Manchester Metropolitan University Business School Working Paper Series

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The Economic State of Belarus: An Assessment of its Economic Policies and Performance with Particular Emphasis on Foreign Direct Investment

WP01/13

July 2001
ISSN 1471-857X

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Biography

Hanna Yakavenka has been a research student within the International Business Unit at the Manchester Metropolitan University Business School. Completing a Master by research, her research interests involve the management of international technology in Belarus and human relations and strategy issues in transitional economies.

Abstract

This paper focuses on the opportunities and possibilities for Belarus to create a favourable business environment for the attraction of foreign investment, which is instrumental in the upgrading and restructuring of its economy. On a comparative note, there is sufficient evidence in a number of transition economies where the economic stability has indeed led to Foreign Direct Investment (FDI). Belarus, however, can be seen to have performed poorly in this regard, in part because of the Government's adherence to a populist economic policy.

The paper presents an overview of the main features of Belarus economic situation and development. The mix of economic, government and social problems particular to the Belarussian case are outlined and analysed, and suggestions for macroeconomic policy making are drawn.

Keywords: Foreign Direct Investment, Governmental Policy, Transition Economies

1. The Economic Development of Belarus: Implications for Inward Technology Transfer

For decades countries of Central and Eastern Europe (CEE) as well as the Commonwealth of Independent States (CIS) have followed the same path of development, but crucial changes in the region in the second part of the twentieth century forced every country to look for its own way of further development. The Republic of Belarus, the object of the present research, is one of these countries.

The current economic situation in the Republic of Belarus can be characterised as paradoxical and uncertain. Belarus began to develop its own institutional framework to guide the transition from command to market economy in late 1991 while maintaining stable employment. By the end of 1998 some positive and negative results of the chosen economic policy became evident. On the one hand, the country had some success: the economy had shown signs of recovery, the GNP had been stable for the last three years and most of the sectoral indicators also had positive dynamics, indicating that governmental policy was successful. One of the strengths of Belarus was that it managed to avoid the proliferation of the infamous financial pyramids, which depleted the savings of the population of Russia and the Ukraine (Bodrova, 1998). Another feature that distinguishes Belarus from other transitional countries is the low level of external and internal debt.

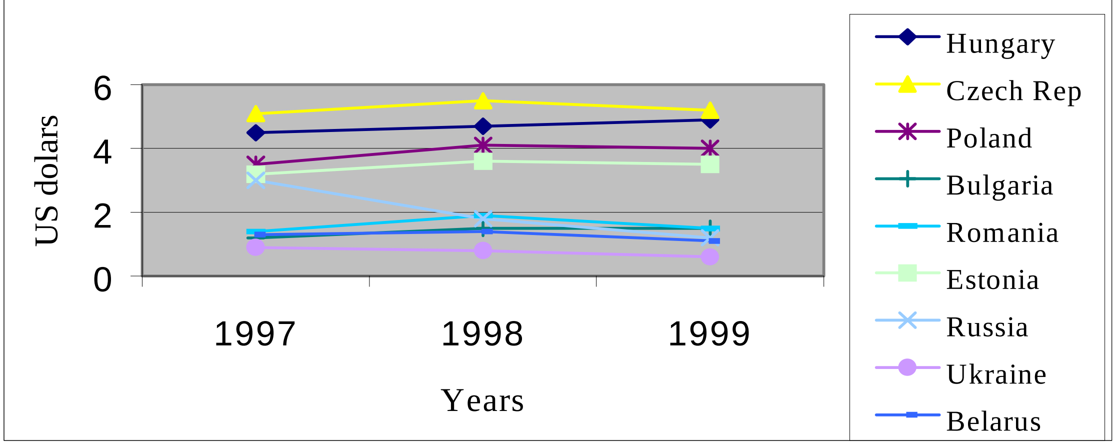
On the downside, economic development has been hampered by a weak and extremely unstable national currency, a high level of inflation, decline in exports, and a decrease in the real income of the population to a critical level (EBRD Report, 1998). Other negative tendencies involved a dramatic decrease in the average profitability of firms in the industrial sector, and a substantial difference in internal prices and prices in neighbouring countries resulting in a shortage of goods in the Republic.

When placing Belarus in line with the transitional economies such as Hungary, Poland, Estonia, its economic indicators, being significantly low, cannot easily be compared to those of others. The results of the analysis by the European Bank of Reconstruction and Development gives the picture of transition in the CEE and CIS economies in the year

1999 (Figures 1 and 2). The countries have been studied in accordance with a number of indicators, such as large and small-scale privatisation, enterprises restructuring, price liberalisation, trade and foreign exchange system, competition policy, banking reform and so on.

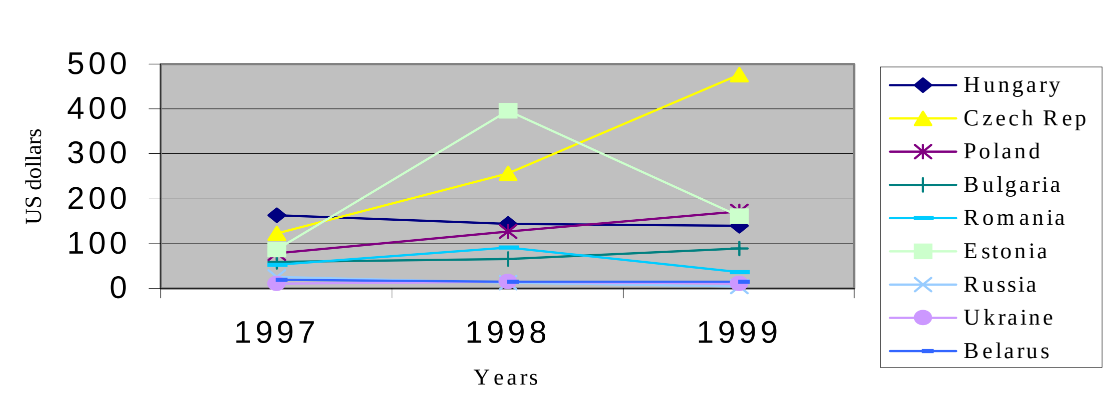
Almost all indicators of the progress of Belarus are significantly lower than those in the other countries analysed (Table 1, see for details Appendix 1).

Figure 1. **The level of GDP per capita in Transitional Economies between 1997-1999**



Source: Transition Report Update 2000, p.8

Figure 2. **The level of FDI per capita in Transitional Economies between 1997-1999**



Source: Transition Report Update 2000, p. 9

The comparison of the average indices of transition (calculated as the arithmetic average of transitional indices (Appendix 1)) to the amount of FDI in the analysed countries shows that FDI inflows are positively associated with the success of transition as identified by the EBRD transition indices (the correlation equals 0.67). This proves the idea that foreign investors feel more secure in such countries as Poland, Hungary, and Czech Republic (the “progressive group” countries), for example, where a certain progress towards market economy has been made.

Table 1: Correlation between average index of transition and cumulative FDI inflows

	Hungary	Czech Republic	Poland	Bulgaria	Romania	Estonia	Russia	Ukraine	Belarus
Average index of transition	3.56	3.44	3.33	2.78	2.78	3.44	2.89	2.33	1.67
Cumulative FDI inflows 1989-99	17,770	14,924	20,047	2,265	5,264	1,615	10,344	2,751	605
Correlation	0.67								

Source: Transition Report Update 2000

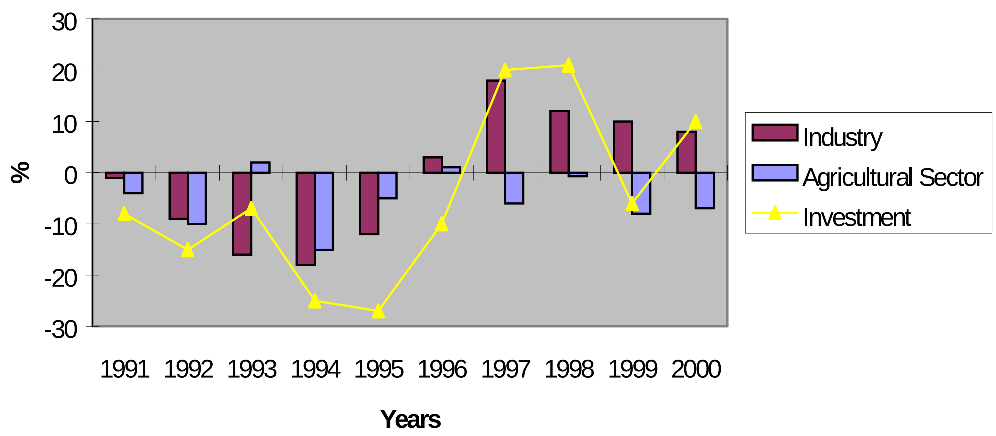
2. The Belarussian economy before and during the period of transition

In order to understand why Belarus is lagging behind the other of analysed countries, it is essential to look at its development since the period of transition started. Historically, the Belarussian economy has been oriented towards industrial production, which represents between 30 and 40 per cent of its GNP. The main industries are petrochemicals, metals, and machinery, in particular military hardware. The share of agriculture has varied between 13 and 24 per cent of GDP in recent years (WIR, 1998).

Before the break-up of the Soviet Union, Belarus enjoyed a trade and budget surplus representing one of the highest standards of living in the Soviet Bloc. With the break-up, demand for Belarussian products dropped sharply, because of broken agreements and low quality of much of the production. The level of the GDP has declined by 35per cent since 1990. The government responded with policies intended to prevent a decline in real wages and employment, but this only exacerbated the problems. Partly as a result of the expansionary policies undertaken to maintain output and incomes, inflation averaged 2,000per cent per year in 1993 and 1994. It continued during the following years although the rate decreased slightly in 1996 and 1997. During the period 1994-1995, the Belarussian government eventually realised the need to take some steps to liberalise the economy and slow down inflation, including the tightening of monetary and fiscal policies. This strategy did, however, not last long: as early as 1996 the authorities reverted to the policy of credit expansion, driven by subsidies from the National Bank of Belarus to selected sectors (capital building and agriculture) and enterprises. This policy achieved modest growth in real GDP in 1996 (2.8per cent) and a much faster growth of 10.4per cent in 1997. Nonetheless, the balance of payments remained under pressure, with the trade deficit reaching $1.3 billion (equal to over 10 per cent of GDP) in 1998, almost twice the figure of 1995.

The situation in industry has been very difficult. Depending on the sector, 47 to 80 per cent of finished products cannot find buyers and have to be stored by producers. Inevitably, manufacturers have become the main debtors to the state: they are responsible for 40 per cent of all non-payments to the budget. Nevertheless, in 1996 it was possible to speak of some "heating" of the Belarussian economy, but by 1999 Belarus was in deep recession, reflected in declining economic figures (Figure 3).

Figure 3. Industry, Agricultural Sector and Investments in Belarus (change in parameters in comparison to the year 1990)



Source: "Economical Reforms in Belarus and Co-operations with World Bank", World Bank Seminars, 2000

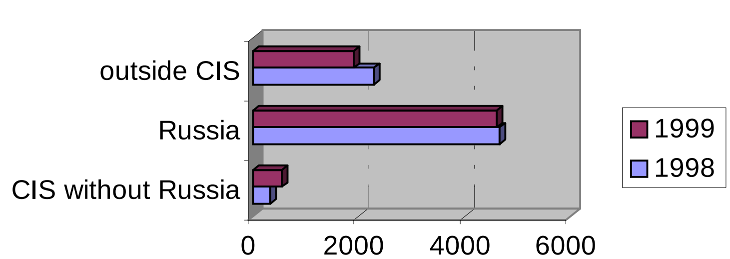
A major element of a market-oriented transformation, that is the significant reduction in scope and availability of budgetary transfers and 'automatic' low-interest bank loans to state enterprises and private companies, is still not in place, despite the provisions of the Law on Enterprises of the Republic of Belarus (14.12.1990). The law maintains that enterprises are fully responsible for compliance with credit contracts and payment discipline and may no longer get budgetary transfers and have to be declared bankrupt if they fail to do so. However, since its introduction this article of the law has never been applied.

Even the most promising alternative to full privatisation, the transformation of state enterprises into joint-stock companies with the participation of the state and the raising of ownership capital by issuing shares, has not found the necessary support from the government. The law passed under the previous administration requires that privatisation is effected by way of the distribution of privatisation vouchers, equal to 50per cent of the value shares of state enterprises, to the citizens of the Republic. Similar schemes have been implemented in the Russian Federation and the former Czechoslovakia on a wide scale, but produced controversial results. This probably explains the cautious attitude of the present government to voucher privatisation. There has been only modest progress in the privatisation of small enterprises during 1998 and virtually no movement forward in the privatisation of medium and large enterprises. As a result, less that 40per cent of vouchers had been used by the end of 1998.

3. Dependence of Belarus on economic relations within the former Soviet Republics

The Belarussian economy developed as an integral part of the Soviet economic complex and has never been fully self-sufficient. Belarus remains highly dependent on imported energy, resources and has made little progress toward diversifying its exports and/or entering new markets. Even though Belarus had a significant scientific and technological potential as one of the leading industrial republics within the former USSR, the core of this potential was mainly in military production. After the break-up of the USSR, most Belarussian enterprises lost their customers and suppliers. Belarus still produces far more than it is able to consume. The future of the country very much depends on its success in international markets, but the current technological base is not sufficient to guarantee this. Imports of new technologies are an obvious solution, although it is not clear how this can be implemented. One of the explanations is that exporting became very problematic because of currency regulation, the National Bank does not allow currency liberalisation, and exchange rate policy. The multiplicity of exchange rates almost completely restricts the activities of the exporters. Importantly, changing prices in external markets affect export and import flows (Figure 4). Source: "Economical

Figure 4. **Exports from Belarus (US $ million)**



Reforms in Belarus and co-operations with World Bank", World Bank Seminars, 2000

On the basis of our analysis the following conclusions can be drawn: Belarus, being dependent for economic development on its neighbours Russia and the Ukraine, is not in a position to replicate their progress. It is true that, as with other transitional economies, it has a rich intellectual potential but more importantly it does not have a huge amount of natural resources which could be used, for example, as payment for technology transfer. The other conclusion is that the experience of the former Soviet Baltic republics could not be applicable in Belarus, as Belarus lacks such advantage as regular support from abroad, market friendly cultural traditions and mentality, and a more democratic foundation for reforms. Unlike in Belarus, politicians in the other states have never been afraid of sacrificing large enterprises and the interests of employees for the sake of restructuring and market reforms.

During recent years Belarus has been isolated from the European and global economic and information environment. According to the EBRD five-mark integrated scale, the efficiency of the local Belarussian law in the area of regulation of investment processes has been estimated as low. The Republic is 140th in the world with regard to the attractiveness of the investment climate (Transition report update, 1999).

The basic causes of this situation are the overall economic and political environment, and the internal constraints of local enterprises. Other issues involve the attitude of the state officials to business, businessmen, the fulfilment of obligations, a weak moral and ethical environment and the absence of legal warranties. The economic policy of the government, and its monetary and credit policy in particular; and as well as the old-fashioned mentality of local managers, with everything done according to Soviet-style rules, continue to restrict market development.

The Belarussian Government recognises that structural reform has been slower than originally envisaged. However, it believes that the chosen pace of reforms has allowed it to minimise their social cost and has expressed its intention to continue its policies (Velikoselz, 1998; Polyakova, 1998). In reality “The Belarussian model” of economic development, based on the use of credit expansion, created a reduction in the decrease of such major macro-economic parameters as GDP and to some extent the level of employment. However, monetary and credit tightening are crucial steps in regaining macro-economic stability. For this particular reason it can be argued that the increasingly fragile banking sector must be strengthened, through for example, the elimination of state directed credits (Manenok, 1999). While some exchange rate restrictions have been eased, Belarus has yet to implement comprehensive liberalisation of prices and trade and to establish the basic market mechanisms necessary for sustainable growth and private sector development. The problem here, however, is that all production is based on imported resources and antiquated technical equipment. The absence of solvent demand, multiple exchange rates and mandatory sales of foreign currency at low National Bank rates, do not allow firms to develop exports. Acceleration of privatisation and enforcement of hard budget constraints on enterprises are needed to initiate the restructuring of industrial and agricultural firms and to attract foreign direct investment. Particularly, Belarus has to overcome the difficulties of increasing investment in high-technology sectors and stimulating credit support for export-oriented sectors in order to facilitate its entry into international markets.

4. Foreign direct investment in Belarus - the pressing issue of economic policy

Most investment in Belarus comes from internal sources. Capital inflow from external markets has been practically stopped. The main investments are concentrated in the building and agriculture sectors and implemented using credit certificates from the National Bank. Some attempts to attract foreign investors were made as early as 1995. However, when a number of performance criteria had not been met, the IMF withdrew support. The IMF claims that the implementation of structural reforms, to liberalise domestic prices and trade, has been slow and inconsistent. Promises to promote competition through encouraging entry by foreign companies, as well as pledging to improve corporate governance and accelerate the privatisation of state enterprises, housing and land, have been broken. Indeed, although some prices were liberalised in 1992, price controls are still applied to consumer products such as meat, dairy products and bread. Centrally controlled prices are set for transport, energy and communications. And only 15per cent of the total labour force work in privatised firms and enterprises (IFC report 1999).

No drastic progress in the area of attracting foreign investors is to be expected in the near future. A report published by the European Bank for Reconstruction and Development (EBRD, 1997) points out that authorities in Belarus continue to pursue a gradual approach to economic development in marked contrast to some other former Soviet Republics, which is ineffective in attracting foreign investment. Though the government has pledged to promote foreign investment and create a favourable climate for the functioning of foreign capital in the domestic economy, the attraction of Belarus to foreign investors depends on actual progress in macroeconomic stabilisation and privatisation.

According to recent statistics, the cumulative amount of foreign direct investment has reached just $605 million dollars in the first eight years of independence, which is a small amount in comparison with other CEE and CIS countries (Transition Report Update 1999). This is despite the fact that Belarus has quite advanced laws on investment activities and on foreign investments, as well as international treaties with Germany, Romania, Bulgaria, Kazakhstan, Sweden, Yugoslavia, France, the Netherlands, Italy and Turkey (Aleinikov, 1998).

These agreements support the right of foreign investors:

- to obtain long-term (up to 99 years) leases of land;
- to participate in the privatisation of state-owned property;
- to operate in the securities market;
- to repatriate, without limits, profits obtained as a result of operations in Belarus.

Unfortunately, the Belarussian government has not been successful in overcoming the scepticism of foreign investors regarding the real value of this legislation. So far, Ford is the most internationally known corporation that has been running an affiliate in Belarus. There are also a number of other significant investment projects, involving well-known firms such as, MAN, Motorola, Bosch, Coca-Cola, Philips, McDonald's, Procter & Gamble, Belwest and Stimorol. Unfortunately, there are lots of examples of failure. The introduction and dissemination of new technologies even in joint ventures is not an easy task because of lack of financial resources for technological upgrading. Hence, most of technology available for transfer never finds its way into the production process (Republican Statistical Report, 1999).

It can be argued, that the economic policy of Belarus should be oriented towards innovative development as well as structural and technological re-organisation with an emphasis on scientific and technical issues, focussing not only on innovative ideas, but on effective adaptation and implementation. The state could play an organisational and regulative role in this process by the development of institutional and economic infrastructures.

5. Micro-economic Problems of the Development of Belarus

To discuss what is really going on in Belarus, what Belarussian know-how is, whether it is possible to use Belarussian formulae in order to neutralise such phenomena as unemployment, budget deficit, debt crisis, symmetry of business cycles of the main components of the real sector is a complex issue. Data on Belarus are contradictory and it is nearly impossible to prepare a development forecast even for the short-term.

For example, since1992, the start of transition, the rate of exchange for the Rouble has moved from 1 Rouble equal to 1 USD to 1 million roubles equalling the same amount. And if in 1992 an average monthly wage was 100 USD, today a full-time employed professional earns a maximum 60 USD dollars per month. Recently, the currency was reformed, introducing 1 new rouble equal to 1000 new old roubles. It is difficult to determine the level of wealth of an average Belarussian, because there are at least three different rates for translation of Belarussian roubles into dollars. Using real wages, the majority of the Belarussian population can be considered as poor. However, governmental policy is strongly supported by most of the population as people get their payment on a relatively regular basis, flat rents are very low compared to modern standards, services are accessible and so on.

This policy also keeps the situation in the country stable. IFC's privatisation project manager in Belarus noticed that one advantage of living in a virtual police state is: "You do not see the levels of corruption and organised crime in Belarus, that exist in the Ukraine and especially in Russia….on the other hand, there's so much state control here, it makes it difficult for private business." (IFC, 1999) This is one of the reasons that there is a smaller amount of wealthy businessmen in Belarus in comparison to Russia, where a generation of new Russians have grown richer.

Multiple exchange rates of the currency, strict control and government interference into pricing and selling prices, and a vast amount of departmental regulations are only a part of the long list of problems for local and foreign entrepreneurs. The government has been slow to relinquish control and influence over the financial system. The banking system is under-capitalised and solvency is threatened by directed credits. Even though the black market rate and the commercial bank rate are virtually the same, the spread over the official rate remains above 200per cent.

For the majority of firms it is simply impossible to achieve a reasonable solution to many economic problems. They have to go to court not simply against competitors, but also against state policy. A great number of licenses, sanctions, orders, and registrations are required for each kind of activity. The uncertainty in obtaining permissions makes commercial activity very difficult. The policy of administrative limitation of price increases has led to a sharp impairment of financial and economic parameters of business activity. The average level of profitability for the past year was 11 per cent and more than 14 per cent of all firms have appeared unprofitable (WB Regional seminars, 2000).

Consequently, the inability of Belarussian managers to adopt modern business concepts is a constraint to enterprise development. They are used to a passive manner of working without necessary evaluation of outcomes of their decisions. Additionally, government policy, which is based on pervasive directed credits as well as explicit and implicit subsidies, allows even non-viable enterprises to avoid restructuring and to remain in the market. The majority of local managers and directors of the enterprises do not know how to apply basic management techniques such as strategic planning, marketing research, total quality principles among others. Those who gain the idea of the necessity to think and act “in a modern way” still cannot put enough emphasis upon such issues as FDI and TQM as they need a lot of effort to overcome state control obstacles (*instability and unpredictability of legal base, administrative interference into pricing and selling policies, rigidity and complicity of taxation system, continuous extension of the list of licensed activities and the lack of a clearcut approach to interpretation of adopted departmental regulations).* This makes business in Belarus unpredictable both for domestic businessmen and foreign companies.

6. Creating a receptive environment for foreign investment

The analysis of the economic and institutional environment in Belarus presented in the previous sections illustrates the starting position for further development of the Republic.

The first thing to be done is to specify the direction which Belarus is going to follow in the near future as, from the analysis, this is not yet clear. The sooner the Belarussian government makes the choice, the easier it will be to determine the most appropriate strategy for managing development.

The Economic Department of the National Bank of Belarus designed four basic models for the development of the Republic (WB Regional Seminars, 2000). Each of the suggested models has its strengths and weaknesses.

Model 1 "Neo-socialist model"

The essence of this model is a prolongation of the socialist traditions of the Belarussian Soviet Socialist Republic with a prevalence of state ownership. The economy will be developed using the resources of effective enterprises by means of taxation, regulation of exchange rates and prices. Paternalism and social policy will dominate. Low wages and pensions will determine the nature of consumption. The standard of living will remain low, but this is not considered to be a significant parameter.

Following this direction, it is unlikely that there will be any development in any sector of activity. The resources of successful firms and enterprises, instead of the improvement of production processes and technologies, will be wasted in support of unprofitable businesses. With regard to people, the outcome of the application of this model will be even more harmful. Low wages and salaries will result in gradual degradation of the population, with no motivation to study or work. According to Dunning's eclectic theory, foreign investors will not want to enter into such an environment (Dunning, 1979).

Model 2 " Integration model"

The essence of this scenario is the continuation of the current process of integration with Russia and the formation of a new state (confederation/ union), by gradually including Belarus in the structure of the Russian Federation. From an overall economic perspective the process of integration will have both positive and negative consequences for Belarus. The Russian currency is more stable and its industrial sector is almost wholly privatised. The "marketability" of the Belarussian economy will be increased. However, there are negative consequence to consider. The inflow of Russian capital may be accompanied by a growth of criminal activity, division of influence, bank wars and so on. From the perspective of social relations a steady increase of the standard of living could be expected, but there will also be a growth in social differentiation.

The perspectives for foreign investment created by this model are more promising. As Russia is already ahead of Belarus, stabilisation reforms might be progressing there and for Belarus it could mean easier access to modern technologies for example. In accordance with Communications and Network theories, the synergetic effect will work, as by joining the European Union together with Russia, Belarus will have to follow the strategies applied by the nearest CEE countries. Sooner or later Belarus is likely to be involved in the world economic processes.

Model 3 " Belarussian version of a shock therapy"

Under particular circumstances Belarus could become a site for a liberal experiment. New authorities or reformers could create a basis for the realisation of “shock therapy”. This model of economic and social reforms has no widespread support within the population. However it is possible to stimulate such a shift in economic rules. In this case Belarus could very quickly adapt to market conditions. Strong monetary policy could well stabilise financial flows resulting in the openness of the economy.

Several economists say that realisation of “shock therapy” could take 1.5 to 2 years (WB Regional Seminars, 2000), but the economy is ready for the change. The largest complexity though will be in a "breaking-up effect". Belarussian society has become used to the particular lifestyle, i.e. cheap power resources (gas, electricity) received from Russia. It will be rather difficult to place the country into a mode of rigid western-style economics based upon supply and demand.

Such a choice might create the conditions for enhancing competitiveness, which would occur first inside the country. This in turn could assist in improving the competitiveness of in-house produced goods, and stimulate the normal exchange of goods/services, knowledge and technologies. Although this model is not very easy for the population such a choice could bring the country to the required positive outcomes in terms of getting access to new markets.

Model 4 “New Belarus”

Some economists see this strategy as an alternative to both “shock therapy” and a prolongation of the neo-socialist economy. The objective of this model is in keeping with the traditions of Belarussian society as well with its modernisation. The issue, however, is what economic mechanisms are to be used.

This might include two parallel processes: positive orientation towards Europe as well as a close partnership with Russia. The orientation towards Europe could be realised in the same way as that achieved by neighbouring countries (such as Poland, Lithuania, and Latvia). On the other hand, it can be argued that Belarus should keep strategic partnership relations with Russia, whilst keeping its substantial political sovereignty and economic self-liability.

Realisation of this model is one of the hardest tasks for the government of Belarus. It means that they will have to change the policy drastically. However, it will allow a certain organisational and economic structure to be established.

These are just basic models for the development of Belarus in the forthcoming years and decades. The final selection of a national economic policy has not yet been made by the Belarussian government. However, it is evident that Belarus will not be able to avoid macroeconomic stabilisation. Otherwise, economic policy remains without changes, shadow currency markets prevail, capital out-flows continue, barter in international trade prevails and the currency deficit will only worsen the current economic situation.

Meanwhile, considering the complexity of problems in the Republic an application of a system approach might be very helpful to deal with the aspects of transition. Such an approach investigates all available resources, constraints, relationships and foreseeable contingencies in order to apply the most effective and efficient means of meeting foreign investors' objectives (Kovtunenko, 1994; GKNT, 1999). This may not only assist in creating job opportunities, tax revenues, capital, advanced technology, management and sales expertise, but it also might contribute greatly to the establishment of a market mechanism and the integration of the host country into the world economy (Dunning, 1993).

7. Problems and Perspectives

The analysis carried out in this paper demonstrates some of the difficulties in attracting foreign investors to Belarus. One of the major challenges in the current stage of economic transition is the attracting of foreign investment. It is clear that Belarus is making economic progress, albeit very slowly. The application of new policies and techniques has started to bring promising results, such as growing GNP and decreasing inflation. Nevertheless, there are certain difficulties, connected mainly to an unwillingness of the Belarussian government to establish structures and promote policies, enabling local enterprises to approve the need of FDI.

This paper raised the issue that foreign direct investment is still a long-term perspective for Belarus. The paper makes recommendations to which mechanisms could actually be applied. Belarus however appears to be in a situation where a number of economic and social reforms should take place first.

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