly relinquish its political grip on power. Therefore, as it will be discussed below, the IMF stated in its post-program monitoring discussions report, that certain measures taken by Belarusian authorities had a merely cosmetic character, and that despite promising initiatives on structural reform their implementation lacked in many cases[86].

86 International Monetary Fund, "*Republic of Belarus: 2012 Article IV Consultation and Second Post-Program Monitoring Discussions—Staff Report*", Country Report No. 12/113 (Washington: IMF,May 2012).

Table 1: main indicators of financial requirements of Belarus, 2008-2011 (million of USD)[87]:

	2008	2009	2010	2011
Financial needs	-10,388	-10,675	-9,461	-9,696
– current account balance (baseline scenario)	-4,523	-7,478	-6,950	-6,950
Financial sources	10,388	3,238	3,862	4,907
– foreign direct investment (net)	2,130	1,523	2,011	2,487
– medium and long term loans	2,392	1,282	2,127	2,221
– short term loans	2,397	1,628	1,516	1,869
– use of official reserves	1,371	-2,339	-2,882	-2,268
Financial gap	0	-7,436	-5,599	-4,790
Adjustment of the current account	0	4,361	4,674	4,790
Current account balance (program scenario)	-4,523	-3,116	-2,276	-2,160

During the program modalities negotiations, the IMF staff estimated that gross external financial needs of Belarus would amount to about USD 10.7 billion and 9.5 billion in 2009 and 2010 respectively, with the most of the mentioned sums – more than 70 percent – resulting from current account deficits[88]. While at the same time financial sources, coming primarily from net foreign investments, short-, medium- and long-term loans, and use of foreign reserves, were estimated at USD 3.2 billion in 2009 and 3.9 billion in 2010, the financial gaps in the country's balance of payments reached USD 7.4 billion and 5.6 billion respectively.

87 Source: IMF staff calculations, in International Monetary Fund, Country Report 09/109, op.cit., 23.

88 Baseline current account deficit scenario was estimated by adjusting the 2008 outcome with the energy price shocks and economic slowdown in main trade partners, without IMF program.

Given the restricted access to foreign capital in light of the global crisis, the financial requirements (mainly to finance the current account deficits) were unlikely to be balanced by market-determined capital inflows. In particular, while the Belarusian authorities hoped foreign direct investments to become an important source of external stability, foreign investors were still cautious about their risks due to political uncertainty and poor investor's and property rights in Belarus – therefore, net FDI inflow was estimated at a moderate USD 1.5 billion and 2 billion levels in 2009 and 2010 respectively.

The estimated large financial gap in Belarus' external balance could be only partially filled by foreign capital inflows and bilateral financing[89]. While most provided by the IMF financial resources would be utilized for building up Belarus' international reserves[90], set of policy reforms aiming at adjustment of the current account, acquired a primary importance. Therefore, the lion's share of the efforts to ensure external stability of Belarus – USD 4.4 and 4.6 billion in 2009 and 2010 respectively – were drafted to result from the current account adjustment.

The figures illustrate the very essence of the IMF conditional approach to lending – besides provision of financial resources the IMF insists on a policy reform to adjust a country's balance of payments to external shocks. According to the staff calculations, adoption of the IMF conditionality and implementing proposed set of reforms and measures as a part of the stand-by Arrangement with Belarus would narrow the country's current account deficit to USD 3.1 billion in 2009 and 2.3 billion

89 Under this entry were counted successive tranches of the mentioned above USD 2 billion worth stabilization loan from Russia, agreed in the previous year.

90 According to the IMF suggestions, a sustainable level of international reserves should cover over more than 90 percent of short-term debt obligations and more than 2 months of the country's imports.

in 2010, compared to USD 7.5 billion and 7 billion deficits respectively in absence of the program. Thus, in case of Belarus, the effect of proposed policy reforms was calculated to overweight the stand-by loan itself. It is worth to mention, that many analysts regarded the program's scenario and the financial requirements schedule as over optimistic[91].

The initially agreed IMF loan of USD 2.5 billion to cover the 15-month program under the proposed stand-by arrangement was scheduled to be released as follows[92]. The initial disbursement in January 2009 would be USD 800 million, followed by consecutive four equal tranches of USD 425 million, with the last one to be transfered in February 2010. The release of consecutive tranches would be contingent on policy reforms' progress and subject to observance of performance criteria and completion of the IMF program's requirements in the discussed below four monitoring reviews.

As a part of stand-by deal with the IMF, the Belarusian authorities committed also to a number of prior actions in support of their request, which included mentioned above (i) devaluation of the ruble against US dollar by 20 percent and shifting from dollar peg to a new currency basket, (ii) abolishing the ceiling of lending rates on ruble loans to the corporate sector, (iii) prohibit the central government from making additional transfers to its deposit accounts with the commercial banks, (iv) approve of the 2009 central government budget targeting a zero budget deficit, and (v) reduce real wages in public sector by limiting wage increase for budgetary

91 Dmitriy Kruk, “*Perspektivy realizacii programmy stand-by v Belarusi*”, Belarussian Institute for Strategic Studies, BB #24/2009RU (BISS, 14 September 2009).
92 International Monetary Fund, Country Report 09/109, op.cit., 28.

workers to 5 percent (lower than inflation rate) at the end of 2008[93].

3.2. The program's implementation

The first review under the stand-by arrangement, based on the discussion held June 2009, noted that most of the end of March quantitative and continuous performance criteria and structural conditionality benchmarks were met, except for a net international reserves target, which was missed by USD 221 million[94]. However, fall in demand for Belarus' exports and factors led to capital account worsening were stronger that initially expected, widening in this way the financial gap in the country's balance of payments. In light of stronger than expected external shocks, the Belarusian economy landed hard in 2009 – GDP grew just by 1.1 percent in the first quarter (compared to 11.2 percent growth in the same period of previous year), industrial output fell by 4.5 percent despite rapid accumulation of inventories, while current account deficit increased to USD 1.86 billion in the first quarter alone (compared to initially projected USD 0.8 billion deficit)[95].

Should the trend remain unchanged, the international reserves would be about USD 2.5 billion lower than initially targeted and there would be a large shortfall of reserves in 2010, making the financial stability of Belarus much questionable. In order to close the widening gap in balance of payments, Belarus committed to further adjust the ruble's exchange rate, widen the band to 10 percent thus allowing greater flexibility, deepen their structural reform efforts, and on top of that requested the

93 International Monetary Fund, Country Report 09/109, op.cit., 28.

94 International Monetary Fund, "*Republic of Belarus: First Review Under the Stand-By Arrangement, and Request for a Waiver of Performance Criterion, Augmentation of Access, and Modification of Performance Criteria*", Country Report No. 09/260 (Washington: IMF,August 2009), 1.

95 International Monetary Fund, Country Report No. 09/260, op. cit., 3.

Fund to increase available finances by additional USD 1 billion (SDR 651.4 million or 168.6 percent of the country's quota)[96]. The Fund ultimately agreed, increasing the value of four consecutive tranches to USD 677 million, while the Belarusian authorities were required to step up their efforts towards liberalizing the country's economy and foster the process of privatization[97].

The Belarusian authorities made a significant progress in their structural reform agenda aimed at improving the country's business climate and private sector developments. Looking ahead, it is worth to notice that in 2009 Belarus turned up in Global Top 10 Regulatory Reformers and achieved the 64th position out of 183 economies in the Ease of Doing Business Index, measured by the World Bank[98]. Belarus achieved substantial results in certain areas of liberalization (4th position in the world in respect of registering property, 9th – starting a business, 14th – enforcing contracts), but significant improvements still have to be done in paying taxes and trading across borders (156th and 152nd positions respectively). Such a progress, registered by a reliable international institution, besides stimulating economy through development of private sector, have played an important role in promoting capital inflow, sending positive signal to foreign investors.

The second review under the stand-by arrangement, completed in October 2009, concluded that all the main end-June performance criteria were met and soften certain performance criteria for end-September[99]. The close to balance

96 Ibid., 1.
97 Ibid., 22.
98 World Bank, *Doing Business 2009 Report, (*Washington: World Bank, 2008).
99 International Monetary Fund, "*Republic of Belarus: Article IV Consultation and Second Review Under the Stand-By Arrangement*", Country Report No. 09/333 (Washington: IMF,December 2009), 1.

general government budget target for 2009 was reaffirmed, while a modest 1.7 percent of GDP deficit was allowed for the following year given relatively low level of Belarus' public debt. However, planned increase in the directed lending under government programs might threaten the country's ability to meet further IMF program targets. The fund also noted a remarkable progress made by the Belarusian authorities on their structural reform agenda aimed at improving the country's productivity and therefore its growth potential, emphasizing one more time the importance of stepping up privatization program, which would attract more FDI and ease the country's external financing constraint in this way[100].

The impact of negative tendencies on Belarus' current account was once again underestimated, while exports contracted by 46 percent year-on-year during the first seven months of 2009, and the energy balance also worsened as export prices for oil products fell more than import prices of crude oil[101]. In light of delaying the last USD 500 million worth tranche of the Russian stabilization loan, the resulting current account of USD 3.7 billion in the first half of 2009 was only partially offset by net financial inflows, including privatization proceeds and government borrowings, while Belarus' gross international reserves went below unsustainable level of USD 3 billion[102]. Furthermore, growing volume of directed lending under government programs, which overall credit to economy share increased to 38 percent in July 2009, was another worrisome trend threatening Belarus' balance of payment stability.

The Fund also stated in its review that the overall 2009 targets remained

100International Monetary Fund, Country Report No. 09/333, op. cit., 1.
101Ibid., 4.
102Ibid.

within reach, i.e. it was possible to contain Belarus' current account deficit to around 9.5 percent of GDP by means of significant import contraction, prudent monetary and fiscal policies and decisive limiting of lending under government programs[103]. While the 2010 target was set to bring down the current account deficit to 7 percent of GDP and increase gross reserves to at least USD 7 billion (covering 2.5 months of imports) given expected recovery of external demand for Belarusian goods in addition to strict adherence to the IMF conditionality[104].

According to the second review, the medium-term growth prospects of Belarus might be improved by strict implementation of the structural reform agenda with the aim of boosting productivity and reducing external vulnerabilities by means of fostering private sector developments and increasing the role of market in the country's economy. The medium-term 7 percent economic growth target was intended to be achieved under the scenario, which besides liberalization also envisaged prudent fiscal and monetary policy with moderate single-digit inflation, the current account deficit stabilized at around 3.5 percent of GDP and the gross international reserves covering at least 3 months of imports[105].

The third review under the IMF stand-by program was completed in December 2009[106]. The IMF staff expressed signs of optimism as Belarus gradually started to emerge from the crisis – output loss was limited, inflation fallen and the ruble's exchange rate stabilized. In light of sharp decline in output in most of the neighbouring countries, Belarus' GDP decline, measured in October 2009, was not

103Ibid., 6.
104Ibid.
105Ibid., 9.
106International Monetary Fund, "*Republic of Belarus: Third Review Under the Stand-By Arrangement*", Country Report No. 10/31 (Washington: IMF,February 2010).

so drastic – it amounted to about 1 percent on year-on-year basis, mainly due to housing construction under government programs, which compensated weak consumption and external demand[107]. However, in light of strong growth of fixed investment, the Belarusian authorities' ability to meet the target of 2.9 percent of GDP for directed lending by the end of year became questionable.

The Belarusian authorities also made a good use of available exchange rate flexibility, depreciating ruble to 8 percent below the central parity of the currency basket, and expressed their willingness to recenter its 10 percent band towards the same direction[108]. According to the IMF staff projection, the effect of depreciation, combined with the Russian ruble appreciation within the basket (as Russia is the main destination for the Belarusian non-oil exports), would improve Belarus' competitiveness and contribute to closing the financing gap during the remainder of the program.

Under the third review, the Fund again noted that all quantitative and continuous performance criteria and structural benchmarks for end-September were met, while the country's authorities requested for modification of NIR and NDA targets for end-December[109]. By adjusting those indicators the Belarusian authorities wanted to be able to accommodate the exchange rate movements in 2010 and possible delay of the bilateral loan from Russia. The Fund supported the request, traditionally emphasizing the need for prudent fiscal policy and restrained credit policy in 2010.

107International Monetary Fund, Country Report No. 10/31, op. cit., 3.
108Ibid., 8.
109Ibid., 1.

As regards the country's balance of payments, the situation was ambiguous: despite improved export volumes, the current account deficit was expected to deteriorate further to reach a USD 5.4 billion or 11 percent of the country's GDP by the end of year, however, there were improvements in the financial account, as by the time of the review the share of ruble deposits reached almost 50 percent, reflecting gradual restoration of confidence in domestic currency[110]. Also given the postponement of the final USD 500 million tranche of the Russian stabilization loan, a USD 200 million development policy loan, agreed with the World Bank in December 2009 with the aim to address the social impact of the structural reform, would ease budgetary burden in the following year[111].

The forecast for 2010 was quite optimistic: with the Belarusian authorities continuous efforts to liberalize the economy, fiscal deficit similar to that of 2009 (1.7 percent of GDP), credit increase in line with nominal GDP (13–15 percent), and a gradual recovery of external demand, the country's GDP was expected to grow by 3.75 percent, inflation to fall to around 8 percent, and the current account deficit to narrow to around 7 percent of GDP and gross reserves to reach USD 7.2 billion[112]. However, taking into account the presidential elections scheduled for the late 2010, the Fund warned the country's authorities about premature loosening of the policies.

The forth review, completed in March 2010, once again noted satisfactory progress on performance criteria and that structural benchmarks for end-December, with exception of further privatization measures, were met[113]. The economy was

110 Ibid., 4.
111 Ibid., 5.
112 Ibid., 10.
113 International Monetary Fund, "*Republic of Belarus: Forth Review Under the Stand-by Arrangement*", Country Report No. 10/89 (Washington: IMF,April 2010), 1.

gradually recovering from the crisis, and Belarus recorded slightly positive growth of 0.2 percent in 2009 instead of projected recession. However, at the same time the current account deficit increased to enormous 13 percent of GDP (instead of initially programmed deficit of 5.4 percent of GDP), largely due to unexpected cut in oil import subsidy from Russia and stronger than projected recession in export markets. In the absence of offsetting measures the terms of trade shock was calculated to increase the 2010 balance of payments and fiscal deficits by about USD 2 billion (almost 4 percent of GDP)[114].

The Belarusian authorities met adjusted fiscal performance target, as the general government deficit amounted only to 0.7 percent of GDP due to disciplined fiscal policy containing domestic demand. However, the credit growth significantly exceeded the program's target of 12 percent, amounting to 31 percent during 2009[115]. While monetary base increased only marginally, lower than projected currency-to-deposit ratio permitted to expand directed lending under the government programs. Gross international reserves reached USD 5.7 billion in 2009, which was consistent with the stand-by agreement, but with the current account financed mostly through borrowing, the stock of external debt increased to 44 percent of GDP (compared to 25 percent in 2008)[116].

Worsened terms of trade implied an adjustment of the 2010 forecast – it would slow the pace of recovery to 2.4 percent GDP growth (instead of previously estimated potential of 6 percent growth), while inflation was projected to fall to 8 percent with further measures to tighten domestic demand, and the current account

114Ibid.
115Ibid., 5-6.
116Ibid., 6.

deficit would narrow to 10.5 percent of GDP[117]. The remaining financing gap of about USD 2 billion in 2010 might be filled with eventual support of the follow-up IMF program or the Eurasian Economic Community Anti-Crisis Fund, or with market borrowings through issuance of Eurobonds.

3.3. Overall evaluation of the program's performance

While the full scope of proposed liberal structural reforms would be possible to implement within at least a several years interval, and therefore the effects of those reforms on the longer term Belarus' external sustainability can not be accurately assessed at the moment[118], it is possible to assess the effects of mentioned above prior actions and the programmed macroeconomic adjustments on the country's economic performance, and above all, to evaluate how successful was the macroeconomic adjustment incorporated in the SBA in addressing the country's external account balance during the program period.

There are several approaches to evaluate the effectiveness of the IMF supported programs, described by the IMF Institute[119]. While given the specifics of Belarus' economic model and the political regime, it would be difficult to find an adequate control group of countries, among the four mentioned by the authors approaches the 'before-after' approach seems to be the most appropriate one in case of Belarus. In order to assess how successful was the program, the 'before-after' approach has merely to compare the macroeconomic outcome under the

117Ibid., 8.

118It is worth to note, that the mere declaration of commitment to structural reform, proposed by the Fund, has a positive effect on a country's investment attractiveness, which in turn improves a country's external balance.

119Nadeem Ul Haque and Mohsin S. Khan, *Do IMF-Supported Program Work? A Survey of the Cross-Country Empirical Evidence* (Washington: IMF Institute, 1998).

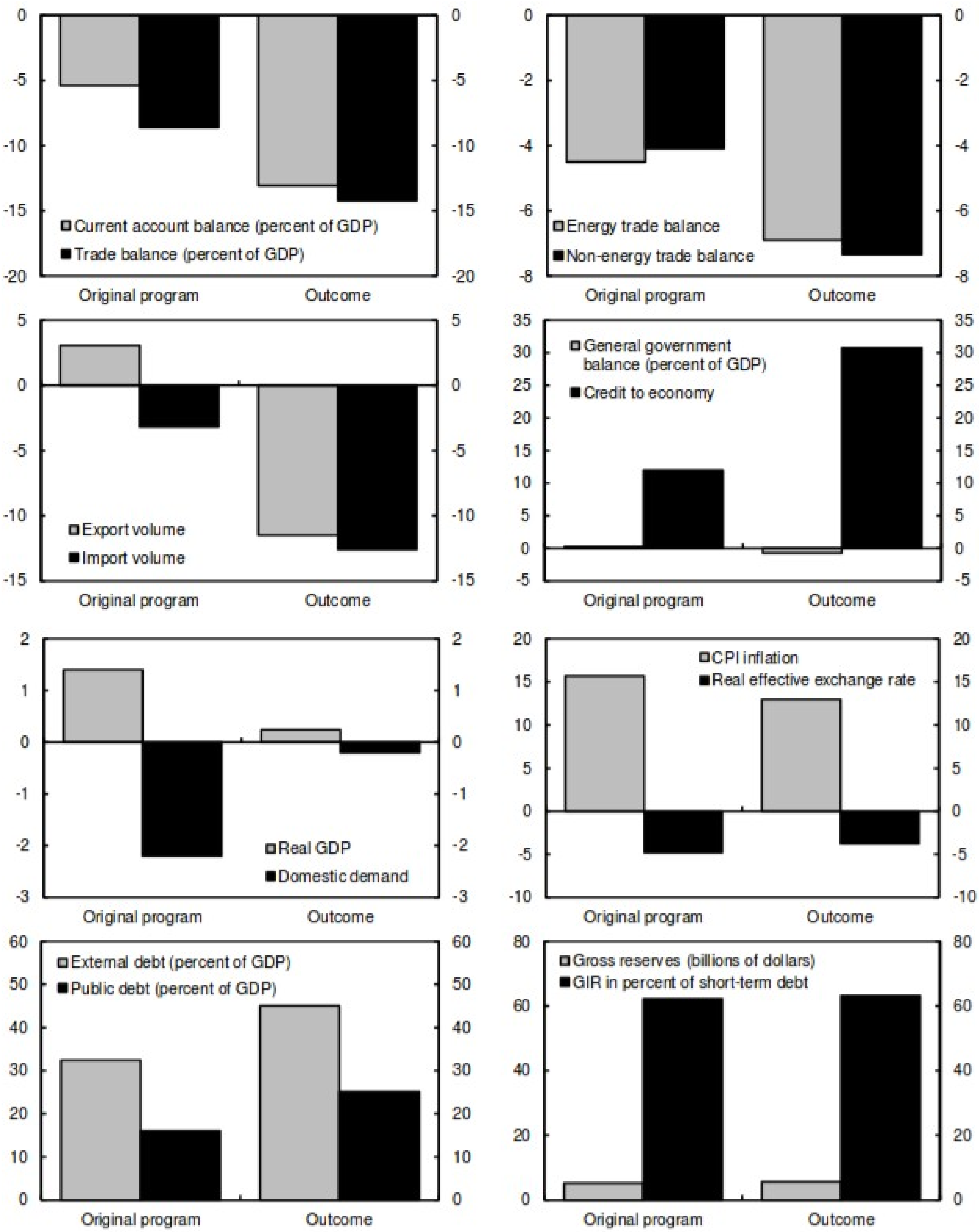
program with the outcomes in the pre-program period[120].

Such approach, however, has an important flaw – assumption that all external factors remain equal. This can be partially offset by comparing the ultimate macroeconomic outcomes with the program's projections, which were calculated with respect to eventual changes of external conditions.

The Ex Post Evaluation of Exceptional Access under the 2009 Stand-By Arrangement, prepared by the IMF staff team in December 2010, was based on the latter approach[121]. It evaluated the program as being generally successful, as most of the program conditions were met, albeit structural reforms on directed lending and privatization remained largely unfinished. The Fund's evaluation reported that all quantitative performance criteria, except for the net international reserves, were met, while performance on the program's structural conditions, except for those on directed lending and privatization, was generally strong[122]. However, there were significant differences in the program's macroeconomic projections and outcomes in 2009, presented below.

120 Ibid., 8.
121 International Monetary Fund, "*Republic of Belarus: Ex Post Evaluation of Exceptional Access Under the 2009 Stand-By Arrangement*", Country Report No. 11/99 (Washington: IMF, May 2011).
122 IMF Country Report No. 11/99, op. cit., 24.

Figure 1: The 2009 SBA with Belarus – projections and outcomes[123]:



123Source: IMF staff estimates and projections, in International Monetary Fund, Country Report No. 11/99, op. cit.,27.

As we can see from the above charts, not all the macroeconomic objectives, projected by the Fund under the SBA with Belarus, were achieved – while the CPI inflation, real effective exchange rate and the gross reserves targets were met, the performance on the others, most notably current account and trade deficits, credit relative to the economy's size, real GDP growth and stock of external debt, was considerably worse. Most of the differences between projections and outcomes can be explained by external environment influence, while the non-consequent character of domestic policies, implemented by the Belarusian authorities, also played an important role in this differentiation.

Despite the fact that the country's authorities implemented a number of critical prior actions, suggested by the Fund, in particular the 20 percent ruble's devaluation, limiting government deposit transfers to commercial banks, wage and fiscal restraints, Belarus' current account deficit – the main focus of the program – widened to 12.6 percent of GDP in 2009, instead of projected narrowing to 5.5 percent from the previous year's 8.2 percent deficit. This was one of the few cases, when the IMF program saw the current account deficit widen[124].

At the same time, the trade deficit account widened to enormous 14.1 percent of GDP, reflecting a sharp terms of trade shock. If to look closer to the country's trade account deficit, both energy and non-energy trade accounts registered higher that expected deficits, and surprisingly, the non-energy trade deficit surpassed the energy deficit by the end of the year. Given that drop in external demand affected both energy and non-energy Belarusian exports, this trend proves that the country's economy lost more by lowered competitiveness due to higher gas prices, that it lost

124International Monetary Fund, Country Report No. 11/99, op. cit., 5.

by lowered the oil refining margin due to introduced oil export duty.

The total export volume dropped by more than 10 percent instead of envisaged growth, however, the negative impact on the country's trade account was flattened by a proportional drop in imports – should there be no import restrictions, introduced by the government, the trade balance deficit in 2009 alone would be even higher, that registered. The main reason for drop in export volume was rapid decline in potash fertilizers exports – one of the main (together with the petroleum products) Belarus' exports positions – which according to the National Statistical Committee dropped more than twice in 2009 relative to the previous year[125].

The widening of external deficits can be explained mainly by sharp terms of trade shock and deeper than expected global recession, which further decreased demand for Belarusian products on the European and Russian markets. According to the IMF calculations in the following post-program monitoring reports, during 2009 the terms of trade for Belarus worsened by about 10 percent to the previous year[126]. As regards diminishing external demand for the Belarusian exports, it affected mostly the country's manufactured products (particularly strong for tractors and trucks, motor vehicles, trailers and semitrailers, furniture) and mentioned above potash fertilizers[127]. While according to the National Statistical Committee petroleum products' export did not drop in 2009, the decreased world market price for them, coupled with introduced oil export duty to be payed to the Russian budget,

125National Statistical Committee of the Republic of Belarus, *Foreign trade statistics*, http://belstat.gov.by/homep/en/indicators/ftrade1.php

126International Monetary Fund, "*IMF Executive Board Concludes Third Post-Program Monitoring with Belarus*", Public Information Notice No. 12/144 (IMF, December 19, 2012).

127National Statistical Committee of the Republic of Belarus, Foreign trade statistics, op. cit.

decreased significantly Belarus' oil re-exports revenues.

At the same time the Belarusian authorities' policy decision to counteract the external shocks (affecting both terms of trade and external demand for the country's exports) by expanding domestic demand through the directed lending channel, contributed to further widening of the current account deficit. As the result of expansionary lending under governmental programs, the credit volume amounted to above 30 percent of the economy in 2009, instead of projected in the program 12 percent. The credit expansion, however, allowed to avoid an economic recession (GDP increased by modest 0.2 percent) by financing SOE's production and stimulating domestic demand.

The last important for the thesis analysis parameter is the gross external debt, which exceeded the program's target by almost one third, increasing sharply to 45.6 percent of GDP in 2009 (albeit from initially low level). Given that substantial part of Belarus' gross external debt was in form of short-term obligations and that international reserves amounted to only 63 percent of the country's short-term debt at the end of 2009, Belarus' debt sustainability was particularly dependent on the prudent macroeconomic policies in the following post-program years.

3.4. Post program developments and the 2011 financial crisis

Belarus' Program for Social and Economic Development for the years 2011–2015 envisaged high growth rates to be achieved through credit expansion, while wages and pensions to be further increased[128]. The five-year plan, was developed

128Ministry of Economy of the Republic of Belarus, "*The Program for Social and Economic Development for 2011 – 2015*".

with the aim of ensuring a constant growing of the living standard of the country's population was a part, which was a part of the social contract between the population (mostly employed in the public sector and by the SOEs) and the country's political leadership. Such development plans set very ambitious however shortsighted targets, not necessarily well-grounded in the country's economic realities, which therefore might be inconsistent with the objective of longer term stability. The IMF in its post-program monitoring judged, that the plan is not grounded in a realistic macroeconomic framework: achieving rapid growth through credit expansion, fiscal easing and boosting household incomes would undermine external adjustment measures taken within the stand-by program[129].

Nevertheless, after the 15-month stand-by arrangement expired in March 2010, the Belarusian authorities decided to loose considerably economic policies ahead of the December 2010 presidential elections in order to fulfill their social contract obligations. As economic analysts agree, this politically voluntaristic decision to pursue ambitious growth and wage targets in order to fulfill the social contract ultimately led to the foreign exchange crisis of 2011[130]. Rapid wage increase, not corresponded in adequate productivity increase, created a strong inflationary pressure, further diminished the country's competitiveness, widened the current account deficit through increased imports, and eventually led to the loss of control over the Belarusian ruble's exchange rate. It also created a danger of getting in inflationary-deflationary spiral, in addition to existing external vulnerabilities, discussed above.

129International Monetary Fund, Country Report No. 12/113, op. cit.
130Aleś Alachnovič and Sierž Naŭrodski, “*Belarusian economy: structural crisis*”, Center for Social and Economic Research Belarus (CASE Belarus, July 2011).

According to the IMF staff interpretation, expressed in the first post program monitoring, the loosening of policies on the eve of presidential elections (e.g. public sector wages increased by 30 percent in November alone, while credit growth accelerated to almost 40 percent by the end of the year) increased significantly the current account deficit, widened further to 15 percent of GDP in 2010[131]. At the same time, the excess demand for foreign currencies, mainly USD and EUR, exceeded the total foreign currency supply by nearly one third in 2010[132]. These developments created strong pressure on the country's reserves which fallen to around USD 3.5 billion (covering less than one month of the country's imports) by March 2011. While the Belarusian authorities could not afford anymore the sizable interventions in order to keep the ruble's exchange rate within the 10 percent band, the parallel foreign exchange black market emerged, where the Belarusian ruble depreciated by 25 percent by mid 2011[133].

Rapid wage increase, not corresponded in labour productivity increase, created a strong inflationary pressure, while panic at the foreign exchange market and the strong devaluation contributed to higher prices of imported goods and strengthen the inflationary pressure. When inflation was registered at 44 percent year-on-year in June 2011, the government announced to increase wages further to the percentage rise in the cost of living, which just fueled inflation expectations. Thus, inflation expectations, not proportional increase in the country's monetary base, coupled with a pass-through effect of the exchange rate adjustment led to

131International Monetary Fund, "*The Republic of Belarus: First Post-Program Monitoring Discussions*", Country Report No. 11/277 (Washington: IMF, September 2011).
132Aleś Alachnovič and Sierž Naŭrodski, "Belarusian economy: structural crisis", op. cit.
133International Monetary Fund, Country Report No. 11/277, op. cit., 5.

inflation acceleration to the level of over 100% in 2011 alone[134].

At the same time, the foreign exchange crisis led also to massive deposit withdrawals and a general loss of confidence of the country's households in banks, thus increasing further financial sector vulnerabilities. Growing inflation expectations together with general mistrust in government policy actions made restoration of confidence in national currency and the country's financial system far more complex goal, which could not be achieved solely through external borrowing[135].

By October 2011, when the foreign exchange crisis deepened and the parallel market BYR/USD exchange rate reached 8000-9000 (compared to the rate of 2200 on the eve of the 20 percent devaluation in January 2009), the National Bank decided to unify the official and the black market exchange rates – consequently the Belarusian ruble's devaluation became threefold in total[136]. This was the record devaluation in the region in the recent past, however, it might be not so sharp, should the Belarusian authorities take the decision to unify the exchange rates earlier.

In accordance with the IMF suggestions, the National Bank of Belarus stopped providing liquidity at below market terms from mid 2011 and gradually increased its rate of refinancing to 45 percent by the end of year[137]. These measure helped to stabilize the exchange rate and slowdown inflation by the end of year. Thus, the stabilization of the situation on the external sector and the foreign

134 Anastasia Luzgina, "*Monetary Policy in Belarus since the Currency Crisis 2011*", Forum for Research on Eastern Europe and Emerging Economies, (FREE, October 2012), http://freepolicybriefs.files.wordpress.com/2012/10/free_policy_brief_luzginaoct8.pdf

135 Alexander Chubrik, "*Balance of payments crisis in Belarus*", Public Service Europe, 18 July 2011, http://www.publicserviceeurope.com/article/622/balance-of-payments-crisis-in-belarus

136 National Bank of the Republic of Belarus, *Exchange Rate Statistics*, http://nbrb.by/engl/statistics/Rates/AvgRate/

137 National Bank of the Republic of Belarus, *Refinancing Rate Statistics*, op. cit.

exchange market with the parallel decrease in inflation became possible due to the National bank conducting tight monetary and fiscal policies since the first half of 2011[138].

The first post-program monitoring report describes the 2011 financial crisis in Belarus as one of missed opportunities in a sense that Belarusian authorities were able to complete the adjustment program set by the 2009 Stand-By Arrangement, sticking to tight fiscal and monetary policy and using available exchange rate flexibility[139]. However they decided to stimulate the economy through rapid credit growth, pursue ambitious wage policy, and to de facto peg the Belarusian ruble to the US dollar. In addition to unstable macroeconomic performance in the wake of the program period, the IMF's second post-program monitoring discussions concluded that Belarus also performed poorly on several structural reform, which was designed to improve the country's competitiveness, productivity and growth prospects, and to reduce the external vulnerabilities in the longer run. According to the report, Belarus in particular failed to complete announced large and small scale privatization, enterprise and banking sector reforms, while trade was not fully liberalized and the price liberalization was partially reversed in 2011[140].

It is worth to mention that in June 2011 the Belarusian authorities reached an agreement to receive a USD 3 billion loan from Anti-Crisis Fund of the Eurasian Economic Community to support the country in time of financial difficulties. The loan was intended to be repaid during 10 years with the annual interest rate of 4.1 percent, while the package of agreed reforms was much softer and the main

138Anastasia Luzgina, "*Monetary Policy in Belarus since the Currency Crisis 2011*", op. cit.
139International Monetary Fund, Country Report No. 11/277, op. cit., 16.
140International Monetary Fund, Country Report No. 12/113, op. cit.

condition attached to the loan was a privatization of up to USD 7.5 billion during 2011-2013[141]. Moreover, in November 2011, in exchange for acquiring remaining 50 percent share of Beltransgaz, additional foreign reserves of about USD 2 billion and significant concessions in terms of energy supplies for the next year were provided[142]. The IMF estimated the effect of a new gas deal to benefit the country's economy to the effect of about 5 percent of GDP in 2012[143].

In addition to the privatization proceeds, as a part of its efforts to close the external financing gap, Belarus entered international bond market, placing USD 600 million in debut five-year Eurobonds at 8.75 percent annual rate in July 2010, another USD 400 million at 8.25 percent in August 2010, and additional USD 800 million in seven-year bonds at 8.95 percent in January 2011[144]. These measures, coupled with mentioned above loan from the EurasEC Anti-Crisis Fund and the Beltransgaz privatization proceeds, however, were not enough to prevent the deepening of the foreign exchange crisis.

In the light of unexpected severity of the financial crisis, while waiting for the decision from EurasEC ACF, the Belarusian authorities discussed with the Fund the possibility of another program with a loan worth up to USD 8 billion. The agreement, however, was not reached – according to the official press release, the financial

141 Tut.by News Portal, 4 June 2011, http://news.tut.by/economics/229578.html

142 Gazprom press release, "*Gazprom and Beltransgaz settle issue of payments for gas supplied in second half of 2011*", 29 November 2011, http://www.gazprom.com/press/news/2011/november/article124414/

143 Eliza Lis and Dmitriy Kovtun, "*Belarus: A Tale of Missed Opportunities*", in ed. Bas B. Bakker and Christoph Klingen, *How Emerging Europe Came Through the 2008/09 Crisis: An Account by the Staff of the IMF's European Department* (Washington: IMF, 2012), 130-131.

144 Interfax, "*VTB Capital, Sberbank CIB to organize Belarusian Eurobonds issue*", 23 November 2012, http://www.interfax.com/newsinf.asp?id=377729

support would be provided, when the Belarusian authorities were to prove their readiness for deep and irreversible structural reforms[145]. Despite a generally positive tone of official Fund's statements, many performance criteria, in particular on domestic credit growth having direct effect on the country's current account, were not fulfilled due to the Belarusian authorities' unwillingness to do so. As the IMF staff stated in its second post-program monitoring report, that certain measures taken by Belarusian authorities had a merely cosmetic character, and that despite promising initiatives on structural reform their implementation lacked in many cases[146]. Therefore, an eventual IMF program for Belarus would have to take into account the factual Belarus' readiness for deep and irreversible reforms, while the question of ownership of reforms would become of primary importance.

145International Monetary Fund, "*Statement at the Conclusion of the IMF Mission to the Republic of Belarus*", Press Release No.12/66, (IMF, 5 March 2012).
146International Monetary Fund, Country Report No. 12/113, op. cit., 21.

Conclusion

Similarly to many other countries in the CEE region, large current account deficit was inherent in Belarus already in the pre-crisis period, while in case of Belarus, the deficit has had rather structural character, not a consequence of easy access to the global financial resources[147]. The current account deficit had been an inherent feature of Belarus' external account even under a favourable external condition in the form non-market preferential price for energy supplies, which implies weak external competitiveness of the Belarusian economy. During the boom years of impressive economic growth and favourable external conditions, the Belarusian authorities, however, did not take appropriate steps to address the country's external vulnerabilities. A sharp terms of trade shock of 2007 due to 'marketization' of relations with Russia just exposed existing Belarus' structural external disbalance. The negative impact of lost preferences was further reinforced by contraction of external demand for the Belarusian exports, caused by the recent global economic crisis. As the current account deficit widened further in 2008, Belarus had to apply for the IMF assistance.

The key objectives of the 15-month Stand-By Arrangement with Belarus were to facilitate the country's economy adjustment to the current external shocks (terms of trade shock due to cut in external subsidies and the global demand contraction) and to reduce its exposure to external vulnerabilities in the loner term. The former mentioned objective was intended to be achieved by means of macroeconomic policy adjustment and provision of external financing in a form of USD 3.5 billion

147As it was the case in e.g. Hungary and Latvia – CEE countries that applied for the IMF assistance at the same period.

loan, while the latter mentioned objective – through deep structural reform, liberalizing the country's economy, and thus, stimulating its competitiveness and growth potential in the long run. While it is too early to accurately estimate the effects of proposed liberal structural reforms on Belarus' economy performance, the thesis evaluates how successful was the macroeconomic adjustment incorporated in the SBA in addressing the country's external account balance.

The well-known and widely-used for more than half century Keynes' mechanism of external balance adjustment, based on the regulating the effective demand in the deficit country, formed a basis of the 2009 Stand-By Arrangement with Belarus. It was designed to eliminate the country's external disbalance through macroeconomic adjustment, which would include inter allia monetary tightening and limiting credit growth, fiscal and wage restraining measures, aimed at limiting the domestic demand of Belarus. However, it appears, that the Fund, designing its program for Belarus, did not pay an appropriate attention to the specifics of the country's economic model and political model.

Despite a generally positive tone of the official declarations, I would assess the IMF's 2009 SBA with Belarus as having been rather unsuccessful, as the country's current account deficit – the initial focus of the program and therefore the main assessment criterion of its effectiveness – widened to 12.6 percent of GDP, instead of programmed narrowing to 5.5 percent of GDP in 2009, while it soured further to enormous 15 percent of the country's GDP in 2010. This became one of the rare cases, when the IMF Stand-By Arrangement saw a country's current account deficit widening during the program implementation phase.

The widening of Belarus' external deficit and its deviation from the program's targets to a certain extent can be explained by unanticipated influence of external factors, in particular deeper than expected at the time of programming recession in the main trading partners, which further decreased demand for the Belarusian exports. Also the terms of trade shock for Belarus was sharper than projected – it worsened due to decreased world market price for petroleum products together with introduced duty on imported oil from Russia, what decreased the country's oil re-exports revenues. At the same time the Belarusian authorities' policy decision to counteract the external shocks and stimulate domestic investments by expanding the directed lending channel contributed to further widening of the current account deficit. However, an expansionary lending under government programs and its stimulating effect on the real economy allowed Belarus to avoid initially projected in the program recession.

In the post program period ahead the late 2010 presidential elections, the Belarusian authorities politically voluntaristic decision to pursue ambitious growth and wage targets by means of expansionary macroeconomic policies contributed to further increase in the country's external deficit and ultimately led to the serious financial crisis of 2011. Also the 2011–2015 Program for Social and Economic Development promises return to a high growth rates to be achieved through credit expansion and envisages further wage and pension increase, therefore, threats Belarus' external sustainability, not being grounded in a realistic and prudential macroeconomic framework.

Thus, besides the external factors, that could be factored better in the program, the Fund also underestimated the specifics of the country's economic model and political regime, while the IMF conditionality was to a large degree inconsistent with the Belarusian authorities commitment to fulfill the social contract. Even though the overly optimistic 5-year plan of Belarus' economic development might be in a contradiction with the aim of achieving external balance stability, the specifics of the country should be taken into account at the phase of initial SBA programming. Taking this into consideration, it could be reasonable to let the less painful in its social consequences exchange rate flexibility to play bigger role in Belarus' macroeconomic adjustment, instead of the emphasize on domestic demand contraction, made in the 2009 IMF program.

In the light of the post-program developments, it appears, that for the Belarusian authorities, found the country in a complicate macroeconomic situation and facing large external deficit in the aftermath of modification of the energy-political model of relations with Russia and the global economic crisis, the IMF stand-by program with its conditionality attached was in a sense lesser of two evils. While full implementation of the proposed by the Fund macroeconomic adjustment might violate the social contract and thus threaten political stability in Belarus, the envisaged under the program deep structural reform might lead to the authorities' loss of control over the country's economy. Therefore, with regaining preferential terms of energy supplies from Russia in the framework of the Common Economic Space and finding additional sources of external financing (more expensive, but less conditional loans from Russia and China), the Belarusian authorities believe that they can balance the country's current account and ensure conditions for a strong growth without painful measures proposed by the IMF. In my view, the mentioned logic explains the program's inability to ensure Belarus' external balance stability and the relatively poor progress Belarus made towards the IMF conditionality to a grater extent than the presence of unexpected external shocks.

However, access to external financing and regained preferences in the framework of the Common Economic Space can not ensure the country's external balance sustainability and stable growth permanently. If to take into account increased competition in the common market, especially in the light of Russia's accession to the World Trade Organization and the consequent reduction in import tariffs, the present status quo in Belarus – conservation of the Soviet-type economic practices and stable economic performance – have to inevitably collapse. Therefore, in the longer perspective, the Belarusian authorities have no better choice as to implement suggested structural reforms – the adjustment might be quite painful, but essential for the country's long-term external stability, economic potential and competitiveness.

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