Belarus: A New Policy Approach to FDI

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In 2007, the Belarusian Government requested the United Nations Conference on Trade and Development[1] (UNCTAD) to carry out an Investment Policy Review (IPR) for Belarus. The Investment Policy Reviews are undertaken at the request of Governments, as part of UNCTAD's technical cooperation services. Their aim is to provide an objective assessment of the enabling environment for investment, especially FDI. The IPRs involve several stages of consultations with stakeholders and a thorough analysis of policy, regulatory and institutional frameworks. UNCTAD then develops recommendations to help authorities improve the enabling environment and maximise the benefits of FDI. The 26 IPRs completed to date in Africa, Asia and Latin America have allowed UNCTAD to build an important repository of knowledge and expertise.[2]

Introduction

In 1991, the States formed as a result of the dissolution of the Soviet Union began independent economic policy-making. At that time, the majority of them decided to pursue liberalisation and privatisation. In contrast, Belarus chose to maintain a centrally-planned economy with limited forays into privatisation. Heavy regulations and administrative procedures, an ambiguous stance vis-à-vis private sector development and frequent reversals characterised the policy environment.

This lack of predictability kept affecting the investment climate and undermining foreign direct investment (FDI) attraction efforts. In 1994, for example, Belarus launched its first attempt at privatising some public assets and companies. Shortly after, however, the Government introduced the "golden share rule", which allowed public interference in the management of partially privatised companies. It then revised the provision so that it would apply irrespective of whether the State maintained or not a stake in the privatised asset. Although it was not exercised extensively, the "golden share rule" generated perplexity in the investors' community about undue public interference in the economy.

These policies have inhibited private entrepreneurship and resulted in a State with dominant presence in agriculture, industry and services. To date, the private sector accounts for only around 25 per cent of GDP.
Not surprisingly, in this context, the FDI attraction performance of Belarus has been poor compared to most other countries of the Commonwealth of Independent States (CIS). Between the second half of the 1990s and the first half of the 2000s, while average FDI inflows increased in all CIS and neighbouring countries (with the exception of Uzbekistan and the Kyrgyz Republic), FDI inflows to Belarus declined. Over the period 2001-2005, average annual FDI inflows to Belarus stood at $197 million, i.e. one third of the FDI inflows to neighbouring Lithuania ($632 million) and one half of the FDI inflows to Latvia ($408 million). Belarus' FDI stock reflects a similar situation.

However, Belarus is now boosting efforts to attract foreign investment. After decades of dirigist policies and State-led economic growth, the authorities have embarked upon a vast reform programme to ease the constraints on private sector development, reduce the role of the State in the economy and attract FDI. The ultimate objective is to support GDP growth and economic modernisation so as to better respond to external shocks, reduce the reliance on Russian energy inputs and diversify exports.

This article illustrates the recent economic policy history of Belarus and discusses the key elements of the new policy approach towards FDI and private sector development. It also presents a number of recommendations to improve the investment climate, based on UNCTAD's forthcoming Investment Policy Review of Belarus.

Recent policy and economic trends

Notwithstanding the limited role of the private sector in the economy, Belarus experienced an unprecedented period of growth with real GDP rising between 5 and 10 per cent since year 2000.

In the mid-1990s, in reaction to a post-independence economic crisis which slashed GDP per capita to one third of its 1991 level, the Government pursued a growth strategy based on expansionary credit policies combined with strict wage, price and output controls. It also favoured extensive State support of industry and agriculture, which frequently involved

1 The United Nations Conference on Trade and Development (UNCTAD) is the UN agency dealing with trade and development issues. It serves 193 Member States as a forum for intergovernmental consensus-building on trade and development policy. It undertakes research, policy analysis and data collection, and facilitates debates among experts to identify good practices and policy advice. It also provides technical assistance to help countries implement international commitments, enabling policies and good practices.

2 For more information about the investment policy review programme, visit www.unctad.org/ipr.

* This article is based on the findings of the forthcoming IPR of Belarus. The views expressed here are the author's and do not reflect the official views of UNCTAD and its member States.

interventions in credit decisions of the central bank. Initially, this stimulated employment, domestic consumption and GDP growth. Soon however, the strategy proved unsustainable. Inflation started to climb drastically, reaching over 200 per cent in 1999, with a deteriorating effect on real GDP growth.

In 2000, the Government began restoring macroeconomic order and bringing inflation under control by tightening monetary policy – increasing lending rates and limiting government interventions in credit allocation. It also began moving away from the barter trade system that had arisen with Russia, improved central budget management (following international accounting standards) and unified the multiple exchange rate system maintained since the early transition years. The economy responded positively to these policy changes and grew at a fairly rapid pace, remaining above 8 per cent from 2004 to 2007.

This good economic performance was fuelled in good part by Belarus' special relationship with Russia. Through the arrangements negotiated during the initial period of independence, Belarus was able to preserve the preferential oil and gas import pricing it enjoyed in the Soviet era and to secure advantageous market access for its products. Belarus earned significant revenues from the re-export of Russian oil and gas. For example, in 2004, Belarus was purchasing gas from Russia at $48 per 1000 cubic meters while Western Europe was paying $135. Similarly, Belarus paid $25 per barrel of oil compared to the international price of $37. Cheap energy, preferential access to the Russian market and a lower wage rate made Belarusian exports to Russia very competitive. Concurrently, Russia's economic growth fuelled demand for the cheaper Belarusian goods.

The rapid pace of economic growth has slackened since 2007, due partly to a new agreement on energy prices, initiated by Russia, which resulted in a gradual phasing out of some of the advantages enjoyed by Belarus. The agreement allowed Russia to steadily raise the price of gas and oil exports to Belarus until 2011, at which time they are set to converge to world market prices. A first increase of 14 per cent took place in the same year, but it was then more than offset by the rise in the international prices for oil and gas, enabling the government to continue subsidising domestic exporters, largely State-owned enterprises (SOEs).

Since then, oil and gas prices have significantly declined in reaction to the global economic crisis which started in 2008. Gradually, nonetheless, the convergence to world prices will increase the cost of gas imports thus reducing the government's margin on gas re-exports. Therefore the capacity to subsidise domestic consumption and industry will diminish. This could be particularly challenging at a time when wage increases are hindering price competitiveness.

At the same time, the international economic crisis and the consequent reduction in international demand for Belarusian goods, particularly from Russia, is taking a heavy toll on the country's exports. Between January and May 2009, Belarusian exports declined by 45.5 per cent, notwithstanding a 20 per cent devaluation of the Belarusian rouble in January 2009. Real GDP growth for 2009 is expected to decline between 2 and 3 per cent.

These issues are exacerbated by the dominant role of SOEs in economic production, along with the continued reliance on price controls and subsidies, which limit internal competition. Hence the pressing need for an infusion of fresh investment, both domestic and foreign, to modernise the economy and take advantage of Belarus' competitive assets including its privileged geographical position between Russia and the European Union, transport infrastructure and highly skilled labour force.

Against this background, the authorities have started to consider the advantages of divesting the SOEs and creating new opportunities for local and foreign investors. Ambitious goals have been set to increase the share of small and medium enterprises (SMEs) in the economy. Likewise, a target was set to increase FDI inflows from 2.6 per cent to 15 - 20 per cent of total investment. In line with the new FDI objectives, the Government has embarked upon a widespread reform effort since late 2007.

Improving the investment climate

The key reforms include the streamlining of the business registration process, a reduction in the number of activities for which a license is required; the removal of the controversial "golden rule"; a new land code which allows enterprises to access property title to land. These add to the more than 60 decrees and edicts aimed at addressing regulatory impediments, improving the interface between the public and the private sector and reducing the cost of doing business. A new round of privatisation was also launched in July 2008, and contrary to the former programme, it openly targets foreign investors in different sectors and includes attractive assets and large SOEs and not only loss-making enterprises.
As a result of these reforms, the regulatory and administrative burden on business has eased. This is acknowledged by both local and foreign investors. In May 2008, the Advisory Council for Foreign Investments, the main dialogue platform between the Belarusian Government and foreign investors, indicated that "the speed and consistency of the recent reforms have raised legitimate hopes regarding the increase in Belarus' attractiveness as an investment location". Moreover, the World Bank's 2009 Doing Business Report showed a marked improvement in the 'ease of doing business' in Belarus.

The findings of UNCTAD's ongoing Investment Policy Review (IPR) of Belarus are also encouraging.
The Reviewers believe that the reforms are heading in the right direction to deliver a more transparent, predictable and competitive business environment - indispensable for attracting high-quality investors. However, significant challenges remain. UNCTAD's IPR has identified a number of areas where determined and coordinated action will enhance Belarus's competitiveness and increase its attractiveness as an investment location.

Weaning the economy off subsidised energy by 2011 and exposing the state-owned productive sector to international competition will be an important part of creating a competitive economy. This will go hand in hand with Belarus's accession to the WTO and harmonisation with the multilateral trading system's openness, transparency and non-discrimination principles and rules.

Notwithstanding recent reforms in the area of taxation, Belarus' fiscal competitiveness is held back by very onerous flat taxes based on sales introduced at the local level, by ad hoc contributions to the various innovation funds of the public administration and by the complexity which tax reporting and payment imposes on business. The IPR leads to several main recommendations on re-orienting tax policy including, among others: establishing loss-carry forward for at least five years; abolishing the sales and services taxes introduced by the local authorities; replacing the "innovation funds" and other ad hoc contributions by "payments for services offered"; and replacing the monthly payments of the corporate tax and most other taxes by three payments per year.

In the area of labour regulations, a rigid wage determination system does not allow investors to attract and reward managers and employees based on their skills and productivity. The IPR recommends that the Government revise the wage classification system so as to protect the lowest paid workers by introducing different minimum wage levels for different categories of workers, while freeing wage-setting above the minimum levels.

The IPR also emphasises how Belarus could benefit from attracting foreign skills through FDI, and how it should make this an explicit objective of its FDI policy. Hence, the foreign workers' entry regime should be streamlined by the adoption of a one-stop approach to the expatriate entry process and the replacement of the labour-market testing procedure by a pre-determined list of skills shortage. Moreover, the work and residence permit should be merged, and the validity of the work and residence permit should be extended according to internationally accepted practice. One of the most recent changes to the investment climate is a new Land Code entered into force in January 2009. This sets the ground for the development of a proper real estate market, and allows companies to access title to land, including in the form of ownership. Until a sufficient number of titles are accessible through this market, however, investors will continue to find it extremely difficult to obtain land title from the State. During this transition period, UNCTAD recommends a number of measures to facilitate land access, including streamlining both the procedures for land zoning and those for land allocation and rationalising the coordination between the local and central authorities in this area.

A properly level playing field among the different economic agents will be key to maximising the benefits of FDI for the development of the local private sector and reducing potential crowding out effects from the entry of TNCs. In this respect, the competition policy and regime need significant strengthening. In particular, the IPR recommends reviewing all discriminatory practices with respect to the access to inputs so as to remove distortions, where these are not strictly justified by public interest.

It also calls for the creation of an independent, professionally staffed and adequately funded National Competition Authority and for bringing the competition legislation up to international standards.

As requested by the Belarusian authorities, the IPR also outlines the key elements of a strategy to support SME development through FDI. The strategy can be articulated around four sets of measures aimed at: improving the FDI-specific regulations by strengthening the treatment and protection provisions of the investment code; enhancing the general investment climate in areas such as taxation, competition and land; removing obstacles to SME development, particularly in the areas of price regulations, reporting requirements and administrative controls; and adopting targeted policy interventions to foster the developmental role of FDI for the SME sector, such as carrying out professional investor targeting activities to attract investor in sectors which are prone to the establishment of supplier linkages and designing specific linkages policies.

Conclusion

Attracting high-quality, competitive investors is a big challenge facing any country. It is also an important strategy a government can activate. The right investors can bring new management techniques, technology, skills, markets and value-chain integration opportunities. In Belarus, they can test-market goods and services, and help transform existing competencies into competitive skills and products.

However, FDI, like trade, is not a magic potion for development. It exposes local producers to competitive pressures and may require short-term adjustments. The Government has an important role to play in mitigating these risks and maximising the beneficial impacts for the embryonic private sector. It can do so by accelerating reforms, fostering innovation, providing education and training to fill gaps in the skills base, and encouraging foreign investors to develop local sourcing networks. Government can also remove obstacles and distortions that reduce competitiveness in terms of time, cost, quality, value-added, etc.

Policy stability and coherence should be prominent objectives of the reform agenda. It is widely recognised that transparent and predictable legal environments play a crucial role in making an economy competitive. Since 2007, Belarus has introduced many policy initiatives, laws, decrees and edicts as part of the reform process. The challenge will be to ensure that these lead to better business conditions. This will require highly effective and targeted consultation, coordination and implementation. The extent to which FDI inflows to Belarus will react to the recent reforms in a sustained way will also depend on the ability of policy-makers to convey a coherent and consistent message not only to international investors but also to the internal administration in charge of day-by-day policy implementation.