

BELARUS

STRENGTHENING PUBLIC RESOURCE MANAGEMENT

CHAPTER I. INTRODUCTION

1.1 **Background.** At its independence in 1991, Belarus inherited a standard of living and capital stock that were among the highest in the Former Soviet Union (FSU). At the same time, the Belarus economy was quite dependent on linkages with the other areas of the FSU. It obtained 90 percent of its energy and 70 percent of its raw materials from other countries of the FSU, and these countries also accounted for virtually all Belarusian exports. This made Belarus very vulnerable to the significant disruptions in trade that occurred in the early 1990s.

1.2 Despite some initial reform steps, GDP declined sharply in the early 1990s, while inflation soared to over 700 percent in 1995. In 1994, the government of newly elected President Lukashenko pursued a new economic strategy that focused on the administrative mobilization of resources to restore linkages in production and enforce greater discipline, while keeping the vast majority of the economy remaining within state hands. Since 1996, growth has been positive, although inflation has remained high (see Table 1.1).

Table 1.1: Key Economic Indicators

	1995	1996	1997	1998	1999	2000	2001	2002
GDP growth (annual %)	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	4.7
Consumer prices (% change over previous period)	709.3	52.7	63.9	72.9	293.7	168.6	61.1	42.6
Gross fixed capital formation (% of GDP)	24.7	21.1	25.2	25.9	26.3	25.2	22.7	21.2
Foreign direct investment, net (BoP, current US\$)	14.7	104.5	349.5	200.9	443.2	118.6	95.5	227.4
Current account balance (% of GDP)	-4.4	-3.6	-6.1	-6.7	-1.6	-2.6	-2.3	-2.0
Real effective exchange rate index	100.0	102.5	82.9	96.4	96.5	96.5	102.5	103.2
Poverty incidence	38.4	38.6	32.1	33.0	46.7	41.9	28.9	30.5

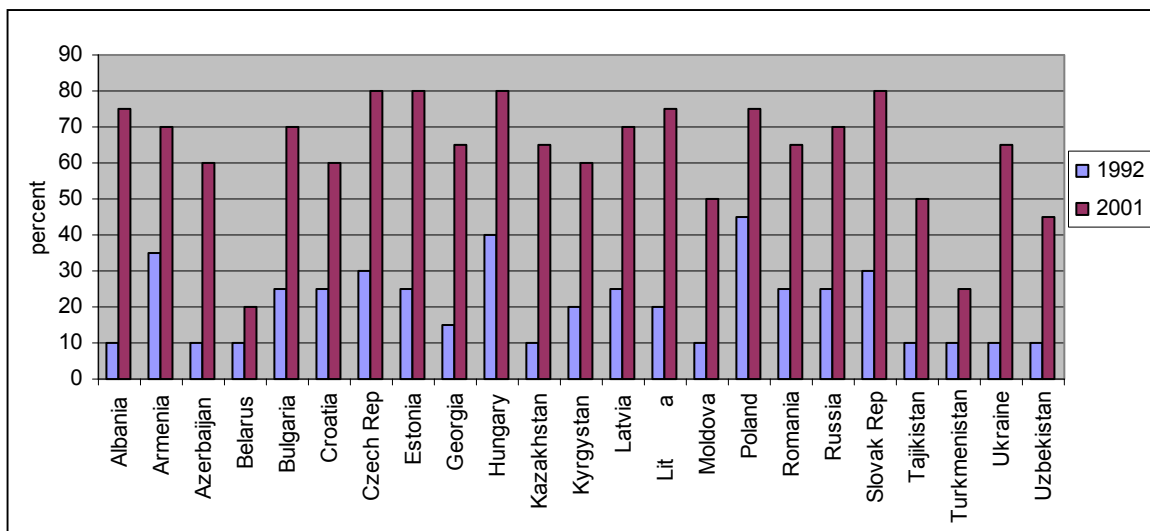
1.3 The path of transition chosen by Belarus since 1995 differs from the other countries in the region. Although some administrative controls have been reduced over time, including those on the exchange rate and a number prices, the economy remains highly regulated and under predominant state control. Relatively little restructuring appears to have occurred in either industry or agriculture and foreign direct investment remains quite low in spite of a new Investment Code. A new Banking Code, introduced in July of 2000, tightens prudential regulations, although banks remain largely state-owned and are subject to government imperatives for directed credits to the national economy.

1.4 In 1999, agreement was reached on the Belarusian-Russian Union Treaty, which formalized Belarus' deep economic links to Russia. This agreement has provided Belarus with substantial economic benefits, including very large energy subsidies and an open border providing easy access to Russian markets. Recently the two countries agreed that Belarusian goods would be transported within Russia at the domestic cost of transport. Belarus and Russia have expressed the joint goal of

a monetary union and potentially deeper integration. However, such integration would have important implications for fiscal policy (See Box 1.1)

1.5 As indicated above, one of the most striking aspects of the Belarusian approach is the degree to which economic activity has been retained within the realm of the state. It is estimated that private sector employment accounts for about 11 percent of economic activity. In most other transition countries there has been a substantial shift of activity away from the state sector and towards the private sector (See Figure 1.1). This has not been the case in Belarus.

Figure 1.1: Private Sector Activity as a Share of GDP, 1992 & 2001



Source: EBRD.

1.6 Such a large state role in the economic activity implies that the allocation of public resources is particularly important for overall economic outcomes. Recent trends that have threatened the liquidity position and budgetary balance of the government speak to the immediate necessity of a more rational allocation of public expenditures. Both growth and poverty reduction will be largely determined by the degree to which public resources are effectively used in the context of overall state expenditure reduction. The Bank's Country Assistance Strategy for 2002-2004 placed emphasis on the need to establish increased transparency and accountability in the use of public resources. This Public Expenditure Review is a step in understanding how public resources are used in Belarus.

Box 1.1: Implications of the Russia-Belarus Union for Public Expenditure Reform

Prospects are unclear for economic and political unification of Russia and Belarus.

Following agreement on a Union Treaty in 1999, movement toward monetary unification accelerated in 2002 with the signing of a “*Joint Action Plan for Introduction of a Single Currency in the Union State*” (JAP). The JAP envisages a range of macroeconomic and structural reforms, including harmonization of tax and customs legislation, budgetary procedures (including a Budget Code consistent with the Russian model) and of course monetary union. To support the integration process, the Central Bank of Russia (CBR) provided a Ruble 4.5 billion credit to the NBB, conditioned on performance against an IMF-style monetary program. The Russian Ministry of Finance also made available a budgetary credit line of \$100 million, also conditioned on reforms. Political developments in the second half of 2002 made it difficult for outsiders to judge the likely next steps in this process, however.

Current plans envisage a rapid move to a fixed peg and subsequent “ruble-ization.”

Already, the NBB pursues a crawling band exchange rate arrangement vis-à-vis the ruble (though monetary policy is *de facto* oriented on the dollar). Under the JAP, the Belarusian rubel is to be pegged to the ruble in 2004, and the ruble is to be introduced in Belarus from January 1, 2005. The NBB and the CBR do not seem to have agreed on the administrative arrangements for managing monetary policy in this new ruble area, as well as on whether or not a new “Union currency” should be introduced in 2008.

International experience with dollarization suggests that a hard peg and ruble-ization will have major implications for fiscal policy and require rapid structural reforms in Belarus.¹

As the experience of Argentina most recently confirms, a pegged exchange rate cannot long persist with loose fiscal policy. In Belarus, where the transition process has been gradual to avoid social dislocations, fiscal policy has traditionally been very loose, accommodated by monetary policy consistent with high inflation. If the rubel is pegged to the ruble, Belarus will more or less immediately be required to run monetary policy consistent with the Russian level of inflation, which in 2003 is expected to be about 12 percent. To move from 30-40 percent to almost single digit levels will require much tighter fiscal policy in Belarus.

For example, direct NBB financing of the budget deficit will have to be abolished. Any NBB credit to government will have to be limited to incidental financing arising from open market operations carried out exclusively on the secondary market at market interest rates. As a result, the housing construction program (the earmarked recipient of these funds at present) will have to be scaled back and financed out of non-earmarked sources.

If currency union is under serious consideration (and even if it is not), the PER team hopes the authorities will find this PER to be timely and useful. Belarus needs low inflation in order to attract investment and to grow at a rapid rate. But if a hard peg or ruble-ization are imminent, the level of public expenditures in Belarus will very quickly need to be brought to a level consistent with sharply lower inflation. To achieve both high growth and low inflation, Belarus will need to re-examine the role of the state in the economy (moving many activities which government now performs to the private sector), and improve the efficiency of government spending. This is precisely the objective of the current public expenditure review.

¹See A. Berg and E. Borensztein, “The Pros and Cons of Full Dollarization,” IMF Working Paper WP/00/50 (2000), available at <http://www.imf.org/external/pubs/cat/longres.cfm?sk=3486.0>.

I.7 The three goals that every budget system must strive to achieve are the following: i) to maintain aggregate fiscal discipline, ii) to allocate resources effectively, in accord with government

y out an
resource

priorities, and iii) to promote the efficient use of budget resources. These three objectives are complementary and interdependent. Without aggregate fiscal discipline, it is impossible to achieve effective prioritization and implementation. Strengthening internal management systems to achieve efficiency is not possible without a hard budget constraint. However, fiscal discipline in the context of arbitrary resource allocation and inefficient operations is also unlikely to be sustainable.¹ These objectives thus provide a framework for both assessing public resource management in Belarus and for thinking comprehensively about the steps that are needed to strengthen the system.

1.8 The study begins in Chapter II with an overview of the fiscal picture in Belarus, and highlights current worrisome trends in the economy and state finance that necessitate state expenditure reductions. Chapter III addresses the allocation of public resources and the implications both of the allocation process and of the allocations themselves. It discusses specific sectoral issues to some extent, but does not go deeply into any given sector. Its aim is to assess the systemic issues in the allocation and prioritization of resources that may prevent effective public service delivery. Chapter IV turns to the institutions of budget process and management in order to identify ways in which budgetary management can be made more effective. This chapter draws on work prepared for the Country Financial Accountability Assessment, as well as a separate background paper. Chapter V concludes the study with the development of a set of recommendations that may form the basis of an Action Plan to be agreed with the Government.

¹ See Richard Allen and Daniel Tommasi , 2001. eds. *Managing Public Expenditure: A Reference Book for Transition Countries*. Paris: OECD, p. 19-20.