

## **Section 1. Russia's Socioeconomic Policy: Emergence of New Horizons**

### **1.1. Global Crisis and the Discourse on the Post-crisis Economic Agenda<sup>1</sup>**

The global crisis, which first emerged in 2007–2008, has remained the major factor determining the socioeconomic development of the world's leading countries, Russia including. In this case, we view a crisis not as a phase in the cyclical fluctuations between growth and decline (or acceleration and slowdown) as part of the development of a given country or group of countries. Instead, we are speaking of a sufficiently lengthy turbulence period when, as a result of some profound shifts, a new economic growth model comes to the fore and begins to strongly influence the socioeconomic situation and the global economic and political equilibriums.

The evolvement of the current global crisis and the associated geopolitical and structural shifts has led to the following three major conclusions. Firstly, the driving force behind the exit from the crisis – just as it had happened during the previous similar crises over the course of the 20<sup>th</sup> century - was the USA. Secondly, the world economy has also undergone a structural shift, when hi-tech companies are assuming a dominating role, while that of the raw-materials and processing industries is becoming less prominent. Thirdly, a new agenda of economic growth and a new economic mainstream movement are taking shape.

The year 2014 demonstrated a gap between the economic development indicators of the world's key countries and regions (see *Table 1*). The assumption formulated five years ago – that the emerging economies may become a new locomotive for the exit from the crisis – has proved to be unrealistic.

The key factor responsible for the emergence of the new post-crisis economic and technological structures and the driving force of the exit from the global crisis has become the USA. That country is displaying a rising growth rate, the formation of new manufacturing sectors, and a narrowing gap between consumption and saving indices. US budget deficit shrank from 8.4% of GDP in 2011 to 2.9% of GDP in 2014; over the same period, the unemployment rate dropped from 8.6% to 5.8%. These positive changes enabled US monetary authorities to depart from their supersoft monetary policy course, thus strengthening the USD exchange rate. The flight-to-quality pattern has emerged once again – the improving situation in the US economy is pushing up the demand for the national currency. This is what always happens in

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spite of the incessant warnings that the US dollar is ‘a particularly risky asset, which is not secured by any tangible assets’.

Table 1

**The GDP Growth Rates in the World’s Major Countries, as % of Previous Year**

	2008	2009	2010	2011	2012	2013	2014*
<b>World, total</b>	<b>3.0</b>	<b>0.0</b>	<b>5.4</b>	<b>4.1</b>	<b>3.4</b>	<b>3.3</b>	<b>3.3</b>
<b>Developed economies</b>	<b>0.1</b>	<b>-3.4</b>	<b>3.1</b>	<b>1.7</b>	<b>1.2</b>	<b>1.4</b>	<b>1.8</b>
<b>G7</b>	<b>-0.3</b>	<b>-3.8</b>	<b>2.9</b>	<b>1.5</b>	<b>1.4</b>	<b>1.5</b>	<b>1.7</b>
USA	-0.3	-2.8	2.5	1.6	2.3	2.2	2.2
Japan	-1.0	-5.5	4.7	-0.5	1.5	1.5	0.9
Germany	0.8	-5.1	3.9	3.4	0.9	0.5	1.4
UK	-0.8	-5.2	1.7	1.1	0.3	1.7	3.2
France	0.2	-2.9	2.0	2.1	0.3	0.3	0.4
Italy	-1.2	-5.5	1.7	0.5	-2.4	-1.9	-0.2
Canada	1.2	-2.7	3.4	2.5	1.7	2.0	2.3
<b>Eurozone</b>	<b>0.4</b>	<b>-4.5</b>	<b>2.0</b>	<b>1.6</b>	<b>-0.7</b>	<b>-0.4</b>	<b>0.8</b>
<b>OECD member countries</b>	<b>0.3</b>	<b>-3.5</b>	<b>3.0</b>	<b>1.9</b>	<b>1.4</b>	<b>1.4</b>	<b>1.9</b>
<b>Emerging economies</b>	<b>5.8</b>	<b>3.1</b>	<b>7.5</b>	<b>6.2</b>	<b>5.1</b>	<b>4.7</b>	<b>4.4</b>
<b>BRICS</b>	<b>6.9</b>	<b>5.0</b>	<b>9.1</b>	<b>7.2</b>	<b>5.6</b>	<b>5.6</b>	<b>5.3</b>
China	9.6	9.2	10.4	9.3	7.7	7.7	7.4
India	3.9	8.5	10.3	6.6	4.7	5.0	5.6
Russia	5.2	-7.8	4.5	4.3	3.4	1.3	0.2
Brazil	5.2	-0.3	7.5	2.7	1.0	2.5	0.3
SAR	3.6	-1.5	3.1	3.6	2.5	1.9	1.4

\*Estimated values.

Source: IMF, WEO Database, October 2014.

One manifestation of a structural shift is that hi-tech companies (first of all those operating in IT and biotechnologies sectors) are becoming leaders in capitalization, getting ahead of the ‘traditional’ corporations, including energy companies (Table 2). While previously, about a decade and a half ago, this was interpreted as a sign of an economic bubble (the dot-com bubble), now this has already become a stable trend. Among the top ten capitalization leaders, nine were US companies, while the companies operating in the emerging markets (including Chinese ones) are losing their former positions.

China, while retaining a high rate of growth, did not become a significant factor of recovery in the framework of a global crisis. It is undergoing some important transformations in terms of strengthening its internal growth factors. The huge Chinese market is becoming relevant for the national economy, which is a testimony to the national political elite’s increasing awareness of the importance of creating a new economic growth model.

The eurozone continues to display signs of ‘ill health’, although the rate of growth here is now once again on the rise. The key issue remains the complexity of the model that relies on a single currency without a single financial system. One may suppose that eventually some solution will be found, and so a euro crisis will be avoided. The current situation in some ways resembles that of the exit from the world crisis in the late 1970s and early 1980s, when the rate of economic growth in the West European countries began to gain impetus following the growth in the USA.

On important aspect of this global trend is its orientation to the prospects of prices for energy carriers. The fact that these prices nearly halved over the last few months of 2014, while still remaining above their record low of 2009, has given rise to the key question (or probably even a riddle) of the year 2015: will this new level of oil prices become stable (as it happened in the mid-1980s), or will it be only temporary (similarly to the situation in 2008–2009), followed by a rebound? No seriously substantiated (or ‘scientific’) answer to that question can

actually be offered: there exist valid arguments in favor of both scenarios. The only certain thing is that this factor will play a significant role in shaping the structure of the post-crisis global economy. For Europe, a sustainable decline in oil prices is more preferable. The position of the USA is neutral, because that country can, most probably, gain from either oil price movement vector, although the actual benefits will be different.

Table 2

**The World's Top Ten Countries, by Capitalization in 1997, 2000 and 2014**

	1997		2000		Q3 2014	
	Company	Sector	Company	Sector	Company	Sector
1	General Electric	Industry	General Electric	Industry	Apple	Technologies
2	Royal Dutch Shell	Oil and gas	Cisco Systems	Technologies	Exxon Mobil	Oil and gas
3	Microsoft	Software Development	Exxon Mobil	Oil and gas	Microsoft	Software Development
4	Exxon Mobil	Oil and gas	Pfizer	Pharmaceuticals	Google	Software Development
5	The Coca-Cola Company	Food	Microsoft	Software Development	Berkshire Hathaway	Investment
6	Intel Corporation	Technologies	WalMart	Retail	Johnson & Johnson	Pharmaceuticals and biotechnologies
7	Nippon Telegraph and Telephone	Telecommunications	Citigroup	Banking	Wells Fargo	Banking
8	Merck	Pharmaceuticals	Vodafone	Telecommunications	General Electric	Industrial
9	Toyota Motor Corporation	Machine-building	Intel Corporation	Technologies	Novartis	Pharmaceuticals and biotechnologies
10	Novartis	Pharmaceuticals	Royal Dutch Shell	Oil and gas	Hoffmann-La Roche	Pharmaceuticals and biotechnologies

Source: Financial Times Global 500.

For the developing countries importing energy carriers, the decline in their prices will be certainly beneficial. And finally, for oil producers this will be a period of trial, which will hopefully create incentives for them to implement institutional reform. Nevertheless, the answer to the question as to which form this institutional response will take remains open. In fact, two scenarios of institutional transformations are possible - one to follow the logic of mobilization (by administrative methods), the other – that of liberalization (via economic mechanisms). (Later in this section we are going to discuss this issue in more detail.)

As the global crisis was evolving, several issues were placed on both the national and global economic policy agendas, and the possible ways to deal with them will be the focus of attention of both researchers and practicing economists in the medium-term perspective.

*The issue posed by the rate of economic growth.* Over the decade preceding the crisis, the global economic growth rate was unprecedentedly high, and this phenomenon was then viewed as the sudden upshot of recent economic and political innovations, to be here to stay. This was the idea behind the reluctance of monetary authorities (especially in the USA) to restrict the growth of lending activity, thereby preventing the economy's overheating. We are not going to discuss here Alan Greenspan's policy in much detail, as much has already been written on this theme, and still more is yet to be written. High growth rates were demonstrated

by both the developed and developing countries, and this was an important result of economic policy, in spite of the fact that it ended in overheating and a crisis.

Now, growth has slowed down, thus giving rise to a new key question: can the low rate of growth be regarded precisely as part of that *new normality*, which had become the focus of discussion early in the crisis? Then, that term was mostly applied relative to the current monetary policy's specific features (quantitative easing and a low interest rate). The outcome of such a policy may be a stable period of low growth rates (the secular stagnation hypothesis). In other words, we will have to decode if the current rate of growth really reflects some short-term problems (the still persisting crisis phenomena, general political instability), or this is indeed a specific feature of the future post-crisis model of economic development.<sup>1,2</sup>

Consequently, there has arisen another issue – that of the prospects for the developing countries, especially those that were expected to produce an economic miracle. It should be remembered that the very idea of BRICS countries had initially been linked to that of 'economic miracle'. Much hope was invested in their dynamic development.

*Unconventional macroeconomic (primarily monetary) policy.* This issue is directly linked to that of economic growth. On the one hand, it must be understood just for how long the policy of quantitative easing can actually be implemented, and how its discontinuation may actually push down the growth rate, with the possibility of a new recession. On the other hand, we do not yet understand the long-term effects of this monetary policy, which has been unprecedented and largely contradicts the experience and logic of prudence in monetary matters, which was typical of the developed countries over the period 1980–2000 (after stagflation in the 1970s). The current situation is still fraught with the risk of a 'monetary policy trap': the low rate of growth will necessitate the downward movement of interest rates, while their growth in response to economic recovery will once again begin to push the rate of growth towards zero.

The contemporary situation in the developed countries resulted in a fundamental rethink of the key macroeconomic threats. After the stagflation issues of the 1970s, the main macroeconomic goal (in the developed world) was considered to be that of suppressing inflation, and this was also offered as a basic macroeconomic recommendation for the developing countries. Now, several decades later and with the experiences of the deflation issues of recent years, inflation is no longer perceived as the core macroeconomic issue, which is actually a replay of the theme voiced at the dawn of the Keynesian revolution. Now support is granted to proposals as to the feasibility of raising the inflation indices in the framework of inflation targeting.

Those economic and political recommendations that no so long ago were considered to be old-fashioned and *de facto* tabooed as a subject for economic and political discussions are now being tentatively recognized to be legitimate. Thus, in particular, the possibility of introducing some elements of foreign exchange control is mentioned increasingly often. The events of recent years have shown that capital market liberalization is sometimes fraught with significant risks that cannot be ignored. Besides, there is the positive experience of foreign

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<sup>1</sup> Teulings Coen and Baldwin Richard (eds.) (2014). *Secular Stagnation: Facts, Causes and Cures*. A VoxEU.org eBook. London: CEPR Press.

<sup>2</sup> L. Summers questioned the possibility of sustainable growth in the USA in the foreseeable future, and so warned against any too drastic departure from the growth-triggering policy course pursued by the FRS (see Summers Laurence (2014). *Reflections on the 'New Secular Stagnation Hypothesis'*. Teulings Coen and Baldwin Richard (eds.). *Secular Stagnation: Facts, Causes and Cures*. A VoxEU.org eBook. London: CEPR Press).

exchange control having been introduced in some Asian countries (especially in Malaysia) as a tool to help deal with the 1997–1998 crisis. However, it should be specified that constraints imposed on free capital movement can only be justified if the following two conditions are observed. Firstly, these measures should be introduced as a structural device intended not to reduce capital flows, but to sustain macroeconomic stability and sustainability of the financial sector and to soften the effects of ‘situational’ fluctuations. Secondly, restrictive measures should be imposed for a short period of time, which will then be used for implementing institutional reform designed to improve the financial market’s performance and create favorable conditions for investor activity. Otherwise the restrictions on capital movement will not yield any sustainable positive results, bringing about a decline in economic efficiency and giving rise to corruption<sup>1</sup>. As shown by historical experiences, it is very difficult to actually create such conditions, and so many of the recent attempts to apply this instrument have proved to be futile.

The situation with the regard to budget policy incentives for economic growth (the discourse on the feasibility of budget austerity) is becoming more understandable. In face of a severe budget crisis, the governments of a number of developed countries have begun to promote policies aimed at increasing budget expenditure as a traditional anti-cyclical policy measure. However, this can probably be afforded only by a country that issues a reserve currency – that is, the USA. European experiences have demonstrated that countries pursuing a tough budget policy coupled with a soft monetary policy (primarily the UK and Germany, but this is also true for Portugal) are more successful in their political and economic development. The attempts at implementing a soft budget policy in France can hardly be called successful – either in terms of economic growth or the popularity of the socialist government<sup>2</sup>.

*The prospects of globalization and global disequilibria.* On the eve of the current crisis and during its initial phase, some economists were already viewing global disequilibria as the most important source of growing problems. In fact, this had to do with the *de facto* division of the world into consumer countries and saver countries, when consumption growth was occurring mainly in the developed countries (and especially in the USA), while the focus of production was shifting to the developing world (in the main to China). This process even gave rise to a new term - *Chimerica*<sup>3</sup>.

Over the years that have passed since the onset of the crisis, these disequilibria have become somewhat less prominent due to the development of new technologies in the West and the rising labor costs in Asia (including China). However, this issue is linked to another, more complicated one – that of the prospects of globalization as the major phenomenon observed

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<sup>1</sup> Similar conclusions can be found in Saborowski Christian, Sanya Sarah, Weisfeld Hans, Yopez Juan (2014). *Effectiveness of Capital Outflow Restrictions*. Washington D.C.: IMF. This study conducted by the IMF demonstrated that restrictions on capital movement may turn out to be beneficial on condition of the existence of at least one of the following three circumstances: strong macroeconomic fundamentals; well-developed institutional environment; and a fully fledged control system that has already been functioning for a long period of time.

<sup>2</sup> In support of the standpoint of France’s socialist government – which is unwilling, in the foreseeable future, to reduce its budget deficit to 3% of GDP by way of complying with the Maastricht criteria, Italy’s leftist Prime Minister Matteo Renzi declared that a higher deficit is better than the electoral victory of the rightists led by Marine Le Pen. ‘I prefer to have a France with 4.4 per cent [deficit-to-GDP ratio] today than a France with Marine Le Pen tomorrow. This is very important for Europe’ (Politi James (October 3, 2014). *Berlin has no right to lecture, says Renzi* // The Financial Times). This is just one example of how politics can prevail over economics, which has become a typical feature of the current global crisis.

<sup>3</sup> Ferguson N. *The Ascent of Money: A Financial History of the World*. N.Y.: The Penguin Press, 2008.

over the last quarter century. As a result of the growing wellbeing rates in some of the developing countries, they are now faced with a new reality, when they are increasingly losing their former capacity to compete with the developed world in terms of labor cost. Now, they have to devise ways to boost their competitive capacity by means of institutional reform and improved business climate. The emerging markets must now become less oriented to the support of exports (although this is also an important factor that can indeed be further boosted) than to the improvement of opportunities for doing business, no matter which markets the exporters are ultimately choosing as their target. Moreover, as the wellbeing index rises in the developing countries, their domestic markets are becoming increasingly more important for their growth than the markets in the developed countries, and not *vice versa*.

Thus, the growing costs in the developing countries coupled with growth of their domestic demand can become the factor responsible for a declining world trade growth rate, or even for shrinkage of world trade turnover. In other words, the possibility of deglobalization cannot be ruled out altogether.

This is by no means an unprecedented situation. In fact, deglobalization was observed previously in the 1870s and 1880s, and then in the mid-20<sup>th</sup> century. Evidently, the periods of globalization and deglobalization alternate over the course of history.

Another factor conducive to deglobalization may become the recent trend of *reindustrialization in the developed countries*. Over the last fifty years, these countries have been demonstrating shrinking industry shares in terms of GDP and the employment rate, and this trend has also become prominent in post-Communist Russia. The critics of modern capitalism view these processes as a sign of deindustrialization, while the majority of economists believe it to be an evolution towards postindustrial economy and society.

The current reindustrialization may be the result of the combined effects of several factors. And the rising labor costs in the emerging markets are by no means the determining factor here. Anyway, there still exist quite a few poor countries with relatively high levels of stability, which will willingly host the production entities moved there for the sake of lower costs. The reindustrialization trend – if its existence should be confirmed – represents not a return to the traditional production mode in the developed countries, but the creation of new branches of industry whose typical feature will be the declining labor share in production costs and the prominent role of factors like the proximity to the research base (due to the increasing share of R&D) and consumer demand. The rising labor costs in the leading developing countries are only an additional contributive factor.

Another important reindustrialization factor may become the energy resources market transformation. Energy is becoming cheaper due to the implementation of state-of-the-art technological solutions aimed at new unconventional methods of natural gas and petroleum production, and more efficient methods of their transportation. This has resulted in the ‘energy price revolution’.

*The inequality issues* represent one more theme that is becoming increasingly prominent. While over the previous decades these issues were discussed mainly in a global context (from the point of view of the developed to developing country ratio, now it is inequality across the developed world that has become the focus of attention. This issue has two aspects.

On the one hand, there are the changes in inequality levels in the course of economic growth. In fact, this has to do with Simon Kuznets’ hypothesis<sup>1</sup> concerning the changes in

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<sup>1</sup> Kuznets S. *Modern Economic Growth: Rate, Structure, and Spread*. New Haven and London: Yale University Press, 1966.

economic growth to inequality ratios that occur as a result of departure from the traditional industrial model and the in-depth structural shifts in modern developed economies.

On the other hand, there is the important question of how inequality can influence the rate of economic growth – that is, the extent to which increasing inequality can become a factor that will determine a slowdown or acceleration of economic development. Evidently, this aspect of inequality has to do with the issue of long-term economic slowdown, as well as the discourse on the modern forms of social state (or welfare state) corresponding to the demographic and political realities of the 21<sup>st</sup> century.

This theme became the focus of special attention after the publication of Thomas Piketty's book<sup>1</sup>, where he underlined the fact that in the modern world, beside inequality between countries, there is also an increasing trend towards disparity in the distribution of income, and especially savings. Importantly, the latter is characteristic not only of the developed countries, but also of the topmost group of the developing economies.

Inequality in the distribution of savings, according to Piketty, plays a major role in the currently observed slowdown in economic development. The concentration of the bulk of savings (generated, among other things, also by incomes from global operations) in the hands of a fraction of the population creates domestic market conditions where the supply of resources is higher than the demand for investment. This disparity pushes down the interest rates. However, in face of dwindling economic activity and low inflation rates, monetary authorities are deprived of opportunities for creating incentives for growth by offering low interest rates (the nominal interest rate cannot go below zero (the so-called zero lower bound)).

The existence of all these issues has necessitated a rethink of the theoretic foundations of the contemporary economic policy and the universally accepted practical recommendations. Over the course of three decades (from the 1980s through the 2000s) the key economic policy issue was to ensure economic growth and macroeconomic stability, while a high inflation rate and excessive government interference were considered to be the main obstacles to achieving these goals. The gist of this concept (based on this specific combination of goals and risks) can be found in the so-called Washington Consensus – a set of basic economic policy prescriptions devised predominantly for the developing economies<sup>2</sup>. While the issue of maintaining macroeconomic stability remained important, the economists and politicians alike were now faced with the task of finding some additional instruments for economic development regulation in order to avoid a lengthy period of stagnation against the backdrop of a low inflation rate.

All these new phenomena and trends need to be empirically confirmed and theoretically reviewed. It can be assumed that such issues will make an important part of economic study programs and become the components of a new economic paradigm.

## **1.2. Russia: the Economic and Political Trends**

### **1.2.1. Overlapping Crises**

The key feature of socioeconomic and political development in 2014 was the simultaneous occurrence of several overlapping crises. In this connection we mean a crisis not as a single

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<sup>1</sup> Piketty T. *Capital in the Twenty First Century*. The Belknap Press of Harvard University Press. Cambridge, 2014.

<sup>2</sup> Williamson J. *What Washington Means by Policy Reform* // Williamson J. (ed.): *Latin American Readjustment: How Much Has Happened*. Washington D.C.: Institute for International Economics, 1989.

strictly defined process (for example, economic crisis), but as a stream of trends and events, each of which goes beyond the framework of any stable inertia-governed trend, and so significantly complicates the process of economic and political decision-making.

We may point to the following major crises and issues that Russia is currently faced with:

- the ongoing global structural crisis that has given rise to profound shifts in the economies and policies of the world's leading countries, to the emergence of new geoeconomic and geopolitical equilibriums; Russia has been experiencing this crisis at a lag behind the other main economies;

- the crisis of Russia's economic growth model of the 2000s, which has been based on increasing demand (including consumption) coupled with the existence of idle production capacities and long-term growth of prices for Russia's exports;

- the increasingly tense geopolitical situation, its causes including (but not limited to) Russia's noticeably higher political activity on the international arena; this higher activity in itself is the upshot of those major shifts that has resulted from the global crisis;

- the external economic shock created by the selective sanctions applied to some sectors of Russia's economy - first of all, in the financial sphere;

- the external economic shock created by the plummeting prices for oil – the most important source of revenue for the Russian budget;

- the foreign exchange crisis resulting from the double external shock (primarily the decline of oil prices, but also, in part, the effect of financial sanctions);

- the cyclical crisis phase associated with declining investment activity (however, this effect is cyclical only in part, because the low investment activity has also been caused by evident political factors);

- the demographic crisis, represented by the able-bodied population decline.

Each of these issues, when taken alone, is quite understandable and manageable in the framework of a responsible economic policy. It is their combination that creates some serious difficulties, because each issue, if it is to be properly dealt with, requires measures that may not only differ from the measures applicable to the other issues, but sometimes directly oppose those measures.

When discussing all those multiple crises, we must understand their varying roles in the current developments in Russia. The key role, in our opinion, belongs to the global crisis that produces structural shifts in the world economies and policies, which, in their turn, necessitate some transformations in the growth model currently existing in Russia. That model had already been demonstrating, by 2008, some signs of having exhausted its potential, and economists of practically any hue were then voicing their warnings. However, the crisis-triggered recession of 2009 and the resulting rebound of oil prices made it possible for that model to survive for several more years. The significant drop in the rate of economic growth, which occurred in 2013, was yet another reminder of the long-due structural and institutional reform. Geopolitical factors (including foreign sanctions), although important, are still playing a secondary role, making the situation more acute, while at the same time creating some additional opportunities for anti-crisis maneuvering and institutional renewal.

All these internal and external circumstances gave rise to some significant innovations in the economic and political life in this country, and intensified the mutual influence of the existing political and economic factors. As has already been noted earlier, politics is gaining an upper hand over economics - which is a typical feature of any period marked by crises and transformations.



### 1.2.2. The Ideological and Political context

The ideological background of the year 2014 was shaped by Russia's mounting confrontation with the West, still more intensified by the mutual misunderstanding and rejection. The Western ideological (and in part also political) model development was viewed by many in Russia's elite and middle class alike with an increasing negativism. Public opinion surveys are manifest of a high level of mistrust towards the West (and first of all, to the USA and the EU) and, as a consequence, of a high level of public support of Russia's political leadership with their loud criticism of 'our Western partners'<sup>1</sup>.

The almost 20-year-long period of mutual attempts at getting together - which sometimes appeared to be sincere, but more often looked just awkward - has given way to a relationship governed by the logic of 'us and them', which in fact is better understandable and more habitual for both parties. Russia and the West returned to their traditional confrontational mode. The transition from the format of G8 to that of G7 put everything in place, and the problem was once again translated into its initial wording, which is now clear for all. Strictly speaking, this is simply yet another turn in the relationship cycle where alliance and mutual mistrust are phases that alternate over time, a pattern that has become well known in the course of the last three centuries. In this context, the Crimea was more like a catalyst that speeded up the reestablishment of the traditional relationship model<sup>2</sup>.

However, in this connection several questions have arisen, which are significant from the point of view of Russia's and her partners' post-crisis development.

So, to what extent will Russia be able to achieve a political and, more importantly, economic reorientation to other countries and regions? In terms of politics, the most obvious option is represented by the BRICS group of countries, which in recent years has evolved from an abstract linguistic exercise of a banking analyst into a politically motivated association. Evidently the leaders of each of these countries are nursing ambitions of turning BRICS into a mechanism no less influential than G7. Russia in 2014, after the effective demise of G8, had an even greater vested interest in strengthening the influence of the new group, which can actually be boosted by Russia's chairmanship in BRICS. This format has yet another aspect which is important for Russia – the prevention of the emergence of an informal (let alone

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<sup>1</sup> According to the results of surveys conducted by *Levada Center*, while almost 90% of respondents had displayed their positive attitude to the USA, and only about 10% disapproved of that country back in 1990, the situation in 2014 was exactly opposite – the distribution of negative and positive opinions was 17% and 75% respectively. Approximately the same results were obtained with regard to the Russians' attitude to the European Union. As for Vladimir Putin's rating, after Russia's annexation of the Crimea it has been stably above 80%.

<sup>2</sup> Some Western researchers have noted that this course of events was actually programmed by the attitude of the EU and NATO to post-Soviet Russia, which had been wary to say the least from the very outset. Jeffrey Sachs, who was involved as consultant in the implementation of Poland's reform, and in the early 1990s also tried to help the Russian government, points to the radical difference in the perception, by Western political establishment, of the problems existing in those two countries. As for Poland, it was encouraged to follow the course of close cooperation with the economically developed countries, which were willing to offer their comprehensive economic assistance, including the writing-off of Poland's foreign debt. However, such measures were not considered to be applicable to Russia (the fact of Russia shouldering the USSR's debt liabilities in full notwithstanding), a country that was regarded as a loser, and the policy suggested with regard to the latter was to be aimed at containment, in order to prevent her strengthening. It is only natural, according to Jeffrey Sachs, that once Russia had begun to gather strength, this triggered a crisis in her relationship with the West (see Sachs J. (2014) Why the shadow of WW1 and 1989 hangs over world events // <http://www.bbc.com/news/magazine-30483873>; Sachs J. (2014). Time to End the Cold War Once and for All // <http://www.cnbc.com/id/102289227#>).

formal) Group of Two consisting of the USA and China, of which Zbigniew Brzezinski already wrote a few years ago<sup>1</sup>.

In terms of economics, the situation appears to be even more complex. On the one hand, the EU accounts for the bulk of EC Russia's foreign economic cooperation, and this circumstance cannot be changed promptly – although this is not a goal that really needs to be achieved. On the other hand, China as the world's second economy and Russia's natural neighbor, in spite of her willingness to cooperate, can hardly be expected to undertake any drastic economic measures in order to neutralize the effect of sanctions imposed by the West. The U-turn in the direction of China cannot become a self-sufficient economic and political strategy. Moreover, the key foreign trade issue for Russia is to gain access to capital (investment) and state-of-the-art technologies, and it has evidently little to do with establishing a partnership with the other members of the BRICS group and other developing countries.

One more alternative in this economic paradigm is integration across the post-Soviet space, and we can see an active development and institutionalization of this concept in recent years. The creation of the Customs Union (CU), and from 2015 - of the Eurasian Economic Union (EEU), and the expansion of this group to include a fifth member country, has been another important direction of Russia's economic policy. Although the process of integration by no means always goes smoothly, the very fact of such an evolution can hardly be overestimated.

We cannot yet fully estimate the scale of the recent ideological split with the West. Over the past three centuries, Russia has visualized herself as part of the Western civilization, and the desire 'to catch up and overtake' was often interlaced with the conviction that, by a number of parameters, Russia runs ahead of the West, being a precursor of things to come in the political and economic fields. Even the USSR, in its classical form, was viewed not as an alternative to the West, but as a model visualizing for the West its pathway towards its own 'Communist tomorrow'.

Today, it seems, the baseline targets are undergoing a transformation: in the logic of a 'multi-polar world' and 'conflict of civilizations',<sup>2</sup> the model of a 'special way' is not clearly visualized. However, an important crossroads still lies ahead. On the one hand, this can be a special development model, which will fundamentally differ from that followed by the West. On the other hand, this model also incorporates some components of the purely Western ideology of conservatism and traditionalism. Besides, this trend may also reflect a return to the traditional values of the Christian civilization, as well as a resurrection of the idea of European nationalism of the 19th century, or the principles of *Realpolitik* (in the style of Alexander Gorchakov, Otto Bismarck or Benjamin Disraeli). The latter assumption is confirmed by the inclination of some representatives of Europe's right wing to solidarity with present-day Russia.

So, we come to the logical conclusion that we also need to rethink the terminology applied to the key challenges that this country is currently faced with. When the transformation crisis was already over - that is, in the 2000s, we spoke of the necessity of *innovation development*. Then the focus of attention shifted towards *modernization*. And today, the main slogan is *import substitution*.

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<sup>1</sup> Brzezinski Z. (2009). *The Group of Two that could change the world* // The Financial Times. January 14. P. 9.

<sup>2</sup> Huntington S. *The Clash of Civilizations and the Remaking of World Order*. N.Y.: Simon&Schuster, 1996.

### 1.2.3. The Economic Specificities of the Year 2014

The presence of several overlapping crises has created some serious difficulties for economic development in Russia, and created specific demands with regard to economic policy. In this connection, a well-substantiated analysis of the negative trends and the issues associated with these trends will be necessary, as well as a sound understanding of the positive elements that can be relied upon whilst elaborating an adequate anti-crisis policy.

So, what are the main features of the economic situation as it emerged in 2014, which will influence the course of this country's development in the medium term? (See *Tables 3, 4 and 5*)

Table 3

#### Main Economic Indicators of the Russian Federation for 2008–2014

	2008	2009	2010	2011	2012	2013	2014
GDP, growth on same period of previous year, %	5.2	-7.8	4.5	4.3	3.4	1.3	0.6
Industry, growth on same period of previous year, %	0.6	-10.7	7.3	5.0	3.4	0.4	1.7
Agriculture, growth on same period of previous year, %	10.8	1.4	-11.3	23.0	-4.8	5.8	3.7
Household final consumption expenditure, growth on same period of previous year, %	10.6	-5.1	5.5	6.8	7.8	5.0	1.9
Investment in fixed assets, growth on same period of previous year, %	9.5	-13.5	6.3	10.8	6.8	-0.2	-2.5
Consolidated budget surplus (+)/deficit (-), % of GDP	4.9	-6.3	-3.4	1.5	0.4	1.3	-1.2
Reserve Fund (2007 – Stabilization Fund), year-end data, bn USD	137.09	60.52	25.44	25.21	62.08	87.38	–
National Welfare Fund, year-end data, bn USD	87.97	91.56	88.44	86.79	88.59	88.63	78.00
Bank of Russia's year-end international reserves, bn Rb	427.1	439.0	479.4	498.6	537.6	509.6	385.5
Consumer price index, December-to-December	13.3	8.8	8.8	6.1	6.6	6.5	11.4
Producer price index, December-to-December	-7.0	13.9	16.7	12.0	5.1	3.7	5.9
Bank of Russia's key rate, annual average, % per annum	6.9	8.3	5.3	5.3	5.3	5.5	7.9
Average interest rate on corporate credits, in Rb, annual average, % per annum	12.2	15.3	10.8	8.5	9.1	9.5	11.1
Average interest rate on individual deposits (except demand deposits)	7.6	10.4	6.8	5.4	6.5	6.6	6.7
Total unemployment rate (ILO methodology), per annum average	6.2	8.3	7.3	6.5	5.5	5.5	5.2

Source: Rosstat, RF Ministry of Finance, Bank of Russia.

Table 4

**Some Parameters of the RF Balance of Payments and External Debt  
in 2008–2014, bn USD**

	2008	2009	2010	2011	2012	2013	2014
<b>Current account balance</b>	<b>103.9</b>	<b>50.4</b>	<b>67.5</b>	<b>97.3</b>	<b>71.3</b>	<b>34.1</b>	<b>56.7</b>
Trade equilibrium	177.6	113.2	147.0	196.9	191.7	181.9	185.6
Exports	466.3	297.2	392.7	515.4	527.4	523.3	493.6
Imports	-288.7	-183.9	-245.7	-318.6	-335.8	-341.3	-308.0
Direct investment*	19.1	-6.7	-9.4	-11.8	1.8	-16.1	-28.5
In RF economy	74.8	36.6	43.2	55.1	50.6	70.7	18.6
Abroad	-55.7	-43.3	-52.6	-66.9	-48.8	-86.7	-47.1
<b>Reserve assets ('-' – growth)</b>	<b>38.9</b>	<b>-3.4</b>	<b>-36.8</b>	<b>-12.6</b>	<b>-30.0</b>	<b>22.1</b>	<b>107.5</b>
<b>Foreign year-end debt</b>							
Total	<b>480.5</b>	<b>467.2</b>	<b>488.9</b>	<b>538.9</b>	<b>636.4</b>	<b>728.9</b>	<b>599.5</b>
Government bodies	29.5	31.3	34.5	34.7	54.4	61.7	41.5
Central Bank	2.8	14.6	12.0	11.5	15.6	16.0	10.4
Banks	166.3	127.2	144.2	162.8	201.6	214.4	171.1
Other sectors	282.0	294.1	298.2	329.8	364.8	436.8	376.5

\* 2014 – less banks

Source: Bank of Russia.

Table 5

**The Structure of Capital Operations in the RF Private Sector in 2008–2014, bn USD**

	2008	2009	2010	2011	2012	2013	2014
<b>Total</b>	<b>-133.7</b>	<b>-57.9</b>	<b>-35.3</b>	<b>-83.0</b>	<b>-56.5</b>	<b>-62.1</b>	<b>-151.5</b>
including							
<b>Banking sector</b>	<b>-56.9</b>	<b>-30.4</b>	<b>15.9</b>	<b>-23.9</b>	<b>18.5</b>	<b>-7.5</b>	<b>-49.8</b>
External liabilities	8.2	-42.1	17.7	7.8	33.3	20.4	-37.1
External assets	-65.1	11.8	-1.8	-31.8	-14.8	-27.9	-12.7
<b>Other sectors</b>	<b>-76.8</b>	<b>-27.6</b>	<b>-51.2</b>	<b>-59.1</b>	<b>-75.0</b>	<b>-54.6</b>	<b>-101.7</b>
External liabilities	98.6	34.2	24.9	58.9	39.8	95.6	0.9
of these							
FDI	64.9	30.1	37.8	50.0	42.8	61.5	18.6
Other obligations	33.7	4.1	-13.0	8.9	-3.0	34.1	-17.7
External assets	-175.4	-61.7	-76.1	-118.0	-114.8	-150.2	-102.6
of these							
currency in cash	-25.2	4.3	14.2	4.0	-1.4	0.3	-33.9
Other assets	-150.2	-66.0	-90.2	-122.0	-113.4	-150.5	-68.7

Source: Bank of Russia.

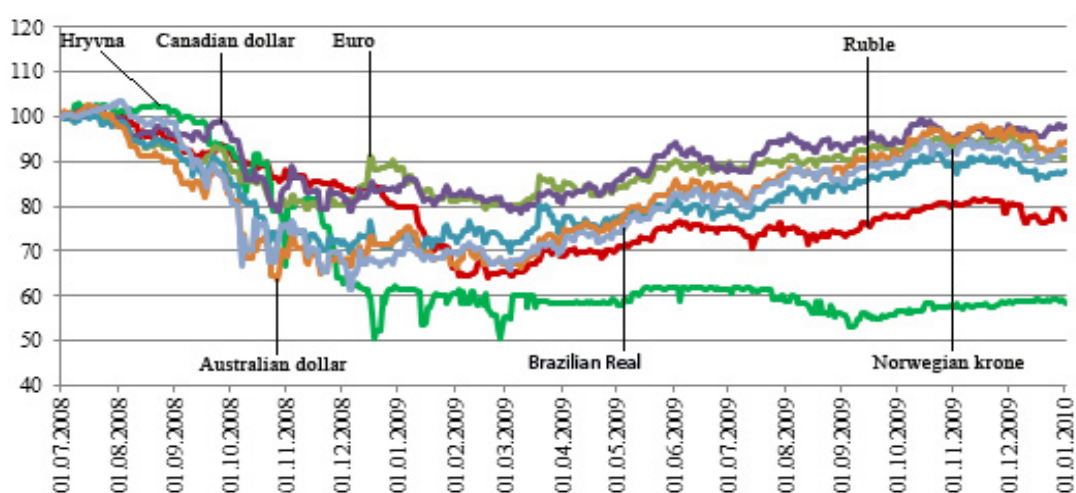
The topmost factor is the slowdown in the rate of economic growth, the first signs of which had appeared back in 2012, and in 2015 the growth rate may become negative. Economic decline in itself cannot become a big issue if it is short-lived. Danger is associated with a protracted recession, which may result from an inadequate anti-crisis economic policy. One example of such a course is the notorious 'acceleration policy' as it was implemented in 1986–1989, which translated itself into a lengthy crisis<sup>1</sup>.

Another issue is the destabilization of Russia's national currency. It would have been wrong to explain the sharp depreciation of the ruble in December 2014 by mistakes committed by the monetary authorities. The main causes of depreciation are the structural issues that have been plaguing the Russian economy, and that have been pointed out over the past 10 years by practically all economists, many of whom differ in their opinions on other issues. The low degree of diversification in the national economy, the low competitive capacity of

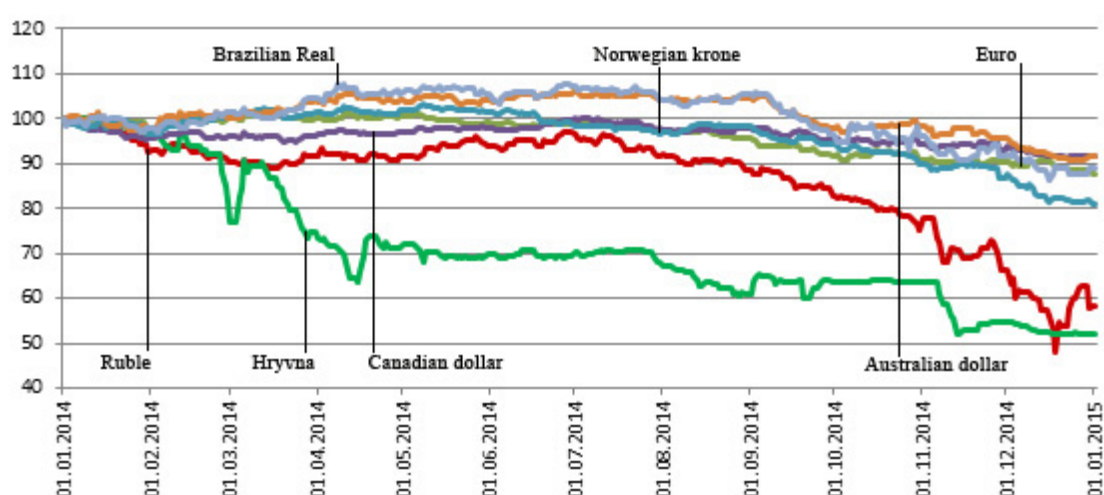
<sup>1</sup> V. Mau. *V ozhidanii novoi modeli rosta: sotsial'no-ekonomicheskoe razvitiie Rossii v 2013 godu* [Waiting for a new model of growth: Russia's social and economic development in 2013]. *Voprosy Ekonomiki* [Issues of Economics]. 2014. No 2, pp. 22–24.

many of Russian enterprises, the low level of trust in society, and the high inflation rate persisting over the past two decades have been the factors that made the economy extremely sensitive to the movement of oil prices and availability of external sources of cheap money. So the country's isolation from external financial markets coupled with plummeting oil prices could not but push down the exchange rate of the Russian ruble against major foreign currencies. We may look for (and find) many other contributing factors, both objective and subjective, but they will be of secondary importance by comparison with the first two exogenous factors.

It is the combination of these circumstances that was actually responsible for the ruble being much more vulnerable than the national currencies of the other economies dependent on raw materials. It is in this that the current situation differs from that in 2009, when the rate of the ruble's weakening was comparable to that of the other national currencies (*Fig. 1 and 2*).



*Fig. 1.* The Movement of the Ruble's Foreign Exchange Rate in 2008–2009 against the National Currencies of Some Other Countries (1 July 2008 = 100)



*Fig. 2.* The Movement of the Ruble's Foreign Exchange Rate in 2014 against the National Currencies of Some Other Countries (1 January 2014 = 100)

Growing political uncertainty was one more factor responsible for the decline in entrepreneurial and investment activity. It triggered capital outflow at a rate comparable to that in 2009. However, then the situation was further aggravated by a simultaneous nearly 9-percent drop in GDP.

The growth rate of prices accelerated, which was a natural consequence of the ruble's depreciation. The inflation rate once again rose to two-digit values, thus making more acute the existing economic problems (through the mechanism of interest rates) and social issues. To bring down the inflation rate – this has once again become one of major goals of Russia's economic policy.

A serious issue emerged when Russian companies were denied access to world financial markets. This factor reduced their opportunities both for attracting credits (which they needed, among other things, in order to refinance their accumulated debt) and for placing their securities abroad. The volume of mergers and absorptions (M&A) dropped threefold on 2013, and that of attracted syndicated loans dropped more than fourfold (\$ 48.4bn to \$ 11.7bn). The volume of eurobonds held by Russian companies shrank from \$ 52.6bn to approximately \$ 10bn.

This was caused not only by the direct restrictions on the access of Russian companies to the capital markets of those countries that had officially introduced sanctions against Russia (the USA, the EU, Canada, Japan). Firstly, capital substitution from the markets of other countries, including the fast-growing Asian economies, appears to be problematic, because under the conditions of globalization the financial institutions in 'third countries' are very cautious and circumspect in their policies towards corporations that are subject to economic sanctions, not wishing to spoil their relations with the regulators in those countries that have imposed the sanctions. Secondly, the access to capital markets also becomes somewhat constrained for those companies that are not subject to formal sanctions, because investors now rate their country risks very high. Thirdly, Russia's business environment inevitably reflects the situation on world markets, with their uncertain global growth prospects (the prospects of secular stagnation) and the declining demand for the core items of Russian exports (energy, metallurgy, etc.).

The sharp depreciation of the ruble, the restricted access to financial markets in combination with the downgraded investment ratings of the country as a whole, as well as some selective companies, have become the factors that complicate the task of foreign debt redemption for banks and corporations. By late 2014, it had risen to \$ 651bn, and by 1 January declined to \$ 548bn (*Table 4*). Although this can be regarded as a positive achievement from the point of view of the prospects of macroeconomic recovery, in the short term the reduced presence of Russian companies in world financial markets will become an additional negative economic growth factor.

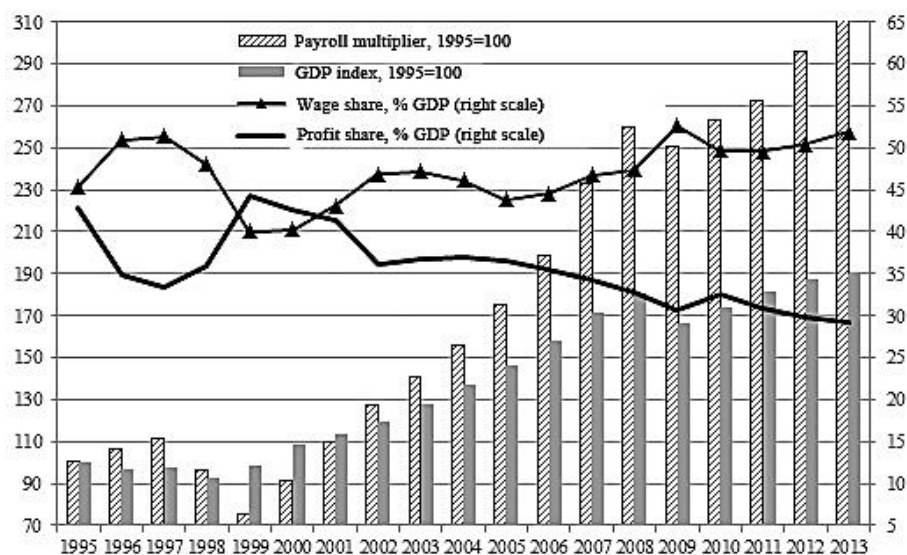
The scale of capital outflow from Russia has also increased significantly, which is also a manifestation of the flight-to-quality pattern. The movement of the capital outflow index should be viewed in comparison not only with the data for the year 2013, which was marked by a high degree of stability, but also the data for the crisis period 2008–2009, when capital outflow indices peaked in the period from Q3 2008 through Q2 2009 at \$ 183bn, which is by \$ 31bn more than in 2014. True, that was the period when Russian non-banking corporations were able to increase their foreign assets, including direct investment. During the crisis of 2008–2009 the amount of those assets increased by \$ 41bn more than they did in 2014 (\$ 142bn vs. \$ 101bn). The amount of capital outflow from the banking sector during the crisis of 2008–2009 was by \$ 32bn higher than the same index for the three quarters of 2014,

and at that time, in addition to the high scale of foreign debt redemption, banks were intensively increasing the amount of their foreign assets (*Table 5*).

In 2014, the main factor that was pushing up the net capital outflow index was the slow-down in the inflow of foreign loans and foreign investment, as well as investment in foreign currency cash. If the indices for 2013 are cleared of the effects of the deal of purchase, by *Rosneft*, of TNK-BP, as well as those of the foreign loan taken in order to complete the deal, the net outflow index for will increase by \$ 98.0bn to \$ 151.5bn.

The growth in investment in foreign assets in the non-banking sector occurred almost entirely due to the increased investment in foreign currency cash. If in 2013, according to the Bank of Russia's estimates, the volume of foreign exchange assets held by Russian residents shrank by \$ 0.3bn, over the course of 2014 it increased by \$ 34.1bn - nearly at the same pace as during the crisis of 2008–2009.

One of sign of the mounting problems in the Russian economy was the movement of wages and profits in terms of share in GDP. We have already pointed out the fact that, over the last 20 years, the surge of the share of wages above 50% of GDP is a sign of an approaching crisis<sup>1</sup>. As seen from *Fig. 3*, the key role here is played by the real foreign exchange rate of the ruble. Its strengthening results in a shrinkage of the share of exports in GDP (even in face of rising oil prices), which means that the share of labor is increasing. In response to the ruble's depreciation the share of labor shrinks, thus becoming one of the factors responsible for the upward movement of the competitive capacity index and the increasing share of exports in GDP. This is exactly what happened in the period 1998–1999. To some extent this pattern also occurred in 2009, but due to the negligible depreciation rate the resulting boosting effect on competitive capacity was also rather limited.



*Fig. 3.* The Movement of Wages and Profits Russia, as Share in GDP, in 1995–2013

<sup>1</sup> V. Mau. *V ozhidanii novoi modeli rosta: sotsial'no-ekonomicheskoe razvitie Rossii v 2013 godu* [Waiting for a new model of growth: Russia's social and economic development in 2013]. *Voprosy Ekonomiki* [Issues of Economics]. 2014. No 2, p. 14.

Alongside all these problems that occurred in 2014, it is also important not to overlook the positive elements in Russia's macroeconomic situation, which can become the levers that can be employed to overcome the forthcoming crisis. They are as follows:

- a well-balanced budget, which could be kept under control thanks to the existence of the 'budgetary rule';
- low government debt, and in particular the amount of debt denominated in foreign currencies;
- the considerable amount of foreign exchange reserves held by the Bank of Russia and the RF Government;
- a low unemployment rate as a factor ensuring social stability.

To these positive indicators, we can add Russia's significantly improved position in the World Bank's Doing Business ranking, which is the proof of this country's steady progress towards the goal outlined in the May 2012 Presidential executive order. Meanwhile, at the present moment the fact of this progress seems paradoxical, because the improved ranking correlates with a slower rate of growth, whereas over the previous decade the economy was displaying growth at a high rate against the backdrop of Russia's steadily declining ranking. However, this does not mean that from now on this index should be ignored. But it is evident that economic growth occurs as a result of interaction of various and multi-vectored factors.

One more positive outcome of the year 2014 is the recognition of the fact that the RF Central Bank is capable of acting independently and contrary to the opinions of the majority in the economic and political elite. This is true with regard to its interest rate policy, as well as its consistent efforts to 'clean up' the banking sector. Over the course of that year, the RF Central Bank revoked 85 licenses, including 72 bank licenses and 13 licenses of non-banking credit institutions, after distortions in their balance sheet data had been revealed.

In spite of all the hardship associated with the decision to proceed with the switchover to inflation targeting in accordance with the earlier established timelines (that is, by 2015), that decision appears to be appropriate and timely. Due to this measure, a significant part of foreign exchange reserves could be saved. This last circumstance is of particular importance, if we set it against the situation in 2008–2009. Then, over the course of 5 months (from September 2008 through January 2009) the Bank of Russia sold about 40% of its reserves (or \$ 209bn) in order to keep in check the ruble's foreign exchange rate in face of the uncertainty produced by the ongoing crisis and the plummeting prices of oil. As a result, the ruble remained stable, while later on the amount of foreign exchange reserves was increased (although the pre-crisis record high could never be achieved) as oil prices once again went up. However, the downside was the overestimated foreign exchange rate of the ruble in the new conditions, and consequently, a slowdown in the process of structural modernization – after the rebound of 2009–2010, the *business as usual* model prevailed.

Thus, the following key features of the current situation in Russia should be underlines, as they will determine the further course of events:

- political consolidation of society;
- stagflation as a key macroeconomic issue, which should be recognized in spite of the absence (so far) of any growth in the rate of unemployment;
- the need for consistent institutional reform capable of securing the competitive capacity of individual companies and the national economy at large.



#### 1.2.4. Economic Policy in the Context of Accumulated Experience

The currently observed issues and challenges are by no means an unprecedented phenomenon. So, when analyzing the present-day situation, we should rely on the available Russian and international experiences and the precedents of the not-so-distant past. These experiences, however, must not be treated as a directly applicable model. Nevertheless, they are important for an adequate understanding of the context in which the tasks to be tackled are currently set.

So, the following events and circumstances should become the focus of special attention.

To begin with, it might be appropriate to analyze the experiences of the two previous structural crises of the 20th century that occurred in the 1930s and then in the 1970s. A structural crisis is not equivalent to a slump; it may actually encompass alternating periods of recession and growth. It is approximately a decade-long period of turbulence, the upshot of which as a new model of economic growth, new foreign exchange patterns, and a new prevalent economic doctrine. Its political and intellectual effects can be felt for decades<sup>1</sup>. Experience has shown that every crisis is qualitatively different from the previous one, so it is impossible to adequately prepare for it. No matter how convincingly Ben Bernanke argued vis-à-vis Milton Friedman<sup>2</sup> that the new generation of economists would avoid the mistakes made by the regulators during the Great Depression of the 1930s, their avoidance of past mistakes did nothing to prevent the emergence of serious macroeconomic issues and problems, or to make unnecessary an in-depth structural reform needed to overcome the 'great recession'.

For present-day Russia, it is essential to study both the experiences of the stagflation economy of the 1970s and the methods applied in securing an exit from that crisis - that is, the combination of structural reform (consistent liberalization), tough monetary policy, and budget stimulation. An exit from stagflation requires tougher macroeconomic solutions, and it cannot be achieved on the basis of the standard Keynesian recipes alone. In the early 1980s, the USA managed to put an end to the crisis thanks to the combined implementation of liberalization measures (launched in the late 1970s under President Carter), the tough monetary policy pursued by the FRS's Chairman Paul A. Volcker<sup>3</sup> (which in the early phase of its implementation produced recession), and the budgetary expansion policy of the Reagan Administration. The budgetary expansion of the 1980s effectively scaled down the effects of monetary toughness and the high interest rates associated with it by boosting additional demand in the economy.

The lessons that can be derived from the course of economic development in the USSR during the last decade of its existence are no less important. Around 1980, the economic and political situation in the country appeared to be super-stable. 'The unity of the party and the

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<sup>1</sup> According to Ben S. Bernanke, 'Not only did the Depression give birth to macroeconomics as a distinct field of study, but also – to an extent that is not always fully appreciated – the experience of the 1930s continues to influence macroeconomists' beliefs, policy recommendations and research agendas.' (See Bernanke Ben S. *The Macroeconomics of the Great Depression. A Comparative Approach*. Journal of Money, Credit and Banking. 1995. Vol. 27. No 1. P. 1.

<sup>2</sup> In his speech in honor of Milton Friedman issued at at his 90<sup>th</sup> anniversary, Ben Bernanke (the then Chairman and member of the Board of Directors of the FRC) said: 'Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton [Friedman] and Anna [Schwartz]. Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again'.

<sup>3</sup> When swearing in as Chairman of the Federal Reserve in June 1979 Paul A. Volcker said: 'We are face to face with economic difficulties really unique to our experience. We have lost that euphoria [...] that we knew all the answers to managing the economy.'

people' coupled with the high prices for oil (which in real terms were approximately at the same level as in 2013) made it possible to pursue practically any chosen course in domestic and foreign policy alike, and render support to the friendly regimes in any region across the globe. The West was in the throes of a systemic crisis, and its former influence seemed to be waning. However, in the early 1980s the capitalist countries managed to exit from the crisis in the wake of their structural renewal, and their growth rate began to run ahead of that of the USSR. The USSR responded by implementing an acceleration policy (which preceded *perestroika* - that is, institutional reform), which coincided with the decline of oil prices by 2.5–3 times and produced a two-year-long rise in the economic growth rate, followed by an economic disaster. In other words, we can see that the rate of economic growth in conditions of a structural crisis cannot become a goal per se, and that only three years (two of which will be marked by an accelerated rate of economic growth) can pass between a period of economic stability and the collapse of the entire economy.

And finally, we should pay attention to the experiences of the New Economic Policy (NEP) of the period 1921–1927. It represented an attempt to combine a state-owned economy with market principles of economic management. The key problem in that context was the open mistrust displayed by the Communist leaders of the USSR towards the private sector, which was at that time quantitatively prevalent in the national economy. The lack of mutual trust between authorities and businesses in combination with the regularly issued decisions in favor of public trust companies which ran contrary to the interests of private producers resulted in a situation where business were very cautious in their plans concerning any production growth, which was especially true in the case of peasant households, which then dominated the economy. Nearly all the eminent economists insisted (with citations from the works by Vladimir Lenin) that, in order to secure sustainable growth and modernization, it was necessary to properly balance the interests of the public and private sectors (the so-called *smychka* or coalescence), and of industry and agriculture, and to ensure proper proportions in the development of each sector<sup>1</sup>.

However, this scenario was oriented to a modest rate of growth and was fraught with the risk, for the Communist party leadership, of losing their political power exercised in the framework of their State still formally ruled by the dictatorship of the proletariat. So, they decided to depart from the logic of economics and opted instead for administrative and political measures as a tool for tackling the existing economic problems: the private sector was speedily destroyed, and its confiscated resources poured into the industrialization project. The economic and political goals were thus achieved, but the cost was tremendous – not only in terms of institutional, but also human losses. In other words, the State has always the option to go beyond the limits imposed by a purely economic logic, because political tasks in the short term usually prevail over economic issues.<sup>2</sup>

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<sup>1</sup> The balanced industrialization model was developed by N. Kondratiev, V. Bazarov and other economists attached to Narkomfin [People's Commissariat of Finance] and Gosplan [the State Planning Committee]. On the political level, it was supported by N. Bukharin, A. Rykov and G. Sokolnikov. The slogan applied to that model called peasants 'to get rich', expecting that 'the kulacks would grow peacefully into socialism'. (For further detail on this discussion, see Erlikh A. *Diskussii ob industrializatsii v SSSR, 1924–1928* [Discussions on industrialization in the USSR, 1924–1928]. M.: DELO, 2010; Yasniy N. *Sovetskie ekonomisty 1920-kh godov. Dolg paniati* [Soviet Economists of the 1920s. Lest We Forget]. M.: DELO, 2012).

<sup>2</sup> 'Politics is a concentrated expression of economics', Vladimir Lenin said in his 1921 article *Once Again on the Trade Unions*. But he immediately added: 'Politics cannot but have primacy over economics.' (Lenin V. I. Complete Works, 5th ed. Vol. 42. P. 278).

In this connection it is noteworthy that China's leaders, after three decades of experiments with the traditional Soviet (mobilization) model, in 1978 took the fundamental decision, from then onwards, to rely on the logic of economics in their industrialization projects, and so in the course of the next three decades they reestablished China's status (lost in the 19th century) of the biggest economy in the world.

### 1.3. The Discourse on Economic Policy and Growth Stimulation

The key issue in the framework of Russia's present-day development is economic growth. Since 2000, the rate of growth in this country was generally above the average global growth rate, which gave rise to certain well-formed expectations – not only economic, but also (and in the main) political. But the situation over the past two years turned out to be different, and in this connection practically all economists and politicians have recognized the fact that this slowdown is determined not by the current conditions, but by certain fundamental, and primarily institutional, factors. Almost all of them have also written that the growth model that relies on the involvement of available resources (production capacities, rent-generated incomes), and is thus oriented to boosting demand, cannot be sustainable and viable in the long run. In order to achieve a sustainable growth trajectory, institutional reform is needed – that is, the elaboration of coherent rules of the game that can be easily understood by economic subjects and enable them to reliably predict the consequences of one or other economic decisions. In this connection, what is important is not so much the specific choice of a set of measures – but rather the fact of existence of such rules *per se*, so that they could be complied with and be understandable for any economic subject.

As noted earlier, short-term economic growth (growth no matter what its costs may be) should not be a goal in itself; growth is a valuable achievement when it is sustainable in the long run, and when it is accompanied by modernization.

It is the sources of such growth that have become the main focus of the ongoing discourse.

#### 1.3.1. Two Models

To achieve economic growth, investment is needed. Under the conditions of restrictions imposed on Russia's access to external markets, the focus of attention should be shifted to domestic sources of investment. And so we come to the traditional choice between two alternatives: should the bulk of investment be allocated by the government, or is this the function of private businesses?

*The first scenario* is administrative in its form, but essentially it is a mobilization scenario. The government, having been disappointed in the willingness of businesses to invest, may concentrate the resources in its own hands and then transfer them to the top priority sectors of the economy. This approach is well known from the experiences of the 19th and 20th centuries; it may indeed boost the rate of growth, but this is the way that can hardly ensure a high-rate performance and global-scale competitive capacity of the national economy. To achieve the goal of accelerated industrialization, the best method is to rely on state budget resources and to employ state-owned banks – this is, indeed, how Alexander Gerschenkron<sup>1</sup> described the institutional development typical of that epoch. Investment sources are taxes, accumulated reserves, government borrowings and the printing press (lending to the government by a lend-

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<sup>1</sup> Gerschenkron A. *Economic Backwardness in Historical Perspective*. Gerschenkron, Alexander. Economic Backwardness in Historical Perspective: A Book of Essays. Cambridge, Mass.: The Belknap Press of Harvard University Press, 1962.

er of last resort). The last two sources are closely interlaced – government loans are ultimately funded by the central bank.

At present we often here suggestions to the effect that the Bank of Russia should be assigned the task of issuing loans to fund large-scale investment projects launched by enterprises (and evidently approved by the government), and charge an 'affordable' interest rate (well below the inflation rate). It is obvious that the mobilization scenario implies emission-based funding – allocated if not to the budget, then to quasi-budget operations. This process inevitably involves the following three steps: to collect or print money; to distribute it among correctly selected enterprises; and introduce foreign exchange control (to impose constraints on foreign exchange operations with the national currency) in order to prevent the entry of the newly issued money to the foreign exchange market. If we follow this logic, inevitably the next step will be (as confirmed by the experiences of many countries over the course of the 20th century) to freeze prices (that is, to impose government control over prices) and wages at their current level. Initially, these rules are never explicitly stated, but they are the necessary preconditions for the implementation of the administrative (or mobilization) scenario.

The other economic policy scenario is the economic (or, more precisely, liberalization) scenario; it is aimed at creating incentives for private saving, then transforming savings into investment, which then will serve as the foundation for economic growth acceleration. This scenario is more complicated, as it requires more intellectual and organizational effort, because many decisions must be properly discussed and thoroughly elaborated. It never yields speedy results, because time is required to build mutual trust among economic agents (entrepreneurs, workers, government officials), without which no 'economic transmission' can be possible. The advantage of this approach is that if the achieved results are more sustainable, and the amplitude of political and economic fluctuations is much shorter.

The liberalization scenario was unpopular under the conditions of classical catching-up industrialization of the first half of the 20th century. However, over recent decade, as the postindustrial model began to evolve, it has become increasingly widespread not only in the framework of measures implemented in order to deal with crises in the developed economies, but also as part of the catching-up development projects in the developing countries. The one large-scale example of this development pattern is China after 1978, and especially after the suppression of the student unrest in 1989, economic sanctions were introduced against that country. In spite of the domination of mobilization champions in the Political Bureau of the Central Committee of the Communist Party of China, Deng Xiaoping insisted on the implementation measures aimed at consistent liberalization and promotion of private initiative. It is this liberalization in China which, from 1992 onwards, gave rise to rapid growth of investment and GDP<sup>1</sup>.

There also exist other examples of accelerated growth triggered by liberalization (Chile, Finland, Ireland, the Republic of South Africa, Poland); however, over the last half-century, accelerated growth has never been observed in the framework of the mobilization model.

Since every structural crisis prompts a reassessment and revision of the existing economic regulation model, the question as to the prospects of the liberalization model and the possibility of reintroduction of large-scale government interference was raised as early as 2008, shortly after the collapse of *Lehman Brothers*, one of US biggest investment banks. At first it seemed that indeed the crisis will translate itself into a return of the 'Big State'. But very soon

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<sup>1</sup> Kissinger H. On China. P. 469–475; Kadochnikov P., Ptashkina M. Trade *Liberalization in China: A Response to the Challenges in the Beginning of the 1990s*. Economic Policy. 2014. No 6, pp. 103–113.

warnings could be heard against any rough interference of the State with economic life, the so-called crass Keynesianism. Vladimir Putin was one of the first to voice such a warning as early as January 2009: 'One is sorely tempted to make simple and popular decisions on times of crisis [...] Excessive intervention in economic activity and blind faith in the State's omnipotence is another possible mistake. True, the State's increased role in times of crisis is a natural reaction to market setbacks. Instead of streamlining market mechanisms, some are tempted to expand state economic intervention to the greatest possible extent. [...] In the 20<sup>th</sup> century, the Soviet Union made the State's role absolute. In the long run, this made our economy totally uncompetitive. This lesson cost us dearly. I am sure nobody wants to see it repeated'<sup>1</sup>. The necessity of liberalization of the conditions for doing business, and the entrepreneurial freedom was also one of the core themes of Vladimir Putin's Presidential Address to the Federal Assembly in December 2014.

### 1.3.2. Growth-boosting Mechanisms

The practical experience associated with the introduction of budget and monetary incentives has become one of the most popular themes in the economic discourse. The developed countries of the West (including Japan, if 'the West' is to be understood as an economic and political entity, and not as a geographical term) have been actively applying such methods, albeit with sometimes controversial results. We can often hear suggestions that such instruments should also be applied in Russia. However, the macroeconomic situation in this country differs drastically from that in the West.

In stark contrast to the West, where the main issues are high debt and (or) budget deficit coupled with an exceptionally low inflation rate (or sometimes even deflation), in Russia the economic slowdown is happening against the backdrop of a sufficiently sustainable budget, low government debt and a high inflation rate, which in 2014 once again mover into two-digit zone. In other words, Russia is faced with stagflation, which cannot be dealt with by means of quantitative easing. On the contrary, in order to overcome stagflation, monetary policy should be tightened, the inflation rate should be pushed down to a level that would make possible a revival of economic growth, and only after these conditions are satisfied, the interest rates can be reduced. To emphasize it once again: for Russia, the experiences of the West in the late 1970s and early 1980s appear to be a more appropriate model to follow.

For Russia today, to resort to quantitative easing would have been impossible, because it would lead to further destabilization, accelerated inflation, and economic activity decline. Moreover, Russia's 'inflation history' is rather bad – this country has been plagued by a high inflation rate for a quarter of a century.

This problem cannot be solved by means of applying administrative measures in order to boost growth and bring down interest rates. Credits are expensive in Russia not so much because of the high rate of refinancing (or its substitutes, say, in the form of the key rate); the main factor here is the level of trust in the policies being implemented, and the reliability of the contracting parties. This can be easily noticed if we look at the gap between the rate set by the RF Central Bank and the commercial rates on credits issued to businesses. In Russia, this gap is rather wide by comparison with the other developed countries (*Table 6*).

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<sup>1</sup> Vladimir Putin's speech at the Davos World Economic Forum on January 29, 2009. <http://www.vesti.ru/doc.html?id=246949>

Table 6

**The Spread between the Loan Rates and the Discount Rates of the Central Banks  
of Some Countries of the World, 2013**

Country	Discount rate % per annum	Loan rate % per annum	Spread pp.
USA	0.75	3.25	2.50
Canada	1.25	3.00	1.75
Japan	0.30	1.30	1.00
Brazil	16.49	27.39	10.90
China	3.25	6.00	2.75
India	8.75	10.29	1.54
SAR	5.00	8.50	3.50
Russia	5.50	9.47	3.97

Another important trust-boosting factor is the sustainability of the exchange rate of the national currency against major foreign currencies. From this point of view, the year 2014 was a period of hard trial for the ruble. The ruble was under the pressure of two powerful external factors – the difficult geopolitical situation and the movement of oil prices.

The interest rates on loans (i.e., money affordability) are not the only monetary policy factor that can influence the rate of economic growth. The level of trust in the national currency is no less important. In a situation when economic sanctions were conjoined with plummeting oil prices, the ruble turned out to be one of the least stable currencies, and this is the main difference between the current situation and the situation in 2008–2009. Now, the main issue is not the ruble's exchange rate *per se*, but its sustainability at a new equilibrium level.

Although Russia's authorities, over the course of 2014, repeatedly denied the possibility of introducing any foreign exchange control, it would be wrong to 'throw out' for good this instrument from the monetary policy 'arsenal'. Indeed, some circumstances may arise when certain elements of foreign exchange control can prove to be feasible, and in such a situation it will be important not to overlook the limitations that we have discussed earlier<sup>1</sup>.

From the point of view of monetary policy, the key goal of the forthcoming period will be to suppress inflation. The two-digit inflation rate and the resulting high interest rates in nominal terms are now the main macroeconomic factors that restrict economic growth. It is necessary to consistently work towards bringing down the inflation to the established target of 4% over the next three years. This goal is not to be easily achieved, but it is nevertheless achievable. In spite of all the budget issues created by the low oil prices (if such a scenario is indeed implemented), it becomes possible to avoid the Dutch disease, thus making disinflation much easier.

While the monetary situation in Russia is much more complicated than that in the West, the budget situation, on the contrary, appears to be much more stable due to the low government debt and the near-zero budget deficit. So, there seemingly appears to be certain extra space for budget stimulation. However, in reality the opportunities for any quantitative growth of budget expenditure are very limited, and there are several reasons why this is so.

Firstly, there are few resources for any additional funding allocation. Foreign debt markets are closed to Russia. An increasing domestic debt coupled with a near-zero growth rate will steer the available resources away from private investment, or they will be spent only on the redemption of government debt by the RF Central Bank. In both cases, there is the risk that

<sup>1</sup> Jeanne O. *Putin Has One Weapon to Protect the Rouble – He Must Use It Wisely* // The Financial Times. 2014. December 23.

the actual effect will be contrary to what has been expected: instead of boosting economic growth, the additional budget demand will translate itself into inflation. The extra demand created by the allocation of funding from the accumulated sovereign funds may indeed produce a certain effect, but this money will evidently be insufficient in view of the existing external and internal constraints.

Secondly, the question as to the availability of internal reserves for an adequate response to the rising demand has remained open. The production capacity estimates, which are currently being discussed in the economist community, are controversial. On the one hand, a number of studies have demonstrated that the economy is almost operating at maximum capacity, and any further growth can be possible only if the combined factor productivity is also increased<sup>1</sup>. On the other, according to data released by *Rosstat*, the current load on production capacities amounts to approximately 60–65%; it is noteworthy that somewhat similar results are yielded by the business surveys carried out by the Gaidar Institute<sup>2</sup>.

However, if the issue of idle production capacities is open to dispute, the low unemployment rate and shrinkage of the able-bodied population groups have created serious obstacles for businesses to react positively to the rising demand. Migration from abroad is also ceasing to be a source of supplementary workforce, because the ruble's depreciation has rendered the prospects of employment in Russia less attractive, and the inflow of migrants in late 2014 began to dwindle.

Thirdly, the structure of budget expenditure from the point of view of its impact on economic growth presents yet another problem<sup>3</sup>. In recent years, this structure has undergone some significant changes. The amount of expenditure allocated to items that can increase the inputs and improve the quality of production factors (labor and capital), as well as boost the combined factor productivity index (which measures efficiency of the use of production factors, and first of all of investment in infrastructure), has not grown, and under some items it even declined in terms of share in GDP. Simultaneously the share of non-production expenditure items (defense; government administration; law enforcement) has been increasing. While the political significance of some of these items is evident, the fact that this structural shift plays down the effects of budget stimulation cannot be altogether ignored<sup>4</sup>.

In short, budget incentives (or stimulation), to be effective, for their part also require relevant institutional reforms and more efficient budget expenditure allocation. The latter, in its

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<sup>1</sup> Sinelnikov-Murylev S., Drobyshevsky S., Kazakova M. *Decomposition of Russian GDP Growth Rates in 1999–2014*. Economic Policy. 2014. No 5. P. 7–37.

<sup>2</sup> 'In December 2014, the average load on production capacities, as estimated by the heads of enterprises participating in the survey, amounted to 62%. 91% of respondents believe that their production capacities will ensure that the demand for their product over the next 6 months be satisfied, 11% of them point to redundancy of their available production capacities.' (Rosstat. *Delovaiia aktivnost' organizatsii v Rossii. Dekabr' 2014*. [Business Activity of Organizations in Russia. December 2014.] // [http://www.gks.ru/bgd/free/B04\\_03/IssWWW.exe/Stg/d04/264.htm](http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d04/264.htm)).

<sup>3</sup> IMF. *Unproductive Public Expenditures: A Pragmatic Approach to Policy Analysis*. Prepared by Ke-young Chu, Sanjeev Gupta, Benedict Clements, Daniel Hewitt, Sergio Lugaresi, Jerald Schiff, Ludger Schuknecht, and Gerd Schwartz // IMF Pamphlet Series. 1995. No 48.

<sup>4</sup> Knobel A. Yu., Sokolov I. A. *Otsenka biudzhethnoi politiki RF na srednesrochnuiu perspektivu* [Assessment of the RF Medium-term Budget Policy]. *Ekonomicheskie razvitie Rossii* [Russia's Economic Development]. 2012. No 12 (19), pp. 23–32; Idrisov G. I., Sinelnikov-Murylev S. G. Budget Policy and Economic Growth. *Voprosy ekonomiki* [Issues of Economics]. 2013. No 8, pp. 35–59; Idrisov G. I., Sinelnikov-Murylev S. G. *Forming Sources of Long-run Growth: How to Understand Them?* *Voprosy ekonomiki* [Issues of Economics]. 2014. No 3, pp. 4–20.

turn, necessitates more changes at least in two directions: a budget maneuver in favor of sectors with higher budget efficiency (these are primarily the social and transport infrastructures), and the introduction of improvements to budgetary procedures.

The functioning of the budgetary rule – the method for the allocation of additional revenue generated by 'situational' factors in the framework of current budget policy - represents an issue in its own right. In 2014, a heated discussion was underway as to the feasibility of preserving the rule whereby it is required that the surplus oil-and-gas should be earmarked for the reserve fund. While oil prices were high, the RF Ministry of Finance was constantly being pressurized to transfer all the surplus revenue to the budget, in order to compensate for the effects of the declining business activity by the corresponding allocation of government funding. But when oil prices began their downward slide and, in accordance with the budgetary rule, the accumulated reserves were to be allocated so as to compensate for the resulting loss of revenue, the Ministry of Finance of the Russian Federation suggested that the budgetary rule should be recognized to be effectively abolished, and budget expenditures to be revised and cut accordingly, in order to save the reserves for future needs.

However, the discourse on the budgetary rule has one important aspect that has to do with the principles of economic policy to be applied in a situation determined by a strong influence of rent-generated revenue. No doubt, it is necessary to create special mechanisms designed to decrease the dependence of the budget (and the entire economic system) on any unpredictable fluctuations in response to newly emerging situations. Over the course of the previous decade this problem was solved by withdrawing part of the surplus revenue to sovereign funds (the Reserve Fund and the National Welfare Fund). This option was much more expedient than the allocation of the entire amount of rent to the current budget expenditure, as it had been the usual practice in the USSR in the 1970s and the 1980s. However, the experience of the period 2009–2012 revealed one serious drawback associated with this type of saving: the existence of a 'safety cushion' is a negative incentive for modernization. Crisis, on the contrary, is the time when modernization can be speeded up. However, the availability of supplementary resources can soften the process in accordance with the business-as-usual logic.

In our opinion, time has come for us to rethink the entire ideology behind the spending patterns applied to the reserves created by the 'situational' super-revenues, and consequently, to rethink the budgetary rule. With due regard for Russia's political realities, it appears feasible to more strictly re-determine the cap on non-situational revenues (to set it at a sufficiently low level) and to properly balance the current budget (i.e., the budget for renewable liabilities) at the revenue level that would be maximally protected from the effects of external factors. If any surplus rent-generated revenue is received, it should be allocated to the development budget, i.e. to cover expenditures with a limited time horizon. This model would make it possible to actively invest in development when the external situation is favorable, while at the same time to resist the temptation to pour money over the 'problem zones' in a time of crisis.

While the macroeconomic stability issues are coming to the fore as a necessary precondition for economic growth, this is still faced with the task of carrying out comprehensive institutional reform, which has already been discussed at length in recent years<sup>1</sup>. Among the *priorities* for the nearest future, we may point out the following ones:

– to ensure legal and political protection of entrepreneurial activity as the fundamental prerequisite of the very existence of a market economy;

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<sup>1</sup> Mau V. *Between Modernization and Stagnation: Economic Policy in 2012*. [Economiceskaya Politika]. 2013. No 2, pp. 4–23.



- to ensure competition across all the sectors of the national economy (this is especially important under the present conditions of imposed economic sanctions and the ruble's depreciation, which are the factors responsible for significant constraints on competition with foreign producers);
- to lower the administrative barriers in the way of doing business;
- to ensure priority development of the sectors oriented to human capital – education and public healthcare;
- to improve the proficiency of the financial system while continuing the activities oriented to the creation, in Russia, of an international financial center as one of the established institutional targets;
- to improve the performance of infrastructure monopolies and companies with state stakes, turning them from an institutional source of inflation into instruments of counter-cyclical investment policy;
- to boost the proficiency of the labor market, ensure its flexibility, and promote workforce mobility and migration towards economic growth points (sectors and/or regions);
- elaboration of a modern foreign trade policy model based on active participation in the emerging integration groups and global value added chains.

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Back in 2008, it was often pointed out that 'the crisis must be made use of' as an opportunity to carry out economic and social modernization. At that time, this principle could not be implemented. It remains to be hoped that this time, the lesson delivered five years ago will finally be brought home.