



# CONVERGENCE AND DIVERGENCE AT THE EUROPEAN PERIPHERY: BULGARIA AND BELARUS



## Rumen Dobrinsky

BULGARIA

Dr. Rumen Dobrinsky is a Senior Research Associate of the Vienna Institute for International Economic Studies, Director of Strategy of the European Alliance for Innovation and a senior consultant at the United Nation Economic Commission for Europe (UNECE). He spent a large part of his professional career at the UNECE where he was a Director for Economic Cooperation and Integration. Previously, he was also the President of the Centre for Economic and Strategic Research in Sofia. He acted as a consultant to several international organizations, participated in numerous international research projects and served on the editorial board of Economic Systems. His main areas of interest include European integration, economic transformation, knowledge-based development and competitiveness. He is the author of four books and numerous scientific journal articles.



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Bulgaria and Belarus have many features in common: geography (they are both at the European periphery); size; traditional ties with Russia (including linguistic similarities); historically strong integration with the Soviet economy; and few significant natural resources. While Belarus used to be the manufacturing workshop of the Soviet Union; Bulgaria also built a strong specialisation in manufacturing within the COMECON. After the fall of communism, however, the two countries followed very different transition paths with Bulgaria joining the EU and Belarus following its own avenue of economic transformation. The historic experience of the two countries therefore provides some intriguing evidence about convergence and divergence at the European periphery.

### Systemic reforms

Bulgaria's reluctance to embrace economic reforms in the early 1990s led to the worst transformation crisis in Eastern Europe. This was resolved with the establishment of a currency board in

1997 under an IMF-supported reform programme. The opening of accession negotiations with the EU in 1999 played a key role in speeding up the transformation. The negotiations on the chapters of the EU's *acquis communautaire* triggered comprehensive



reforms that brought the country's national institutional environment in line with that of the rest of the EU.

In Belarus, by contrast, market reforms were far more limited and conventional measures of 'progress in market reforms' paint a picture of an economy 'frozen' in a state of unfinished market reforms. In fact, Belarus embarked on a gradualist transition path of its own, moved in a different direction, and established its own economic model. The political and economic system that has evolved in Belarus can be classified as a specific brand of state capitalism with three main characteristics: 1) the state plays a significant role in the economy in terms of asset ownership and direct interference in the economic process; 2) it is capitalism because the previous mechanisms of central planning were abolished; 3) it is specific because many state-owned firms operate under soft budget constraints. This economic model is matched by a centralised decision-making pyramid, with excessive powers concentrated at the presidential level.

### **Economic structure**

Privatisation in Bulgaria was delayed by almost a decade and by the time it started, many of the large industrial plants it had inherited were obsolete and were closed down. Three privatisation waves (commercial and mass) after 1997 helped to

privatise the surviving firms. Today, it is the new private sector (both domestic and FDI-driven) that shapes the structure of the Bulgarian economy, which is well integrated into global value chains. The structure of trade changed radically and the EU is now the Bulgaria's key trading partner, accounting for more than 60% of its exports and imports. The once dominant trading partner, Russia, is now a negligible market for Bulgaria's exports, although it remains a critical supplier of oil and gas imports.

Belarus did not privatise the large state-owned companies and banks it inherited from Soviet times. Most of them still exist and operate but have been re-organised and are now managed differently. Despite this, new private firms and foreign companies have been the most dynamic economic players, even though they operate at a disadvantage to state-owned firms, which benefit from public support. Sectors like trade and business services are entirely dominated by the private sector. As regards foreign trade, Russia remains the main trading partner, accounting for some 40% of Belarus' exports and 60% of its imports. Belarus has also benefited from privileged access to Russian oil and gas, which was equivalent to implicit rents. The investment climate is not very friendly and inward FDI mostly flows from Russia.



## **Policy mix**

Bulgaria's macroeconomic policy stance is predetermined by the currency board, which will likely remain in operation until Bulgaria joins the euro area. The currency board leaves little freedom for macroeconomic policy and the authorities have been sticking to a conservative fiscal stance, thereby imposing on themselves additional constraints on the scope of policy choices. Apart from public investment (largely supported by EU transfers), the policy stance on the economic process has been consistently neutral or even passive. Any business success stories in the last two decades have happened despite, rather than thanks to any form of government support.

Belarus maintained an activist policy stance throughout its transition process. Targeted industrial policies supported the top priority policy objectives, such as rising welfare and high employment. Industrial policy was implemented through state development programmes supporting state-owned firms and collective farms. By contrast, at least until recently, price stabilisation was not among the priority objectives of the authorities. The macroeconomic policy mix was rather accommodating and subordinate to higher priority policy objectives. The government applied a number of unconventional instruments to pursue their objectives, in particular, directed

credit and wage targets. The authorities also abided by a 'social contract' with the population, targeting close to full employment. The expansionary policy stance was supported by the economy's access to cheap energy from Russia.

## **Economic performance**

The transformational recession in Bulgaria was followed by a decade of relatively fast growth which coincided with the preparation for EU accession. Between 1997 and 2008, GDP grew by an average annual rate of 4.4%. The reforms and the prospects of EU membership were applauded by foreign investors and both FDI and financial capital flooded into Bulgaria, contributing to the economic revival. The currency board and the conservative policy stance helped a rapid and sustained macroeconomic stabilization. Unfortunately, Bulgaria's accession to the EU coincided with the global financial crisis, which triggered a reversal of capital flows. As a consequence, the first decade of Bulgaria's EU membership was a period of recession or near stagnation and there was little visible catching up. The rate of annual average GDP growth between 2009 and 2018 was a meagre 1.5%.

During the period 1996-2008 Belarus also enjoyed a period of high growth (annual average GDP growth of 5.7%) thanks to





a favourable external environment (the re-integration with the Russian economy which opened the way for Belarusian exports) and expansionary policies promoting fixed investment and rising incomes. Things started to change around 2007 when Russia began eliminating energy subsidies. External imbalances widened and foreign indebtedness escalated. Between 2009 and 2016, Belarus experienced three episodes of currency crises. Economic growth plummeted to an average annual rate of 1.6%. By 2015, the authorities were forced to elevate the priority of macroeconomic stability over economic expansion.

### **External anchors**

External anchors played a pivotal role in Bulgaria's reforms. In 1997 the IMF helped install the policy package of macroeconomic stabilization. Subsequently, the realistic prospect of EU accession coupled with the disciplining mechanisms of accession negotiations was the key driver and catalyst of systemic reforms. The aspiration for EU membership served as a powerful anchor for unifying a critical core of society around a common objective. Local politicians regarded EU membership as a reward for the success of a difficult policy agenda.

By contrast, in terms of external anchors, Belarus has been in a zone of 'no gravity' throughout its transition. EU membership

was never seen as a realistic prospect. On the other hand, despite its close economic and political ties with Russia, Belarus was keen on maintaining some distance from its big neighbour. Russia also was not seen as an attractive anchor point due to the perceived corruption of its own transition process. The IMF's role in Belarus's transition was only marginal and Belarus resorted to IMF assistance on only one occasion. In these circumstances, visionary politicians can shape (or manipulate) local expectations more easily, offering development models that are not anchored externally. In reality, Belarus's unique transition path was entirely engineered by local policy makers.

### **Divergent reforms, similar catch-up**

Bulgaria and Belarus started with similar economic and institutional structures but are now in very different positions. Bulgaria's economy is now entirely dominated by the private sector and is well integrated with the EU economy, enjoying free movement of goods, capital and people. Bulgaria established market institutions that operate (or should operate) in compliance with EU rules and norms. Belarus, by contrast, was the only former Soviet bloc country that preserved a large share of its "old" industry by keeping it in the hands of the state. However, business services are dominated by the private sector. As regards trade, Belarus remains largely integrated with



the Russian economy but policies in the two countries differ substantially.

Somewhat surprisingly, despite these divergent transformation paths, the speed and degree of real convergence in Bulgaria and Belarus over the past 20 years has been roughly the same. In 1996, Bulgaria's GDP per capita was 28.5% of the EU-28 average, whereas Belarus' was 23.4%; in 2006, the corresponding numbers were 38% and 36.7% and in 2016 they were 48.6% and 45.9%.

### **A convergence puzzle?**

So, do systemic and institutional reforms matter for real convergence? After 1997, Bulgaria followed the mainstream policy paradigm of economic and political transformation and is now part of the EU. Belarus embarked on a non-conventional transition of its own, resulting in an unusual transformation path. Despite such a radical departure, 20 years later both countries achieved similar progress in terms of prosperity and welfare. Does Belarus's experience defy the implicit postulate that reforms under the agenda of EU accession should deliver superior results in terms of prosperity and growth?

There is no simple answer to this puzzle, despite the fact that in this comparison Belarus can be regarded as an almost ideal

counterfactual. Still, here are some concluding reflections on this issue. First, there is no one size-fits-all policy advice and model that will deliver the optimal solution in all cases. Reforms and policies work best when they are tailored to the local context and enjoy popular support. By the same token, we can have the same outcome by following different policies and models, depending on the specific local circumstances. This is probably what we observe in the case of Bulgaria and Belarus. Finally, a time period of 20 years is probably insufficient to draw unequivocal conclusions. So far, Bulgaria has not been among the most successful EU member states in terms of catching up, while in the case of Belarus, the future is still rather uncertain.