Financial Liberalization in Belarus and Estonia

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Abstract

Following the 1991 dissolution of the USSR, the newly independent republics implemented a wide range of financial regulations and monetary policies. The McKinnon/Shaw model of government financial participation predicts financial liberalization spurs economic growth and financial deepening. Although rapid liberalization can create problems, the literature generally accepts that a prudent, and possibly gradual, move toward financial liberalization improves economic viability. Estonia implemented liberal financial policies, while Belarus's government has consistently intervened through interest rate controls, mandated financing of government debt, directed credit allocation, and exchange rate manipulation. Although economic growth has been healthy in both countries during the last two decades, the overall level of price stability, investment, and future potential is higher in Estonia. Belarus's economy may benefit from changing its financially repressive policies.

Key Words: Estonia, Belarus, financial liberalization, financial repression

1. Introduction

The breakup of the Union of Soviet Socialist Republics (USSR) in 1991 altered the course of political and economic history for the countries in Eastern and Central Europe. During the 1980s Soviet Leader Mikhail Gorbachev pursued limited political and economic liberalization with the intent of improving economic conditions within the communist union. However, leaders of the communist party who wished to maintain a strong central regime attempted an August 1991 coup d'état to remove Gorbachev from office and re-establish authoritarian rule. The attempted coup d'état ignited concerns among the republics that the reforms of the 1980s might be undone and brought suppressed nationalism in the republics to the surface (Gaidar, 2007). Therefore, many of the republics declared their independence in August 1991to avoid a reversal of the 1980s reforms and to pursue statehood. The USSR formally ceased existence on December 25, 1991, and the fifteen former member republics became independent sovereign states.

After gaining independence, the former republics faced the daunting task of re-establishing political structures and developing economic policies. These transition economies typically had outdated and labor-intensive production facilities, inadequate agricultural equipment, and a generally low-skilled labor force (Bakanova, de Souza, Kolesnikova & Abramov, 2003). In addition, the abrupt move from a centrally-planned Moscow regime led to U-shaped gross domestic products (GDP) for most of the transitioning economies. Output initially fell sharply, reached a minimum, and then rebounded. The depth of the "U" and the elapsed time before rebound varied across the countries, influenced by both initial conditions and government policies (DeMelo & Denizer, 1997).

The paths chosen by the sovereign states resulting from the breakup of the USSR varied widely with some nations implementing liberalized political and economic reforms and others retaining an authoritarian central government. The Baltic republics of Estonia, Latvia, and Lithuania formed democratic governments and pursued financially liberalizing policies. In contrast, while Belarus declared its independence in August of that fateful year, the presidents of Russia, Ukraine, and Belarus met in December 1991 and agreed to dissolve the USSR and replace it with a looser union known as the Commonwealth of Independent States (CIS). Ukraine, Belarus, and the other Central Asian Republics largely retained authoritarian regimes and maintained close ties with Russia.

This paper uses a case study approach to compare and contrast the Republics of Estonia and Belarus, two countries which have taken seemingly opposite approaches to political and economic policies since gaining independence. This study focuses on the level of financial liberalization in the two countries as a key aspect within the general political and economic framework. The remainder of the paper is organized in the following manner. The next section briefly discusses the literature on financial liberalization and its impact on economic growth, particularly for transition economies. The following section summarizes the financial policies of Belarus and Estonia during the two decades since becoming sovereign states and analyzes the impact of these policies as reflected in actual and projected economic data. It also summarizes the impact of the recent global financial crisis on the two countries and each country's economic outlook.

2. Literature Review

McKinnon (1973) and Shaw (1973) provided the initial conceptual support for policies of financial liberalization. They identified several common practices of the 1960s and 1970s that McKinnon termed "financial repression," including the regulation of interest rates, high reserve requirements on bank deposits, requiring banks to finance government deficits, administration of foreign exchange rates, and qualitative restrictions on credit allocation that mandate resource use. These repressive policies usually result in low savings and private investment rates and credit rationing. McKinnon and Shaw believed that, in contrast, financially liberating policies would free financial markets from government intervention and allow market-determined pricing and credit allocation to prevail. Therefore, the policy implications associated with financial liberalization are to "remove interest rate ceilings, reduce reserve requirements and abolish directed credit programs" (Arestis & Demetriades, 1999, p. 442). As real interest rates adjust to market equilibrium levels, investment projects with low yields are discouraged and investment efficiency is enhanced. Increases in real interest rates also encourage higher savings and investment rates. Therefore, economic growth results through both increased volume and productivity of investment. Lowering reserve requirements should theoretically increase bank lending, and the abolition of mandated capital allocation should result in more productive capital use (McKinnon; Shaw). These policies encourage financial deepening, or the increased provision of financial services, in a society.

The McKinnon/Shaw model was widely accepted during the 1970s and 1980s, and a body of literature both expanded these theories and used empirical data to support this argument. For example, Pagano (1993) demonstrated that interest rate controls and reserve requirements could lower the availability of financial resources, while Roubini and Sala-i-Martin (1992) showed that repressive financial policies led to weak growth performance in Latin America. Financial liberalization theories became the basis for World Bank and International Monetary Fund (IMF)policies in transition economies after the 1970s (Korosteleva & Lawson, 2010).

2.1 Criticism of the McKinnon/Shaw Model

Despite this early adoption, support for pure financial liberalization models came under fire for two reasons: academics questioned the underlying implicit assumptions and the less than optimal results from financial liberalization in Latin America and Asia (Huang & Wang, 2011). Financial liberalization theories are implicitly based on three assumptions: 1) perfect information; 2) profit-maximizing competition by banks; and 3) institution-free analysis (Arestis & Demetriades, 1999). Perfect information assumes the two parties of a financial transaction are equally informed. However, Stiglitz and Weiss (1981) argued that asymmetric information exists between borrowers and creditors and can lead to both adverse selection and moral hazard. Adverse selection may be higher when interest rates rise as high-quality borrowers exit, leaving only high-risk borrowers. In this case, interest controls or credit rationing may be prudent decisions for reducing loan portfolio risk. Asymmetric information is particularly problematic in developing countries that lack the credit information systems of developed economies (Akerlof, 1970). Therefore, Arestis and Demetriades (p. 445) concluded, "There is no doubt that the higher interest rates associated with financial liberalization exacerbate information-related problems, which threaten the stability of the banking system."

The second assumption of the financial liberalization thesis is profit-maximizing competition by banks. The desirability of this assumption has also been questioned. Hellman, Murdock, and Stiglitz (2000) showed that competition may result in imprudent and riskier banking practices.

Therefore, deposit rate controls may positively impact capital allocation decisions through financial restraint, particularly in environments with asymmetric information. Pure financial liberalization also implies financial laissez-faire, or a financial sector free of significant regulatory or supervisory institutions. These institutions include an effective legal system, central banks to maintain currency value, strong bankruptcy laws, and bank supervision and regulation (Arestis & Demetriades, 1999). However, the importance of these institutions and their ability to promote macroeconomic stability is supported by research (Fry, 1997; Huang & Wang, 2011). Fry argued that several prerequisite conditions should exist prior to considering financial liberalization policies, including: price stability, fiscal discipline, the avoidance of inflationary money expansion, and prudent regulation and supervision of the financial sector. As one can see, the implementation of pure financial liberalizing policies in transition economies is not universally supported, particularly without first considering other necessary structures and stability.

2.2 Financial Liberalization in Latin America and Asia

Several Latin American and Asian countries pursued financial liberalization during the 1970s and 1980s. Columbia, Uruguay, and Venezuela adopted these policies in the early 1970s, followed by Malaysia, Argentina, Brazil, Chile, and Mexico in the latter part of the decade. Turkey, Israel, the Philippines, and Indonesia implemented similar reforms in the 1980s. In many cases interest rates climbed over 20 percent, bank failures caused by bad debts were common, and overall economic volatility was evident. In general, the economies experienced severe and prolonged recessions that encouraged them to abandon financial liberalization (Arestis & Demetriades, 1997). It appears the underlying problem was unleashed consumer and investment demand that was not met by domestic savings. Speculative credit allocation triggered a cycle of loan losses, increased interest rates, unstable foreign investment chasing high yields, and higher susceptibility to international markets (Arestis & Demetriades, 1999). Many of the countries faced banking crises and/or economic collapse leading many to question the desirability of pure financial liberalization (Diaz-Alejandro, 1985). Based on these experiences, Stiglitz (1994) suggested an optimal level of financial repression was necessary to improve the efficiency and stability of emerging financial markets.

Although pure financial liberalization has its critics, there appears to be a general consensus that financially repressive policies stunt financial development and consequently economic growth in the long-run (Korosteleva & Lawson, 2010). Several studies (Li, 2001; Maswana, 2008; Huang, 2010) have examined the effect of financial reforms in China. China's financial liberalization has taken place gradually since the 1970s. China's repressive financial policies have resulted in efficiency losses that have hurt its economic growth, particularly during the last decade (Huang & Wang, 2011). Although the gradual policy changes have allowed the government to maintain the ability to quickly adapt to a changing environment (Maswana, 2008) and enjoy some measure of financial stability (Li, 2001), Lardy (2008) estimated that financial repression, primarily through negative real interest rates, was costing Chinese households approximately 4% of GDP. Li (2001) and Huang and Wang (2011) concluded that China's gradual reform approach may be an appropriate model for transition countries; however, failure to aggressively pursue financial liberalization at some point may create a low-efficiency trap that is self-propelling and self-sustaining.

As noted above, the existing literature identifies both potential benefits and pitfalls to financial liberalization. With this foundation in mind, the next section summarizes the degree of financial liberalization exhibited by Belarus and Estonia and the economic performance of each since gaining independence. This provides a chance to compare and contrast the potential outcomes associated with these policies for countries with a similar political and economic starting point.

3. Estonia

3.1 Estonia: Financial and Economic Policies After 1991

Present-day Estonia was part of the Russian empire until 1918 when it became an independent state. It remained independent until 1940 when it was absorbed into the Soviet Union. Although Germany briefly controlled the country between 1941 and 1944, the Soviets regained control in 1944 and remained until 1991. The country formed a parliamentary democracy and held elections in 1992(CIA, 2012b).

As mentioned earlier, most of the transition economies of the former USSR and Eastern Europe experienced a sharp decline in economic activity immediately following the fall of the USSR.

Estonia is not an exception as the economy shrank 36% from 1990 to 1994 as it lost markets to the east. In the midst of this decline, Estonia made a distinct decision to break away from communist policies and consistently initiated economic reforms after gaining independence in 1991. One of the early initiatives was privatization of most major industries and state-owned enterprises (SOEs), a goal which is largely complete (US State, 2012b).The railroad, two power plants, and a small number of municipal enterprises remain in public hands (Country Watch, 2012). Estonia also adopted a simplified flat tax in 1994, which has helped to reduce the shadow economy and tax evasion to levels envied by neighboring countries (Putniņš & Sauka, 2011).

Estonia adopted a currency board arrangement (CBA) when it replaced the ruble with the kroon in June 1992. A CBA is essentially a fixed exchange system with a "country specific gold standard" (Khoury & Wihlborg, 2006, p. 127). The kroon was first pegged to the German mark (8 kroon: 1 DM) and then the Euro after Germany converted in January 1999. The currency was initially undervalued, which allowed for relatively high inflation during the early years (Choudhry & Wallace, 2008). The CBA allowed currency reform to be enacted quickly and inspired confidence in the currency that moved the economy away from the dollarization it had been experiencing (Sorg & Vensel, 2002). Enacting a CBA requires the country to use tight fiscal policy as the financing of budget deficits is not allowed. CBAs also limit the central bank's ability to bailout banks or act as a lender of last resort. While this may reduce policy options during a crisis, it also encourages banks to adopt more prudent risk management practices. Liberal economic policies and free capital movement are also essential under a CBA in order to prevent distortions in exchange and interest rates. Estonia met these criteria given the lack of restrictions on currency or capital flows in and out of Estonia and the absence of interest rate controls on either deposits or loans (Sorg & Vensel). The central bank, the Bank of Estonia, was tasked with operating the CBA and was prohibited from devaluing the kroon or financing government debt (Khoury & Wihlborg). In order to maintain its independence from political pressure, the Bank of Estonia's assets were kept separate from the government and its managers were appointed by the President and Parliament (Sorg & Vensel). In many ways, Estonia's monetary policy was "outsourced" to the pegged currency (Germany) given the fixed exchange rate and strong controls on central bank operations (Khoury & Wihlborg). The CBA is no longer necessary since Estonia joined the Eurozone in 2011.

Estonia experienced two banking crises from 1992 through 1999 which encouraged the development of supervisory practices and helped eliminate inefficient and poorly managed institutions. During the first crisis of 1992 through 1994, the Bank of Estonia established minimum financial requirements and a 10% reserve requirement. These actions encouraged the use of better risk management practices and attracted foreign investment. The second crisis (1998-1999) was partly influenced by Asian and Russian crises, as well as continued inefficiencies and mismanagement within the domestic sector (Sorg & Vensel, 2002). This second crisis initiated mergers and restructuring that resulted in Nordic banks gaining a strong presence in Estonia bringing total foreign ownership to 60% in 1999 and 78% in 2000.Swedbank has consistently maintained the highest market share at almost 50%, and Swedish and Finnish-owned banks collectively hold more than 90% of Estonia's banking assets (Khoury & Wihlborg, 2006).

Estonia's primary stock exchange, previously known as the Tallinn Stock Exchange, began trading in 1996 as the product of a coalition of commercial banks, brokerage firms, and state agencies. It was acquired by Finnish HEX Goup in 2001, merged with a Swedish operator to form OMX in 2004, and further merged with Nasdaq in 2008. Now called the OMX Tallinn, it provides a relatively small, but healthy, secondary market for the country's private firms (Sorg & Vensel, 2002).

Estonia's liberal economic policies allowed it to reorient toward the West and integrate with the European Union and other international organizations. It joined the International Monetary Fund in 1992; the World Trade Organization in 1999; the European Union in 1994; and was invited to begin accession discussions with the Organization for Economic Cooperation and Development (OECD) in 2007. It completed the OECD accession process in December 2010 and was allowed to enter the Eurozone in January 2011 (US State, 2012b).

3.2 Estonia: Economic Conditions 1991 – 2008

While Estonia has suffered through financial crises and recessions during the last two decades, it has generally experienced a steady growth in the standard of living, as shown by GDP per capita. As depicted in Table 1, GDP per capita (PPP) has improved from $5,700 to $20,400 since gaining independence.

Services contribute approximately 72% to GDP, followed by industry (25%) and agriculture (3%). These numbers have shifted more heavily toward the services component given the country's increasing development and global participation since 1991. Financial and insurance services are the largest services sector, while electronics and telecommunications are important industries (CIA, 2012b). Estonia has benefited from research and development activities in these areas. For example, Skype, the commonly used video-telecommunications product, was developed in Estonia (US State, 2012b).This is one product of the country's sound investment rate, which consistently remained between 25-35% of GDP from 1991 through 2008 (IMF, 2012b).

In addition to private domestic investment, Estonia has enjoyed an increasing level of FDI over the last two decades. It attracted an average of $679 million for the years 1995 through 2005, primarily from Europe and the US. This increased to $2.7 billion in 2007, but fell significantly during 2008 and 2009 as a result of the global financial crisis. Estonia is known as the "Baltic Tiger" and in a 2010 survey of corporate executives it enjoyed one of the highest levels of awareness among potential FDI participants. Of the former Soviet republics, it was considered the closest to being ideal for FDI based on its accommodating business environment and stable political and economic environment (Festervand, 2011).

Estonia's export markets have contributed heavily to the country's economic growth and development (Bruneckiene & Paltanaviciene, 2012). In 1990, 87% of Estonia's trade was with the Soviet Union and only 5% was with Western markets (US State, 2012b). Although it still conducts trade with Russia, Estonia reoriented toward the West following the breakup of the USSR. Its strongest trading partners are Finland and Sweden with over 30% of exports, followed by other European neighbors (CIA, 2012b). In addition to electronics and other technology products, Estonia exports electricity generated through local oil shale or alternative sources to Finland through undersea cables (US State, 2012b).Total exports increased from about $6 billion in 2002 to $13.4 billion in 2009; imports similarly grew from $6.9 billion to $15.4 billion. Entering the Eurozone in 2011 should allow Estonia to maintain or expand its strong presence in foreign trade.

Despite strong economic growth and investment, unemployment continues to plague the Baltic nation. The unemployment rate ranged from approximately 9.5% to 14% for 1995 through 2004 before leveling off closer to 5%-6% through 2008. The global financial crisis of 2008 resulted in rising unemployment that peaked early in 2010 at over 17%. While it has started to fall during the last 18 to 24 months, long-term unemployment appears to be a growing concern (US State, 2012b). This situation appears to reflect, at least in part, a jobs skills mismatch that could have a long-term detrimental impact upon the economy if not corrected (IMF, 2011).

Conservative monetary and fiscal policies during the last two decades have allowed for a moderately low inflation rate and low external debt. Although the inflation rate remained in the double digits through 1997, it averaged approximately 4.5% for 1998 through 2007. Following a spike during 2008, growth in prices resumed more moderate levels during the financial crisis and since (IMF, 2012b). Estonia's "enviable fiscal position" is the result of fiscal policies aimed at maintaining a balanced federal budget. This position gives Estonia a strong reserve and buffer against downside risks and the ability to adopt a more growth-oriented budget, if necessary and desirable (IMF, 2011).

3.3 Estonia: Global Financial Crisis

Estonia was hit harder by the 2008 financial crisis than most countries in the European Union. Estonia, along with its Baltic neighbors of Latvia and Lithuania, suffered a double-digit decline in GDP during 2009. As stated above, unemployment spiked higher. Estonia's CBA, combined with a large exposure to foreign trade, likely exacerbated the financial crisis for the Baltic states (Terazi & Senel, 2011).Inflation peaked in 2008 at 10.4% before experiencing a minimal deflation rate in 2009. Although inflation has stabilized, real wages have declined. Commercial and individual domestic credit contracted about 15% from its 2008 peak as a result of declining demand during the crisis. Estonia also experienced a real estate bust with almost 25% of mortgages having loan-to-value ratios above 100% (IMF, 2011).

Although Estonia did not undertake major financial sector bailouts like those by other western governments, its public finances were indirectly affected by factors such as reduced commercial activity and high unemployment. General government revenues fell; however, their level as a percentage of GDP increased due to the decline in economic output. Government expenditures as a percentage of 2009 GDP also increased, but are much lower when compared to 2008 GDP (Terazi & Senel, 2009).

Unlike other countries in the region, Estonia pursued aggressive revenue-enhancing policies such as higher unemployment insurance contributions, divergence of pension contributions, higher value-added tax rates, higher excise taxes, and some transfers from SOEs (IMF, 2010). As a result, the budget deficit during the crisis was below 3 percent of GDP in spite of substantial GDP declines. In order to quickly mitigate the impact of the crisis, the government facilitated faster methods of approving budgets (Jõgiste, Peda & Grossi, 2012).

In most ways, Estonia recovered rather quickly from the crisis; however, unemployment continues to be a concern. Despite the high unemployment rate, labor shortages exist in many markets due to mismatched skills and job opportunities in the Nordic states (IMF, 2011). The government is trying to improve the long-term employment situation with vocational training programs and other job-matching efforts.

3.4 Estonia: Future Prospects

Based on most economic indicators, Estonia appears to be poised for future economic growth and development. The business and political environment is attractive to foreign investors, and a history of conservative fiscal policies gives it a strong position for managing future risks. The banking system, which is largely Nordic-owned, demonstrated stability during the 2008 financial crisis and is considered well-capitalized. Although Estonia's adoption of the Euro may make it susceptible to the ongoing debt crisis in other portions of the Eurozone, the Nordic banking system is less vulnerable than other European banking markets. Estonia's overall competitiveness in the global market continues to improve as evidenced by export market share and real exchange rates (IMF, 2011). Economic growth continues to be among the highest in the European Union, and GDP per capita trends indicate the overall standard of living continues to improve. By addressing the labor market concerns noted earlier, Estonia would improve its ability to maximize current and future economic growth. Overall, Estonia appears to have effectively implemented market reforms that liberalized its financial markets and spurred its transition from a communist Moscow-led regime to a free market economy with healthy growth and participation in the global economic community. Unlike other transition economies that faltered after liberalizing financial markets, Estonia seems to be thriving (Sulling, 2002; Khoury & Wihlborg, 2006; IMF, 2011).

4. Belarus

4.1 Belarus: Financial and Economic Policies After 1991

Unlike Estonia, Belarus had not experienced independence until 1991. It was occupied by the Russian empire from the late 1700s through 1918. It declared itself a National Republic in March 1918, but was soon forced into the USSR. Like Estonia, it experienced a short period of Nazi control before being retaken by the Soviet Union in 1944. After declaring independence in 1991, Belarus adopted its constitution on March 30, 1994, and formed a republic government. Following the election of Alyaksandr Lukashenka in 1994, a revised constitution was implemented in November 1996 that significantly expanded the powers of the president. The referendum that implemented the revised constitution was not recognized internationally. Similarly, the United States and other western countries consider the most recent re-election of Lukashenka in December 2010 to be illegitimate. Lukashenka has consistently consolidated power in the executive branch, implemented a 2004 referendum that eliminated term limits, disregarded basic rights, and oversaw a violent crackdown on those protesting the 2010 election (US State, 2012a).

Like other former republics, Belarus experienced an initial economic decline after the fall of the USSR, but a relatively strong industrial base and continued strong relations with Russia allowed it to mitigate the severity. The communist leaders and society in general seemed content to maintain the status quo, "including a single ruble zone and an assured supply of oil and gas at subsidized internal Russian prices" (Korosteleva & Lawson, 2010, p. 35). Following a recession in 1993-1994 coupled with inflation of 2,221% in 1994, authorities implemented limited financial reforms, including positive real interest rates, allocation of short-term loans through credit auctions, tightened monetary expansion, and reduced reserve requirements (Korosteleva & Lawson). These actions restored value to the Belarusian ruble and some stability to the economy. Limited privatization of SOEs and the creation of a legal framework for private property also took place prior to 1996 (US State, 2012a).

The financial sector developed modestly from 1991 through 1996. Institutions within Belarus that were previously part of USSR banks were considered the country's property. The National Bank of Belarus (NBB – central bank) began operations, and several joint-stock commercial banks sprang up.

Altogether, approximately 40 banks started before 1996 and gave the country a limited source of private capital that promoted the privatization of the country's industries. The NBB had its greatest level of independence and monetary authority during the early 1990s (Daneyko & Kruk, 2005). In 1995, President Lukashenka adopted a "socially-oriented market economy" that repealed many of the reforms from previous years (Bakanova et al., 2003). In order to maintain his own popularity by preventing declining living standards, Lukashenka oversaw resource allocation and interest rate controls that would boost aggregate demand and keep SOEs alive. He also increased nominal wages, created licensing of economic activities, and instituted foreign exchange restrictions. "Repression of the financial sector was placed at the centre of this policy, to make financial intermediaries serve government needs" (Korosteleva & Lawson, 2010, p. 35). The privatization of the financial sector that had started in the early 1990s was abandoned as the state once again retook control.

The NBB was placed under the operation of the central government, and the Belarusian president assumed the power to appoint and remove the chairman and board members of the central bank, giving him significant control over policy decisions. Executive decrees issued in 1996 further served to re-nationalize the banking sector by increasing the government's share and SOE's share of bank funds, listing the banks providing state programs, and officially listing six banks whose priority would be servicing state projects and government debt (Korosteleva & Lawson). For example, Belarus Bank's mission became "implementation of government policy aimed at protecting household deposits, improving banking services for individuals and corporations, lending to targeted government programs for the development of priority sectors of the republic's national economy, and raising additional financial resources for investments in the economy and the social sphere" (Daneyko & Kruk, 2005). The six 'system-forming banks' essentially constituted a government banking monopoly that controlled over 90% of total assets (Korosteleva, 2004) and still account for 75% in 2011 (US State, 2012a). "Re-nationalisation of specialized banks, subordination of the NBB to the government, centralization and state monopolization made the banking system impotent and turned it into a control tool. Moreover, this occurred in a system with very shallow capital markets, where finance was solely bank-based" (Korosteleva& Lawson, 2010, p. 36-37).

During the late 1990s, Lukashenka and his administration continued to implement financially repressive policies, including high reserve requirements, interest rate controls, easy credit to finance output at SOEs, and currency exchange administration. These helped to implement Lukashenka's strategy for economic growth which required directed and preferential loans for key industries, negative real interest rates, and multiple exchange rates (Daneyko & Kruk, 2005). The credit was primarily directed toward agriculture and housing construction with lending margins of only 1-2 percent and outstanding principal and interest was rarely fully received. Interest rates were administratively controlled with little documentation regarding these levels; however, real interest rates were at or below zero for 1995 through 2000. This level discouraged savings leaving an inadequate supply of lending funds that was usually given to SOEs receiving preferential treatment. The use of directed credit expansion without savings growth led to inflationary pressures and excess liquidity, which the NBB "corrected" by requiring high reserves for the system-forming banks. The government also adopted a planned devaluation of the ruble from 1996 through 2000 with an official exchange rate that was 60 percent below the market rate (Korosteleva & Lawson, 2010).

From 2000 through 2008, Lukashenka and his administration moved the economy modestly toward financial liberalization. The NBB made efforts to end direct lending to the central government and tightened monetary policy in order to reduce inflation and stabilize the currency value. Some changes to the ownership of system-forming banks were also instituted, but the government retained control in Belarus Bank and three others. The banking sector was minimally opened up to foreign capital and some private ownership in enterprise zones existed (Daneyko & Kruk, 2005). Despite these modest changes, the IMF (2012a) still labels the Belarusian financial sector as small and inefficient and in need of more private banks and stronger governance. This is typical of Belarusian industries as the involvement of the state is seen not only in the financial sector but across the spectrum with only 20 percent of all industry in private ownership. Most industry, including food processing, automobiles, chemical production, and energy remain almost entirely in the hands of the state (US State, 2012a; Filatotchev, I., Buck, T. & Zhukov, V., 2000).

4.2 Belarus: Economic Conditions 1991 – 2008

Belarus enjoyed a somewhat enviable position among the former Soviet republics in 1991.

It had a relatively diversified and extensive industrial base, a GDP per capital above most of the CIS countries, and a high level of human capital (Bakanova et al., 2003). It also benefited from favorable energy policies with Russia. It was a "double recipient" that imported underpriced energy resources and exported overpriced industrial goods (p. 9). In fact, as discussed later, these trade patterns continued to boost the country's economy through the two decades following the USSR breakup. Belarus, although a landlocked country, is located in a strategic position between Russia and the Western European market. This, coupled with relatively developed transportation infrastructure, allowed Belarus to capitalize on some geographic benefits.

Despite these benefits, Belarus also had some significant roadblocks to future economic growth. The fallout from the Chernobyl nuclear accident severely impacted Belarus as almost 70% of the fallout landed in the country and contaminated about 20% of the land (US State, 2012a). The local agriculture was destroyed and many villages were abandoned. In addition, given its history of being almost continually occupied, Belarus was not prepared to design or conduct economic policy or develop trade relations with countries outside the USSR (Bakanovaet al., 2003). By being an importer of energy resources and an exporter of technical goods, Belarus was also vulnerable to changing input prices and trade structures, a reality that was recognized in 2006 (US State). Last, although Belarus enjoyed a large industrial base, it was inefficient, interdependent among industries, and outdated (Bakanova et al.).

Given the benefits listed above, Belarus's initial economic contraction was relatively small with output declines of only 3 percent and 1.2 percent in 1990 and 1991, respectively. However, its vulnerability to increasing oil and gas prices, contraction in trade markets, and a decline in production resulted in an overall 40 percent decline from 1990 through 1995 (Bakanova et al., 2003). This was still the second-best record among the CIS nations. During this time period, the country was also able to reduce inflation from 2,221% in 1994 to a still-high 709% in 1995 (IMF, 2012b).

As depicted in Table 2, Belarus enjoyed strong GDP growth from 1995 until the financial crisis in 2008-2009. After the record-setting levels of 1997 and 1998, the country had average growth of about 8% from 2000 to 2008. The boom in oil prices helped the economy as Belarus exported oil-based products at market prices while continuing to purchase crude oil from Russia at a deep discount. This allowed the government to enter a "social contract" with its citizens that slowly increased their standard of living and reduced political outcry against continued authoritarian measures (US State, 2012a). However, this pattern was disrupted in 2006 when Russia reduced its oil and gas subsidies for Belarus. The two countries signed an agreement in December 2006 that introduced a series of price increases that brought trade closer to European market prices. Gazprom, a giant Russian gas company, acquired 50% ownership in the pipeline firm of Beltransgaz. Conflict arose again in 2010 when Gazprom raised gas prices and Russia stopped all commercial subsidized oil exports to Belarus. Discounted oil started flowing again in December 2010, but the terms were less favorable for Belarus. In November 2011, Russia agreed to supply discounted natural gas to Belarus in exchange for full ownership of Beltransgaz (US State). The continued dependence upon Russia is clearly depicted in this arrangement.

Key economic indicators depict mixed results for Belarus. Moderately high to high inflation continues to plague Belarus, which is a reflection of the monetary expansion policies discussed above. As is typical with countries demonstrating a strong state presence in the economy, the official unemployment rate hovered around a low 2% during the same time frame. However, given the inefficiencies discussed above, it is likely that significant underemployment exists (US State, 2012a). The Gini index for Belarus of 0.262 in 2006 and 0.272 for 2011 depicts a society that experiences little economic inequality. Economic stratification studies done periodically from 1995 through 2006 depict a profile that is shifting towards the lower paid strata. This shift gives Belarus a large "poor" class consisting of workers employed by the state and a relatively small middle class (Sokolova, 2010).

The economic and political environments in Belarus prevent the inflow of foreign direct investment. Although the government formally supports foreign investment, a lack of structural market reforms and a generally hostile regulatory and business environment has limited investment. The continued lack of basic freedoms and the December 2010 political crackdown exacerbated this situation. In a study of former Soviet countries, corporate executives were least familiar with Belarus as an FDI destination.

Although its geographic location should give it an advantage, its business environment and political/economic environment were cited as significant obstacles (Festervand, 2011). The government announced efforts in January 2012 to attract more western foreign investment, explicitly rejecting investment by Russian businesses (Liakhovich, 2012).

Although the growth in GDP was strong throughout the decade leading up to the global financial crisis, the overall sustainability and health of the economy is questionable. Economic growth was primarily achieved by state-facilitated and funded demand, tightened controls over economic activities, and favorable trade patterns with Russia. The lack of private domestic or foreign investment does not bode well for the future (Bakanova et al., 2003).

4.3 Belarus: Global Financial Crisis

Belarus has endured two separate crises during the last five years. The 2008-2009 crisis was ignited by the global financial crisis, and reduced GDP growth to a minimal level. Russia's overall economic crisis and the depreciation of the Russian ruble exacerbated Belarus's position. Belarusian authorities depreciated the currency throughout 2008 and 2009 to counteract the drop in exports. Although this helped in the short-term, IMF authorities recognized the potential for longer-term concerns if domestic demand was not appropriately monitored and if state involvement in the economy did not change (IMF, 2010a). This proved to be accurate just a few months later.

The 2011 Belarusian crisis was "self-inflicted" and caused by the reversal of macroeconomic policies implemented during the 2008-2009 financial crisis (IMF, 2012a). During 2010 and early 2011, the government implemented expansionary wage and credit policies that resulted in a widened current account deficit, loss of exchange rate control, a sharp spike in inflation, and a reduction in economic activity. The policies did allow GDP growth to reach 7.6% in 2010; however, it came at the expense of overall economic stability through an "inflation-depreciation spiral."Although the government stopped intervening in the foreign exchange market in March 2011 and stopped providing below market terms for liquidity in June 2011, confidence in the Belarusian government's ability to maintain the value of the currency was greatly eroded. Altogether since 2008 external debt has more than doubled through current account deficits and the sale of government assets (IMF, 2012a).

4.4 Belarus: Future Prospects

Belarus entered the two recent crises with a history of financially repressive policies and a shallow financial system. While this system did not prevent the country from enjoying relatively healthy GDP growth over the last two decades, the sustainability of this growth is questionable (Bakanova et al., 2003;Korosteleva & Lawson, 2010). The actions of the last few years have caused a further deterioration in the country's economic and financial stability. In order to address these concerns, the IMF (2012a) has identified a number of issues the Belarusian authorities should consider, including: 1) Adopt macroeconomic policies focused on domestic and external stability; 2) Engage in price liberalization, privatization, and enterprise reform; 3) Establish a stronger role for private banks; and 4) Avoid expansionary policies that are used to promote high growth and wages. In other words, Belarus should pursue policies associated with financial liberalization. Lukashenka and his administration have consistently used financial sector intervention to encourage GDP and wage growth; however, this has distorted price stability and exchange rates and is detrimental to the long-term viability of the economy. In addition, price controls prevent market-based resource allocation leading to inefficiency in production and output. The banking sector continues to exhibit elevated risks. Although the state banks were recapitalized following the 2011 crisis, the level of non-performing loans is increasing and the frequent use of imprudent loan restructuring likely understates this level (IMF, 2012a).

After two decades of financially repressive policies, the Belarus economy faces ongoing concerns with its financial markets and monetary policy. Investment, either domestic or foreign, is limited and does not bode well for future development and growth. Continued emphasis on expansionary credit and wage policies threatens currency and price stability. As noted throughout this paper, researchers stress the need for movement toward policies of financial liberalization. While these movements may need to be gradual, as those undertaken in China, a move in this direction should increase the likelihood of future sustainable growth.

5. Conclusion

The case study approach employed in this paper does not allow one to draw firm conclusions regarding the effects of financial liberalization policies in all scenarios. It does, however, demonstrate the vast differences in economic and financial policies undertaken by the former Soviet republics. It also recognizes the potentially negative consequences of using financially repressive policies to focus on short-term demand or wage growth, as demonstrated by Belarus. By all indications, the adoption of liberal financial reforms has contributed to Estonia's healthy economic and financial position. In contrast, Belarus has experienced a self-inflicted financial crisis, elevated inflation, and low private investment that put its economy in a more precarious and isolated state. While the immediate release of state controls such as implemented in Estonia may not be prudent, gradual implementation of financial liberalization may move Belarus to future economic growth and price stability.

Table 1

Economic Statistics for Estonia (1993-2012)

ESTONIA	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
GDP in US $Billions	1.731	2.424	3.779	4.727	5.057	5.602	5.72	5.675	6.238	7.319
GDP per capita in US $	1,145.29	1,641.19	2,609.58	3,317.06	3,596.63	4,021.33	4,147.08	4,136.21	4,563.31	5,376.36
Inflation Rate	n/a	47.656	29.003	23.058	11.182	8.207	3.306	4.011	5.752	3.563
Unemployment rate	6.5	7.6	9.7	10	9.6	9.8	12.2	13.681	12.575	10.25
Population in Millions	1.511	1.477	1.448	1.425	1.406	1.393	1.379	1.372	1.367	1.361
GDP Growth Rate	-5.7	-1.6	5	5	10.8	5.4	-0.1	9.6	8.5	7.9
ESTONIA	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012 (est.)**
GDP in US $Billions	9.84	12.026	13.906	16.798	21.994	23.883	19.226	18.946	22.225	22.296
GDP per capita in US $	7,256.66	8,901.06	10,319.45	12,492.53	16,383.74	17,810.59	14,343.17	14,137.65	16,583.39	16,636.58
Inflation Rate	1.34	3.048	4.09	4.43	6.598	10.366	-0.085	2.894	5.121	3.889
Unemployment rate	10.025	9.653	7.914	5.901	4.655	5.519	13.762	17.256	12.476	11.295
Population in Millions	1.356	1.351	1.348	1.345	1.342	1.341	1.34	1.34	1.34	1.34
GDP Growth Rate	7.6	7.2	9.4	10.6	6.9	-5.1	-13.9	3.1	n/a	n/a

Note. Data was obtained from the International Monetary Fund World Economic Outlook Database, April 2012. The GDP Growth Rate was obtained from the World Bank's country database.

Table 2

Economic Statistics for Belarus (1993-2012)

BELARUS	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
GDP in US $Billions	3.662	4.854	3.384	14.5	14.098	15.222	12.138	10.418	12.355	14.595
GDP per capita in US $	357.589	474.532	332.486	1,429.74	1,396.78	1,515.40	1,211.52	1,042.82	1,241.57	1,474.38
Inflation Rate	1,190.32	2,220.90	709.297	52.688	63.82	73.018	293.733	168.601	61.133	42.568
Unemployment Rate	1.4	2.1	2.896	4.022	2.787	2.339	2.1	2.112	2.277	2.9
Population in Millions	10.24	10.228	10.177	10.142	10.093	10.045	10.019	9.99	9.951	9.899
GDP Growth Rate	-7.6	-11.7	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	5
BELARUS	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012 (est.)**
GDP in US $Billions	17.825	22.716	30.21	36.962	45.276	60.752	49.209	55.221	55.48(est)	58.068
GDP per capita in US $	1,809.87	2,317.95	3,098.15	3,805.01	4,672.42	6,385.56	5,179.86	5,824.38	81.47(est)	6,186.34
Inflation Rate	28.398	18.094	10.336	6.992	8.429	14.828	12.95	7.743	53.228	65.955
Unemployment Rate	3.1	1.9	1.5	1.2	1	0.8	0.9	0.7	0.6	0.6
Population in Millions	9.849	9.8	9.751	9.714	9.69	9.514	9.5	9.481	9.43(est)	9.386
GDP Growth Rate	7	11.4	9.4	10	8.6	10.2	0.2	7.6	n/a	n/a

Note. Data was obtained from the International Monetary Fund World Economic Outlook Database, April 2012. The GDP Growth Rate was obtained from the World Bank's country database.

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