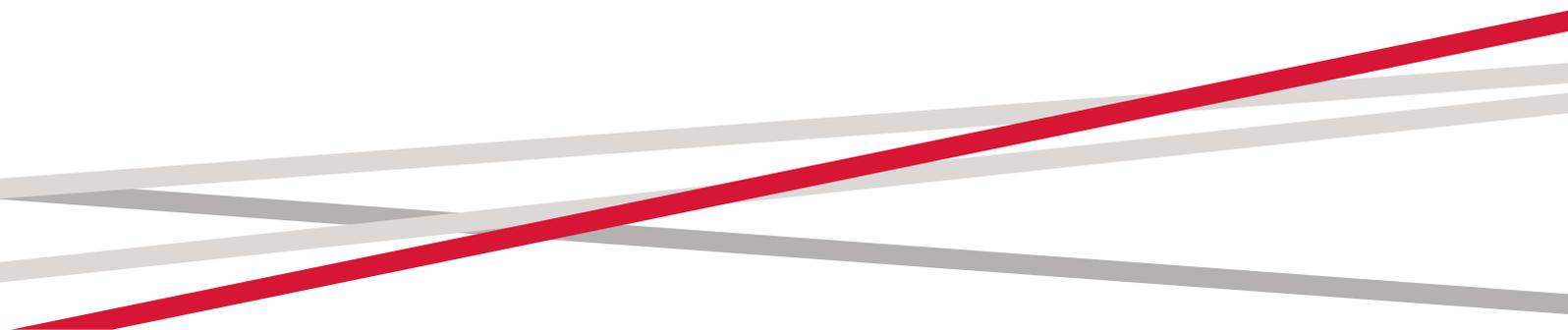


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Does political illegitimacy in Belarus imply new economic risks?

Today's political crisis in Belarus has given rise to the phenomenon classified in political science as political illegitimacy. However, this is not a pure political phenomenon. It causes adverse and severe economic adjustments. In a short-term perspective, it gives rise to numerous risks of financial destabilization. Moreover, it is likely to deepen the current recession and make it protracted. In the long-term, political illegitimacy causes adverse institutional adjustments and erosion of human capital, which is likely to lead a country into a long-lasting depression. We argue that resolving the political crisis in a way that revives trust and legitimacy is the only 'good' solution.



Short-term economic effects of political illegitimacy

Since August 9, 2020, Belarus has been widely discussed worldwide in mass media because of the country's political crisis. Political scientists classify the current situation in Belarus as a case of political illegitimacy, i.e. there is no consensus in the Belarusian society concerning the recognition and acceptance of a new term for the governing regime.

In turn, the governing regime prefers to ignore the illegitimacy issue. There is an implicit assumption behind this: illegitimacy is an intangible issue that can hardly result in any tangible threat to the sustainability of the governing regime.

We oppose this view and argue that, at least in an economic dimension, there are numerous channels through which illegitimacy transforms into tangible problems. Inasmuch as the stance of the economy affects political sustainability, it will undermine the latter.

From a short-term perspective, the issue of political illegitimacy has become part of the information accounted for in the decision-making of economic agents in Belarus. Hence, in their economic decisions they either try to struggle against it, or at least to hedge against corresponding adverse effects.

Most evident, the adjustments in decision-making has already visualized in households' savings behavior. Directly, illegitimacy considerations gave rise to deposit withdrawals from the banking system and enlarged demand for hard currency. Consequently, this led to a rise in depreciation-/inflation-expectations and lowered public trust in the banking system, which in turn has amplified these patterns of the households' behavior. In August, Belarus experienced historical peaks in deposit outflows and international reserves were depleted as a result. This has substantially amplified the risks of financial turmoil.

So far, the authorities have curbed the financial stress by implementing a restrictive monetary policy. However, this does not suppress adverse patterns in households' behavior. It only somewhat allows for a shift of adverse adjustments from financial markets towards the real economy. Moreover, it weakens, but does not completely remove the threat of full-fledged financial turmoil, taking into account the systemic financial fragility in Belarus.

In addition to the illegitimacy issue itself, other adverse expectations are likely to give rise to unfavourable trends in households' consumption behaviour as well. First, household consumption is likely to be dampened as a result of poor consumer confidence and sentiment. Second, additional losses in consumption are likely to occur due to tightening access to credit and progressing financial fragility.

Similar mechanisms are likely to be in place with respect to investment demand. First, poor confidence and sentiment undermine the investment activity of businesses. In Belarus, this channel is likely to be more powerful for private businesses, as investment plans of SOEs (due to their directive nature) are less sensitive to confidence and expectations. Second, investment activity is likely to decline due to deteriorating financial conditions and consequent contraction of credit. This linkage is especially important for the SOEs and housing investments.

The power of adverse consumption and demand trends is still questionable. However, preliminary estimates (introducing negative shocks in addition to scenarios in Kruk, 2020) show that they will reduce the output growth rate by at least 1.5-2.0 percentage points in 2020 Q3-Q4. In other words, they are expected to deepen the current recession and are likely to make it more long-lasting.

Deteriorating payment discipline is one more expected outcome from political illegitimacy. Being amplified by deteriorating financial conditions and



economic activity, it can turn into a full-fledged payment crisis and fiscal instability.

Adverse institutional adjustments and effects on labor market

Human-to-human interactions based on mutual benefit and trust are the core of a modern market-based economy. Key institutions created to support this interpersonal trust are laws and law-enforcement agencies. If a person does not trust her counterpart in a deal and does not think that she can take him to court to defend her rights, no deal will be signed. When an individual observes unrightful and politically-motivated court decisions in criminal cases, the distrust is also passed on to her beliefs that she would be able to defend her economic rights in the same court. As we observe police violence, tortures, and criminal charges of protesters with no attempt to prosecute those responsible, public trust in the law-enforcement system fades away, and thus all kinds of deals previously supported by a contract-enforcement system cease to exist.

The quality of a judicial system is widely recognized as a powerful determinant to overall institutional quality and the business environment. Hence, poor trust in it would likely undermine business activity directly. Existing businesses are to re-orient towards shorter-term strategies, being reluctant to initiating long-term and risky projects. Moreover, their inclination to geographical diversification of their business activity or even full migration is likely to rise. New entrants - that are extremely important to achieve productivity gains (Foster, Haltiwanger, and Syversen, 2008) – are less likely to start business in the country.

An increase in emigration is a usual consequence of political crisis, especially if it is accompanied by violence and politically-motivated incarcerations. What is unique about the current Belarus crisis is that the list of potential emigres include not only

individuals but also firms, especially those working in the IT sector. After 11 August 2020, many IT companies found their employees detained, beaten and tortured. The offices of Yandex, Google and PandaDoc were searched and four top managers working at the latter were detained on tax evasion charges which are likely to be politically-inspired. As of the 18th of September, around 200 IT companies are considering relocation from Belarus and many more are considering partial relocation of their employees to already established foreign offices (Dev.by(2020a)). Results from a recent survey show that 33% of IT specialists have already decided to leave Belarus and the rest indicated that they will leave if the situation worsens (Dev.by(2020b)).

There are several major reasons for why the IT-sector is affected more by the current crises compared to traditional sectors of the Belarusian economy. Firstly, IT companies rarely own physical capital and thus can change their location in a matter of days by simply relocating their employees and laptops. Secondly, the IT labor market is global and mobile, and companies compete for the workers. Therefore, if many workers hold similar strong views on a particular situation, employers are bound to support them to a certain extent. As a result of the latter, many IT companies have openly voiced their disagreement with the election results and the politically motivated violence following the election. High-level employees and owners of major companies have participated in various opposition initiatives and as a result, now face retribution from Lukashenko's government.

In addition to politically-motivated emigration, we can expect an increase in economically-driven emigration rates as the economy is expected to shrink (Bornukova and Lvovskiy, 2020).

What is the way forward?

The political crisis in Belarus has triggered multidimensional adverse economic adjustments.



Nevertheless, the authorities prefer to ignore the links between politics and economics. Hence, they try to overcome the problems with economic policy tools only. However, the room to maneuver with these tools is considerably restricted, and in some cases completely ineffective in suppressing adverse trends.

With respect to the short-term agenda, the authorities cannot offset the adverse trends. They can just mitigate challenges in one dimension and try to re-direct it to another one. For instance, currently the authorities focus on mitigating the probability of a full-fledged financial crisis. This consideration requires restricting monetary conditions. Otherwise, the exchange rate is likely to depreciate, which would be problematic from a corporate debt sustainability perspective. Although being somewhat effective in this regard, this policy mix dampens economic activity. From a financial dimension, the challenge is being re-directed to the real economy.

A similar picture might soon emerge in a fiscal sphere as well. An economic downturn and political crisis can result in a widening income gap. At the same time, the room for maneuver on the expenditure side is constrained. The funds accumulated from the previous periods have to a large extent already been spent to support SOEs. Hence, a further expansion of expenditures is hardly possible, as it would undermine fiscal and public debt sustainability. Therefore, fiscal stimulus is likely to fade away and can gradually even become negative.

Based on estimations in Kruk (2020), before the issue of illegitimacy appeared, the economy was developing according to a scenario of about a 3% drop in GDP in 2020 and a meagre recovery (if any) in 2021. Adding the assumptions associated with adverse adjustments due to the illegitimacy issue into the Kruk (2020) estimates, we show that the recession is likely to deepen by at least 1 percentage point in 2020. In 2021, output losses are likely to expand considerably. In regard to the long-term agenda, the situation is even worse.

Conceptual decisions on economic activity by firms and households are closely linked with the issues of trust and legitimacy (Bornukova et al., 2020). Having lost them, the authorities are unlikely to have any effective tools for standing against adverse institutional adjustments and the erosion of human capital. Hence, we may expect that today's poor growth potential of the Belarusian economy - up to 2.5% of per annum growth (Kruk, 2020) - is likely to weaken further and could even become negative. This means that the stagnation over the recent decade is likely to turn into a long-term depression.

Conclusion

The political crisis and the arising issue of political illegitimacy in Belarus imposes severe economic challenges for the country. In a short-term perspective, there are numerous channels that are likely to deepen the recession and make it long-lasting. Moreover, risks to financial stability are progressing rapidly. Hence, there is a little room for securing macro stabilization in near future.

In a long-term perspective, the country is likely to suffer from the disruption of productivity enhancers. It will stem from lower business initiatives and the erosion of human capital. This is a way to a long-term depression.

Standard economic tools are mainly ineffective against both the short-term and long-term challenges. Resolving the political crisis in a way that revives trust and legitimacy is the only 'good' solution.

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