Vladimir Mau

1. The drama of 2008: from economic miracle to economic crisis[1]

The year 2008 will acquire a special significance economic history of Russia and of the world. This was a year in which the economic crisis developed with extraordinary rapidity and in which pubic opinion devolved from feelings of euphoria to feelings of despair. In a matter of months in Russia and other countries with developing markets belief in the certainty of an economic miracle was replaced by to expectations of economic collapse. In the course of 2008 we have passed through three phases of understanding of the crisis that began in 2007 in the USA.

The first few months of 2007 witnessed stable (to some extent even increasing) rates of economic growth in a context of booming prices for Russia's exports and of low interest rates in international financial markets. The financial crisis in the West was forcing interest rates down and it seemed that a new powerful long-term growth factor had appeared, over and above sustained high prices for energy resources. A frequent topic of discussion for the Russian political élite was whether by 2020 Russia would be the fifth or only the six largest economy in the world in terms of GDP.

The spread of the crisis to the European countries at a time when growth rates remained high in China, India and Russia gave rise to the theory of "decoupling", according to which the developing countries would serve as the engine that would overcome the crisis and drag the developed countries out of incipient recession.

Only in August and September did it become clear that the financial crisis was turning into an economic and global crisis, in other words that it was affecting all of the world's major economies – whether developed or developing. Countries that had until recently been proud of their economic success now became fragile and unstable and the political outlook in these countries became uncertain.

The crisis was not unexpected. Early in 2008 we warned of the instability of the two major contributory factors to Russian economic growth: high energy prices and the availability of cheap money in world financial markets. We also warned that Russia's institutional framework, which is an essential precondition of stable economic growth was underdeveloped; it was unlikely that Russia's political and economic institutions would be able to manage and moderate the impact of deteriorating political and economic conditions.

Amongst the principal causes of the crisis we highlighted the beginning of a global recession; a decline in prices for oil and other Russian exports; the appearance of a deficit in the balance of payments and a consequent growing dependence upon the inflow of foreign investments; the rapidly increasing external indebtedness of Russian companies and the

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likelihood that in the event of a crisis they would be able to repay their debts only with State assistance; and also the dubious efficiency of many of the investment projects that had been initiated during the boom. It was also of some significance that during its eight years of plenty, Russia had produced a generation of politicians who were accustomed to 'managing the growth of affluence", but who lacked any experience of crisis management. Similar attitudes were noticeable amongst the general public.[2]

Sadly, these dire prognostications were more than borne out by events. Simultaneously, Russia's sources of economic growth disappeared – prices for Russia's principal exports collapsed and cheap sources of finance disappeared from the world market. The crisis began to unfold. Are we capable of dealing with it? And if so, to what extent?

Specific features of the present crisis

First of all, let us consider the nature of the present crisis. Of course, our assessment can only be provisional, because events are unfolding very rapidly and require constant reappraisal.

Over the past eight years, the Russian political and economic élites, in their anxiety not to repeat past mistakes, have busily prepared for a crisis similar to that of 1998. The lessons of the past were well learnt, but the current crisis turned out to be of a different nature. The causes of the crisis of 1998 were intrinsic and stemmed from the weakness of a government that was incapable of pursuing a responsible macroeconomic (above all, budgetary) policy. At the present time Russia – for the first time in a hundred years – is involved in a world crisis whilst being part of the global economic and financial system. That Russia is a normal market has been demonstrated by the impact upon the economy of global events.

Of course, the crisis that is unfolding does not conform to the common definition of a cyclical crisis. It has three specific features:

Firstly, having arisen in conditions of globalization, the crisis is unprecedented in scale, encompassing as it does almost all of the developing countries and regions of the world. It has also had a greater impact upon the countries that have been most successful during the past ten years. By contrast, laggard countries and regions have suffered less. This variation is also noticeable within individual states, including Russia: regions that enjoyed an economic boom have had the most serious problems whereas there has been almost no effect in the depressed areas. This makes it more difficult to find a way out of the crisis: it is not clear where the "locomotive" of recovery is to be found.

Secondly, the present crisis is structural in nature. It will result in a profound renewal of the structures of the world economy, including the technological infrastructure.[3] At present, it

[2] See V. Mau. The economic policies of the year 2007: successes and risks // *Voprosy ekonomiki* (Problems of Economics). 2008. No 2.

[3] This is also emphasized by S. Glaz'ev (Glaz'ev S. Iu. *Vozmozhnosti i ogranicheniia tekhniko-ekonomicheskogo razvitiia Rossii v usloviiakh strukturnykh izmenenii v mirovoi ekonomike* [The opportunities and limitations of the technological and economic development of Russia in conditions of the current structural changes in the world economy.]. M.: GUU, 2008).

is difficult to say what these structural changes will be, but it is already clear that there will be a redistribution of resources between branches of the economy and between regions.

Thirdly, the crisis carries within it a potential for innovation. In recent years much has been written about the need for the Russian economy to be directed onto an innovative path of development, following the example of the financial sector. In the financial sector there have been a number of innovations that soon became widespread, for example the introduction of new instruments in the financial markets which, it seemed, were capable of creating the conditions for unlimited growth. Unfortunately, as we now realize, many financial managers had only the vaguest idea how these instruments would function and this has had two kinds of consequences:

On the one hand, these new financial practices considerably transformed a number of commodity markets, in particular the markets for the most important raw materials. The price of oil has always been difficult to forecast; even so it did vary according to supply and demand and for this reason it could to some extent be regulated by the oil producers. As we know, the sharp rise in oil prices in 1973 was organized by the Arab oil-exporting countries; and the drastic reduction in oil prices in 1986 was also deliberate and politically motivated. At present, given the development of markets for secondary financial instruments, circumstances have radically altered. Now the oil price varies almost independently of the actions of producers and responds feebly to the interventions of OPEC and of other oil producers. The price of oil is now formed at financial markets and in the minds of finance brokers trading in secondary financial instruments related to oil supplies, instruments that have practically nothing to do with actual shipments of oil. The world is becoming not only “flat”, as Thomas Friedman has put it,[4] but also “virtual”, in that the most important economic indicators are now formed in the markets for financial instruments. It is unlikely that such a situation will last for long, for real shortages or surpluses of material goods will sooner or later have an impact. Even so, this considerable strengthening of the role of virtual factors in determining the most important relative economic scarcities must be taken into account.

On the other hand, in the course of this flurry of financial innovation, the economic and political élites lost control over the new financial instruments. The current crisis can almost be described as a “revolt of financial innovation” – a revolt of the machines against their creators. It is not the first time that such an unpleasant phenomenon has occurred in history. As we now realize, the collapse of Barings Bank, brought down single-handedly in 1995 by Nick Leeson, a young trader working in the Singapore branch, was a harbinger of the impending crisis and a warning to the world of finance. At the time this warning went unheeded.

The nature and the mechanisms of great economic upheavals are always mysterious and never completely understood. The great crises of the past have been examined for decades by economists, politicians and historians; hundreds of dissertations and thousands of scholarly articles have been devoted to them. The Great Depression of the 1930s is not fully understood even today: its origins, its development and the adequacy of the anti-crisis measures taken by Franklin Roosevelt continue to be debated. Future economic historians will also struggle to reach definitive conclusions.

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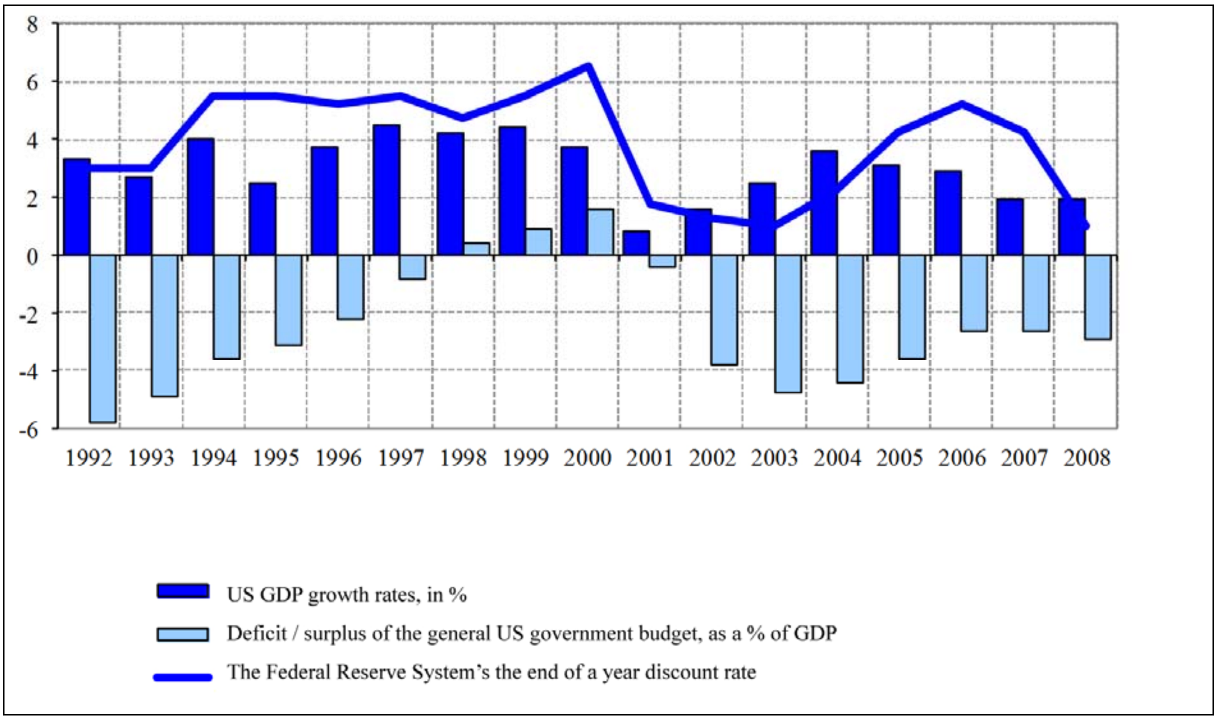
[4] Friedman T. *The World is Flat. The Global World in the Twenty-First Century*. L.: Penguin Books, 2006.

Causes of the crisis

If the crisis that is unfolding is to be fully understood, three groups of causes need to be examined separately: the first group relates to the specific problems of the US economy; the second group consists of the systemic problems of contemporary economic development; the third group relates specifically to Russia.

When the crisis is discussed in Russia, the policies of the US administration and in particular its inappropriate budgetary and monetary policies are frequently criticized. Criticism applies mainly to the pro-cyclical policy that followed upon the 2001 recession, when, in conditions of economic growth, the government allowed the budget deficit to increase instead or reverting to the policy of budget surplus of the Clinton administration. This was reflected, in particular, in interest rate policy which kept rates for a long time at a low level, even during the period of economic growth (see *Fig. 1*).

Fig.1: Indicators of economic growth and of the budget system of the USA



The developed countries considered this policy of artificial stimulation of growth to be necessary, in view of the double-digit economic growth of China. Many governments adopted measures to stimulate growth and the risk of overheating was discounted. The attitude was – "We have come a long way intellectually since the Great Depression intellectually, and in other respects as well." This was clearly also the attitude of the Russian leadership when it set itself the task of "doubling GDP" in ten years, placing the emphasis, moreover, upon quantitative indicators. But whereas in the Russian case policy was based on the availability of spare capacities left over from the crisis of the 1990s and on an enormous inflow of petrodollars, the US administration was pursuing economic development and at the same time waging two wars. The funding of these wars was bound to result in a budget deficit.

Unprecedented rates of economic growth, reflected in an increase in world GDP by a quarter over a period of five years, also contributed to the crisis. Such a increase in growth inevitably generates systemic contradictions that are concealed by a growth in prosperity. And even if the existence of these contradictions is recognized, it is very difficult to make adjustments: "Why should we intervene or set limits when everything is going so well?" Invariably, during an economic boom, when someone starts to issue warnings or express doubts about the validity of current policy, the cry goes up - "this time things are different".[5]

There is another aspect to globalization (over and above the new financial instruments), which, in the opinion of some, was a guarantee of perpetual financial success and steady growth. This was the phenomenon described by Niall Ferguson as "Chimerica" (China plus America). In this view, there has come about a reversal of the global relationship which for decades and until the beginning of the twentieth century accounted for the stability of economic growth: whereas one hundred years ago capital was moving from the centre (developed countries) to the periphery (the emerging markets of that time), nowadays it is the developing markets that have become centres of saving, whilst the USA and other developed countries have acquired the role, predominantly, of consumers.[6]

The developing crisis has one more fundamental cause. Over the past one and a half to two decades, the goal orientation of the business community has changed. Capital growth has become the key objective of corporate development. Capital growth is what shareholders now regard as the key success indicator and it is by this criterion that the efficiency of management is measured. However, the striving for maximum capitalization is at variance with a more important driver of socio-economic progress – the growth of labour productivity. Of course, capital growth can contribute to gains in labour productivity, but only *in the long run.* Despite this, the expectations of shareholders that they will find progress in capital growth in the accounts that they receive annually, means that methods are employed that have nothing to do with advances in productivity. Mergers and takeovers are attractive from a reporting point of view since an increasing volume of assets is conducive to capital growth. It is also undesirable that a failing enterprises should be shut down, since this will make for a short-term reduction in capital growth. For this reason, many big industrial corporations still hang on to old and inefficient plants and enterprises.

This kind of behaviour was common during the Soviet period and was typically described as the "struggle to fulfil the plan". Enterprises preferred to produce outdated products rather than re-tool in order to produce better products since innovation would have made for a decline in unit output (whether measured in kilograms, meters or roubles). This, in turn, would have made it impossible to fulfil or over-fulfil the plan. This became known as *planning fetishism.*[7]

Over and above the general factors underlying the current crisis, there are a number of specific reasons why the crisis is gathering momentum in Russia. On the face of it, we have a paradox: the crisis has spread rapidly throughout a country in which macroeconomic conditions were especially favourable: there was both a budgetary surplus and a surplus in the balance of payments. The macroeconomic framework made for an influx of capital into Russia and this increased the scope for borrowing. Naturally, the onset of the crisis resulted in

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[5] The illusion inherent in the belief that "this time it's different" was convincingly exposed in the investigation of a succession of different crises, beginning with England in the fourteenth century, in Reinhart C. M., Rogoff K. S. *This Time it is Different: A Panoramic View of Eight Centuries of Financial Crises* // NBER No 13882. 2008.

[6] Ferguson N. *The Ascent of Money: A Financial History of the World*. The Penguin Press, 2008.

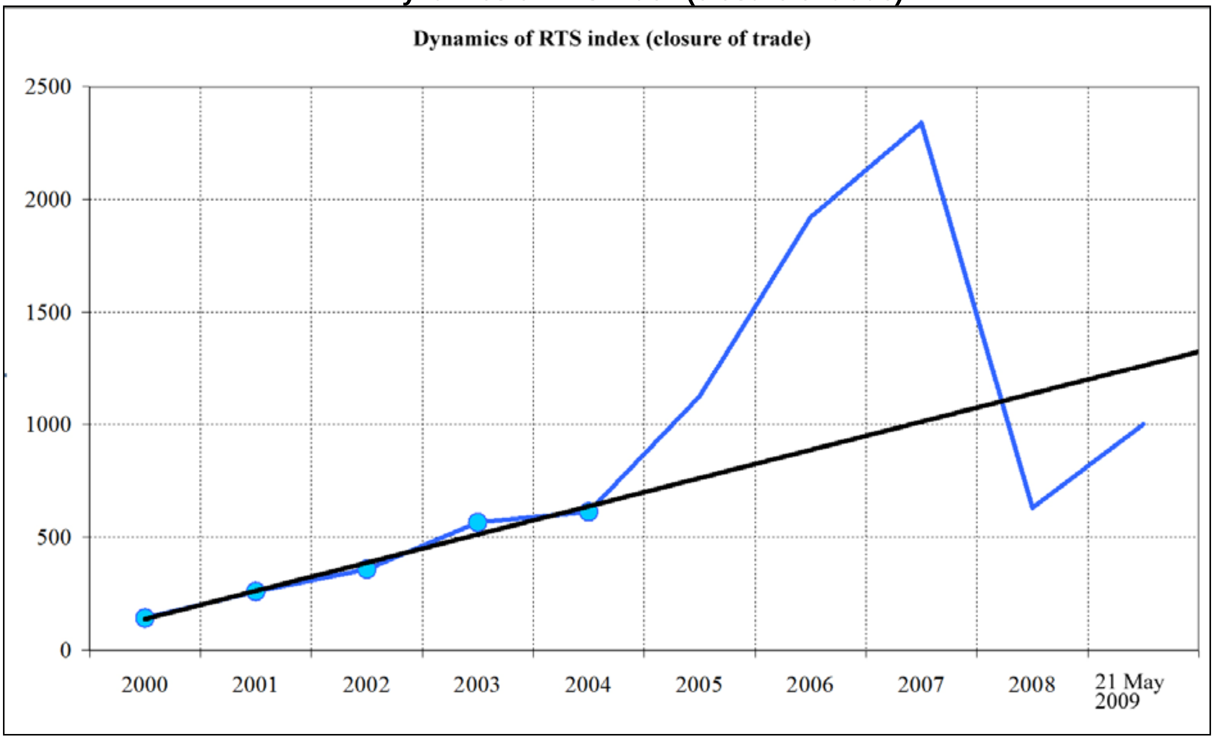
[7] On "planning fetishism", see Mau V., Starodubrovskaia I. Planovyi fetishism: neobkhodima politico-ekonomicheskaia otsenka (Planning fetishism: a political and economic assessment is necessary) // *Ekonomicheskie nauki*, 1988. No 4.

a reduction in opportunities for borrowing, which, in turn, led to a downturn in the stock market.

In the course of these events it transpired that, despite its dynamic growth during the years 2004 – 2007, the Russian stock market was still at an embryonic stage of development. In a very short space of time stock market values could virtually collapse. Having said this, the movement of stock market indices displayed a certain inherent logic. As we can see from *Fig. 2*, the collapse of the market resulted in indices arriving approximately at the point where they could have been if the surge of 2005 had not taken place. The roughly triangular curve in the graph is a vivid representation of the financial market bubble produced by the boom, with its ever growing disproportions.

***Fig. 2.* Dynamics of the RTS market 2000 – 2009**

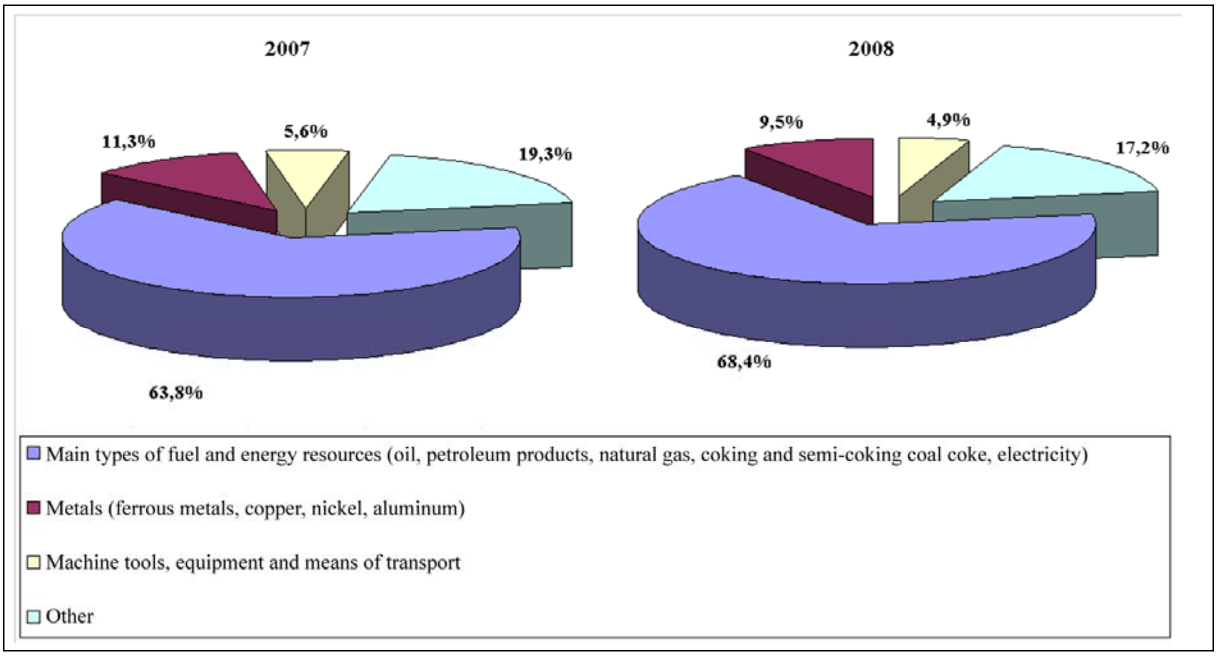
Dynamics of RTS index (closure of trade)



Defects in the structure of the Russian economy and in the structure of exports have also aggravated the crisis. The predominance of raw materials and investment goods in the composition of exports renders Russia's balance of payments more vulnerable to cyclical fluctuations than would be the case in a more diversified economy. The multiplier effect resulting from a slowing down of growth and a decline in investment activity in importer countries can have a severe impact on the growth of an economy that is dependent on raw materials exports and can make for a 'hard landing'.

This is the reverse image of the phenomenon experienced by Russia after the crisis of 1998. At that time, as the world economy grew, there was a growing demand for Russian products, which resulted in a boom as soon as prices for energy resources started to rise. Naturally, much was said at the time about the need for structural diversification, but in boom conditions no-one was minded to take this question seriously. (see *Fig. 3*).

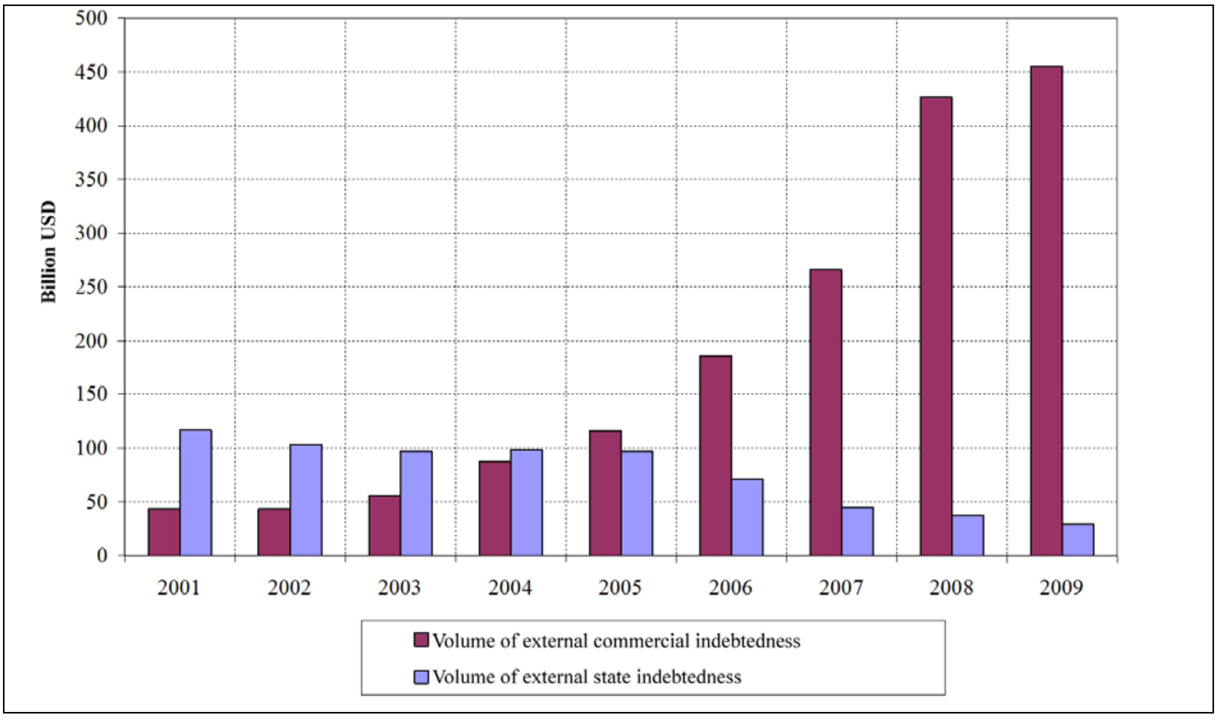
***Fig. 3.* Structure of Russia's exports 2007 – 2008**



The rapid growth of external corporate borrowing became an acute problem. It became particularly acute because the bulk of this debt was, in fact, quasi-state borrowing. Many borrower enterprises have close links with the State and behave according to a logic of "privatization of profits and nationalization of losses". Furthermore, this is how their behaviour is perceived in financial markets, where brokers are well aware that in the event of a crisis the biggest Russian private borrowers can always rely upon support from the federal budget. In this way, a condition of moral hazard is created – a condition familiar since the Asian crisis of 1997 when some players could irresponsibly borrow money while others could lend it with insufficient justification. It is indeed the State that will have to save the debtors in the event of an economic crisis. By analogy with the "*chaebol*" of South Koreas (a firm that is de facto under state control and dedicated to the same principle of "privatization of profits and nationalization of losses") we can speak of a growing tendency towards the "*chaebolization*" of a number of leading Russian companies.

2007 witnessed an important change in the dynamics of external indebtedness in Russia: previously, the aggregate burden of debt (both state and corporate) had been decreasing, but now it began to grow. This considerably increased Russia's dependence on fluctuations in world financial markets and led to a rapid escalation into full-scale crisis (see *Fig. 4*). We can point to yet another error committed by Russian borrowers: they willingly entered into a variety of maintenance agreements, notwithstanding the fact that the success of the Russian economy in previous years made it possible in many instances to dispense with such agreements. This meant that when the crisis set in, there was a rapid fall in the value of accounts and, the margin-call mechanism was triggered (the requirement to provide additional funds to maintain the value of the original trading account) and borrowers faced the real possibility of losing their assets.

Fig. 4. **Dynamics of external indebtedness of the RF 2001 – 2009**



These circumstances had a major impact upon budgetary and exchange-rate policies. The considerable indebtedness of prominent (including part-budget-funded) players, in many cases the owners of strategically important assets, reduced the possibility of lowering the exchange rate of the rouble, since this would have increased the cost of external debt servicing. At the same time the State was having to allocate budget funds to enable borrowers to meet their instalments or pay off their debts.

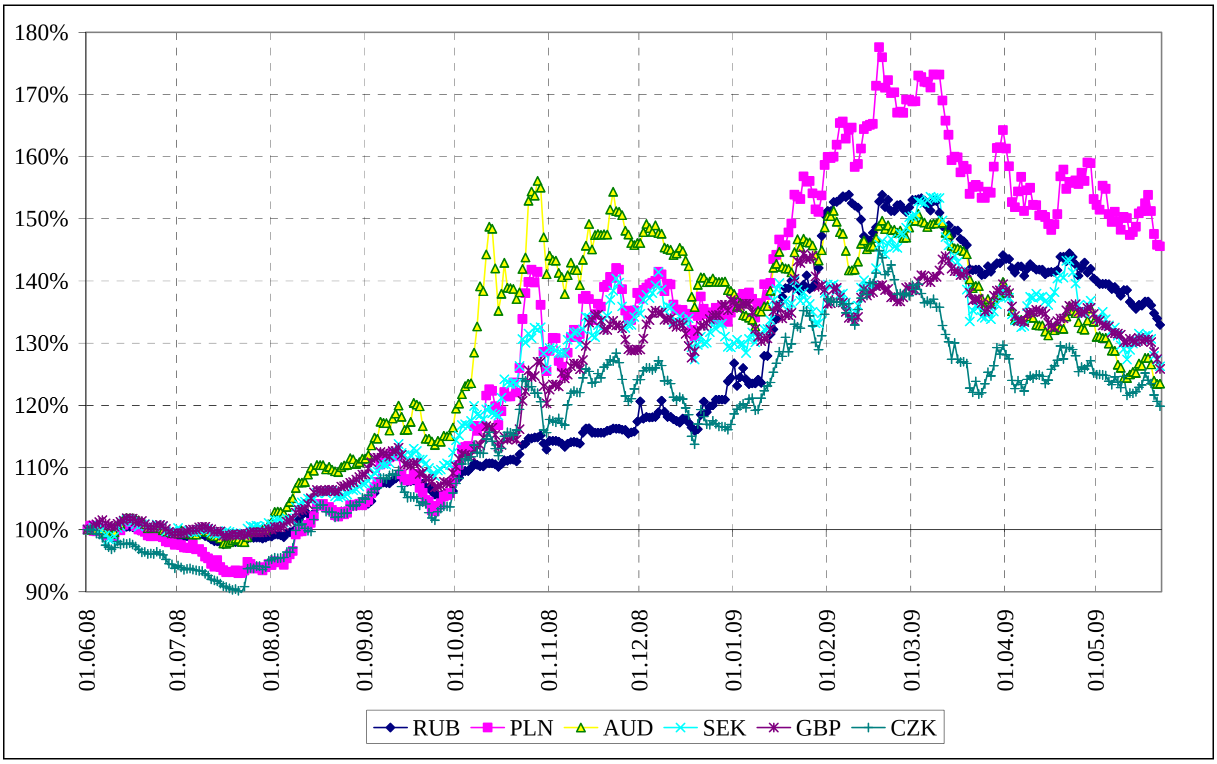
Reaction to the crisis

The reaction of the world's political and economic élites to the crisis was one of profound shock. Nobody had expected the crisis to be so severe or for it to escalate so rapidly.[8] The initial response was somewhat confused as governments of developed countries tried desperately to prevent the crisis gathering momentum. Attention was focused firstly, on avoiding the collapse of the credit system (saving financial institutions) and secondly on preventing, or at least mitigating, a recession, so as to avoid a major decline in production.

Fearing the collapse of the banking system and the consequences of deflation, economically developed countries implemented a number of aggressive measures designed to support the banking system and stimulate production. The most important measures include the creation of liquidity, the expansion of the deposit guarantee system for physical persons, the nationalisation of a number of banks, a significant reduction of refinancing rates, and the adoption of "stimulus plans" (injections of budget funds into the real economy with a view to stimulating demand). Simultaneously, many governments lowered their currencies' exchange rates against the US dollar (see *Fig. 5*) in order to preserve their foreign currency reserves and provide an additional stimulus to domestic production. An analysis of the logic and effectiveness of these measures is beyond the scope of the present article. The main point is that these measures can have a seriously destabilizing macroeconomic impact.

[8] On the unexpectedness of the crisis and the reactions of the political and economic élites, see Giles Ch., 'The Vision Thing' // *The Financial Times*. 2008. Nov. 26.

***Fig. 5.* Dynamics of the exchange rates of various national currencies relative to the US dollar**



Conceptually and ideologically, this policy constituted a renaissance of Keynesianism and the more the crisis developed the more popular Keynesianism became. The unexpectedness and abruptness of the crisis made for the adoption of a number of incoherent anti-crisis measures, most of which were at variance with the economic doctrines and political traditions that had hitherto been deemed to be sacred and indisputable. "This was the year when political labels lost all meaning. With governments of all persuasions nationalizing banks and pumping money into the economy what now distinguishes left from right, liberal from conservative, socialist from capitalist, Keynesian from monetarist?".[9]

The phrase "We are all Keynesians now", which appeared on the cover or *Time* magazine in the early 1960s, is once again in vogue. John Maynard Keynes is being represented, just as he was nearly half a century ago, as an advocate of state intervention and as an opponent of economic liberalism, with flagrant disregard for what the great economist actually wrote and thought. As it happens, when Richard Nixon employed this phrase, his purpose in invoking the name of Keynes was to legitimize his introduction of state regulation of prices, despite the fact that Keynes would hardly have given his blessing to such a policy. Politicians more capable of reflection treat this "collective Keynesianism" with scepticism: the German Minister of Finance Peer Steinbrück (for all he is a Social Democrat) has described the measures taken by his EC partners as "crass Keynesianism".

In fact, the majority of measures implemented are better understood not as "Keynesianism", however one might define it, but as forms of *dirigisme*, *socialism* or *populism*. These categories are interrelated but not synonymous.

We would describe as *dirigiste* the assumption by institutions of the state of particular powers; the making of judgments by the state (rather than by the market) as to who is exempt

[9] Thornhill J. 'A Year of Chocolate Box Politics' // *The Financial Times*. 2008. Dec. 24. p. 6.

from blame and who is culpable; and a readiness on the part of the state to dictate to economic agents which goods they should produce and which services they should deliver. The treatment of *Lehman Brothers* on the one hand and *Bear Stearns*, *AIG* and *Citibank* on the other, makes no sense from the standpoint of market economics. The “powers that be” took it upon themselves to bankrupt the one and bale out the other, with an arbitrariness characteristic of a centrally managed economy.

The next – quite logical – step has been the adoption by governments of decisions affecting the activities of institutions that have, *de-facto*, been nationalized. The Prime Minister of Great Britain, Gordon Brown, has repeatedly stated that he would encourage the banks now under his control to invest more money in small businesses. Similar demands are being made of Russian state–owned banks, irrespective of how these measures would reflect on the quality of their portfolios. Of course, nowadays, support for small business is the sacred cow of every government. However, the consequences of such decisions are easy to predict: if the government instructs a bank where to invest its money, it follows that they should render assistance to this bank when politically motivated investments turn out to be loss-making. State support and inefficiency of investments form a vicious circle.

We may describe as *socialist* measures that are tantamount to the collectivization (or nationalization) of risk. By safeguarding borrowers, pumping capital into banks and guaranteeing private deposits, the State takes upon itself the risks that rightfully belong to all of the major participants of economic life, bankers, investors and borrowers alike and all the more so in that these are often the same entity. Thus, the fundamental principle of capitalism – individual responsibility for decisions taken – is put in question. So far as the Russian situation is concerned, it is clear that the nationalization of losses will lead inevitably to the nationalization of risks. This process has already begun in the banking sector. Through the intermediary of the banks, a guarantee is, in effect, extended to all companies and sectors.

Property relations – the bedrock of every socio-economic system – are also being significantly transformed. We are witnessing a *de-facto* nationalization of companies in difficulty by means of rendering them financial assistance. Nationalization of this kind is effected by at least three methods: through repurchasing the debts of individual firms; through recapitalization in exchange for shares; and as a consequence of the inflation of accumulated liabilities. States have shown themselves ready to assume all of the liabilities of financial institutions – by providing guarantees and by directly injecting capital. Needless to say, the aid provided to financial institutions is accompanied by a formal or actual dilution of the blocks of shares held by private owners. In this way, private property rights are immediately jeopardized.

P*opulism* is in the ascendant. The beginnings of recession have triggered appeals for subsidies to producers. It is amusing to read recommendations in the analytical reports of Western banks that are identical to those that were made in Russia during the 1990s: there are claims for massive budgetary and monetary expansion that “would help sustain the viability of aggregate demand”. If Russia or any developing market economy had even recently come out with such proposals they would have encountered severe and well-founded criticism.

The provision of cheap money to producers can, in these circumstances, have dire consequences since the result will inevitably be an increase in inflation. It is in this respect that Russia differs fundamentally from the USA. In Russia (as in most of other countries) the printing press does not produce a world reserve currency: monetary populism in Russia would result not in economic growth but in a flight from the rouble.

The *volte face* performed by those countries in which capitalist traditions were most deeply embedded resembles the abrupt abandonment of "War Communism" and adoption of the "New Economic Policy" (NEP) in Soviet Russia in 1921. In March 1921, there was no hint of the impending rejection of the rigid economic model that was intended to usher in the Communist utopia. Suddenly, in a matter of weeks, there was an about-turn and a partial reintroduction of market relations. For what reason? The Bolsheviks had grasped the significance of an insurrection in the city of Kronstadt and unerstood that the Soviet régime was on the brink of destruction. The New Economic Policy was designed to resolve conflicts, reduce social tensions and restore economic growth. Even so, whilst Lenin declared that the the NEP was "in earnest and long-term", he did not intend if to be "for ever".

By analogy, at the present time, the flirtation with socialism is undoubtedly an attempt to obtain a respite and to reappraise accepted values. It is still too early to say how long this interlude will last, but it will also not be "for ever". All forms of superfluous state regulation are in contradiction with the flexible and dynamic character of the modern productive economy and cannot meet the challenges of the post-industrial epoch - just as the chaos of market competition was incompatible with the need for rapid industrialization in the early twentieth century. That is why the market model of the NEP was abandoned only a few years after it had been introduced. And that is why current state-socialist tendencies cannot be assumed to be "in earnest and long- term".

How long will this statist "neo-NEP" last? A rapid exit from the crisis would apparently render most of the state regulatory measures redundant. If the crisis is long term (which is more likely), everyone will be eventually be cured of illusions as to the effectiveness of state intervention ("crass Keynesianism") as a remedy for the shortcomings of the market. The logical incoherence of the view that the crisis justifies further state regulation has already become obvious: the State has attempted to regulate financial markets, but has proven to be incapable of doing so. As one US Congressman has commented "it was not deregulation that produced the crisis, it was a proliferation of regulations and the actions of regulators who were too limited in their understanding of increasingly integrated markets."[10] There are no grounds for assuming that the state will make a better job in the future of regulating the markets. Of course, there is clearly a need for new institutions that will enhance the transparency and stability of financial markets.

Russia's battle with the crisis

The Russian authorities also introduced a number of significant measures aimed at mitigating the crisis. These measures were broadly similar to those taken by the governments of the most developed countries, but in a number of important aspects they differed.

A number of measures were taken to prevent the collapse of the credit system. Considerable financial resources were allocated to banks to help them overcome the liquidity crisis. These measures were primarily designed to sustain production for the most important institution promoting growth in the real sector of the Russia economy is the availability of

[10] *The Financial Times*. 2008. Oct. 24, p. 4.

credit and not the stock market. At the same time, the stability of the banking system is directly linked to the maintenance of socio-political stability. Losses sustained by citizens in the banking system would be immeasurably more dangerous, politically, than losses sustained in the stock markets.

Of course, some of the measures implemented were of dubious value. Banks that received liquidity support from the State chose to convert these funds into foreign currency so as to insure themselves against currency risks or to repay part of their debts to foreign creditors. From an economic point of view, this was quite rational; but it was not what the monetary authorities had intended. There were also some instances when the re-distribution of state-allocated funds involved bribery, which is hardly surprising when a resource in short supply is being distributed at a reduced price. (It had been intended that primary recipients would re-allocate funds to second-tier borrowers at an interest rate only slightly higher than that applied to the primary recipients and at well below the market rate).

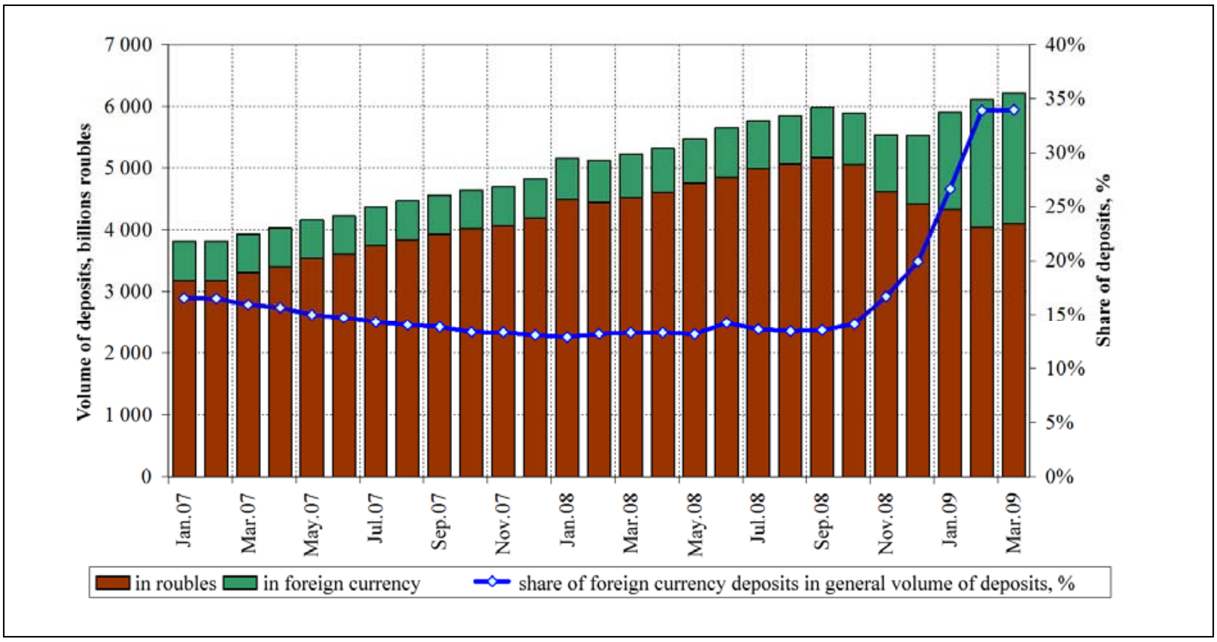
The State took some steps to support stock prices, but quickly abandoned this initiative. The effect could only be to enable investors who were fleeing the country to sell their securities at a higher price. Of course, shareholders are never pleased to see the value of their stock falling and a decline in share prices can create problems with accounts involving maintenance agreements (margin calls), but a different solution to this problem will have to be found.

There was a debate over how to avoid a crisis in production. The rapid economic growth of preceding years had been, to a significant degree, due to the availability of cheap finance in world markets and this cheap finance had been readily taken up by Russian companies. However, there could be no guarantee of the efficient utilization of this cheap credit, especially if the borrowers were linked to the state. Lenders were only too aware that the state, if problems arose, would come to the rescue of these companies.

Now the situation has changed: credit is hard to come by and bonds issued in order to raise funds are rapidly loosing their value. At the end of 2008 the amount due in repayment of these debts amounted to about 43 billion USD. The State proclaimed its willingness to make available a sum of 50 billion USD through the Russian Bank for Development (formerly *Vneshekonombank*) in order to alleviate this problem.

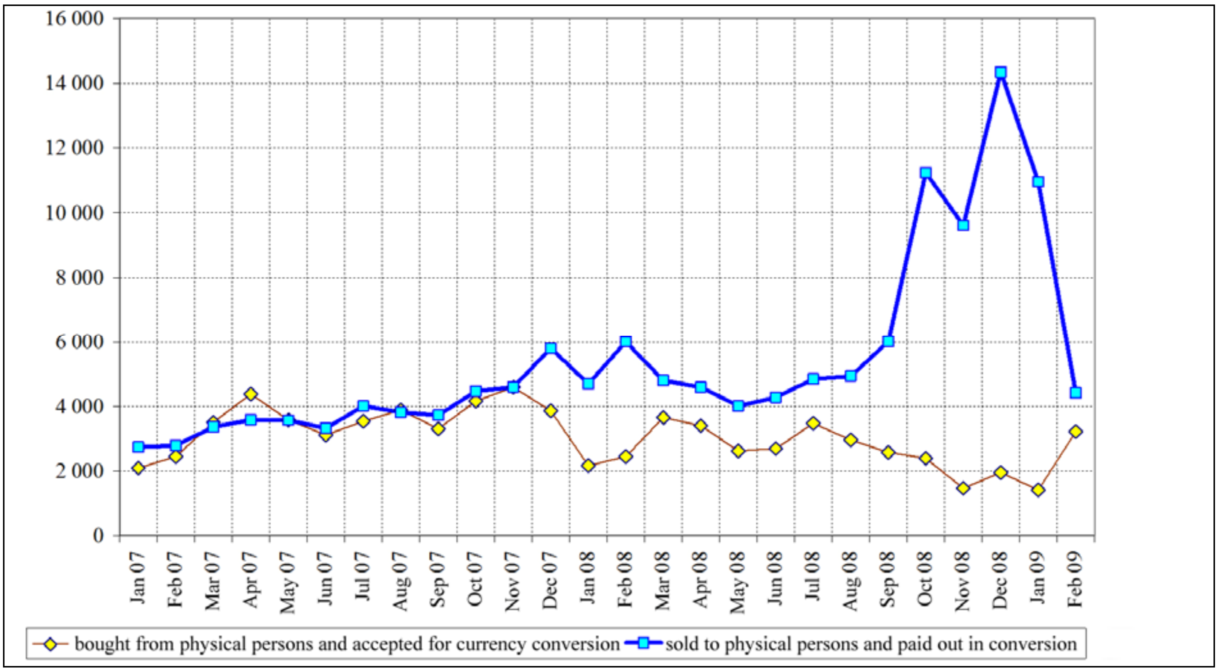
Currency policy was also rather ambivalent. For political reasons, the authorities did not dare fully to abandon control over the rouble exchange rate and so they resorted to a gradual devaluation of the currency. The reasons for this circumspection are clear: a third devaluation of rouble savings in twenty years would hardly have strengthened confidence in the national currency. Whilst this policy was fraught with a number of serious risks, it had one positive feature. This was that the population obtained the opportunity of insuring against a depreciation of the rouble: almost everybody who wanted to exchange their rouble-denominated savings into dollars or euro was able do so (see *Fig. 6* and *7*).

Fig. 6: Structure of the population's bank deposits



Source: Central Bank of Russia. Author's calculations.

Fig. 7. **Volume of foreign currency operations between authorized banks and physical persons, million USD**



However, the smooth devaluation of the rouble only generated panic on the market and led to a substantial depletion of gold and foreign exchange reserves. It is therefore quite likely that the new equilibrium level for the exchange rate of the rouble will be lower than it would have been had there been an immediate devaluation. Moreover, uncertainty over the exchange rate effectively paralyzed the activity of credit institutions. Expecting the exchange rate to fall, banks were not inclined to grant rouble credits, whilst potential borrowers, for the same reason, did not want to take out loans in foreign currency. Besides, a sharp devaluation of the rouble would have served as an additional means of supporting domestic production and protecting the Russian market from imports and would have created additional stimuli for the inflow of foreign capital in the form of direct investments.

Finally, the government introduced a wide range of incentives, primarily in the sphere of taxation, in order to promote the development of real production. These consisted of tax cuts, measures for the support of small businesses and the drawing up of a list of system-forming enterprises that would receive special attention from the State. There are different views as to the value of these measures.

There is no doubt that support for small businesses is important for both economic and social reasons, because this sector can make a significant contribution towards reducing unemployment. However, in Russia it is not in the economic sphere but in the spheres of law enforcement and politics that small businesses experience problems. Traditionally viewed in Russia with scepticism, small businesses have always been powerless when they encounter bureaucratic arbitrariness and extortion. They will flourish only when the values of Russian society and especially of its élite undergo profound change.

There are serious doubts as to the effectiveness of direct support given to large enterprises. The principal circumstances inhibiting the development of production are not so much shortages of finance as the malfunctioning of the economic system and, in the final analysis, the inefficiency of many sectors of the productive economy. Lavish injections of finance will not enhance the efficiency of production or bring about a structural renewal of the economy and in the absence of these an exit from the crisis will be delayed. It is true, of course, that such support to producers does mitigate ongoing social problems.

Lessons to be learned from anti-crisis measures of the past

Discussion of the present crisis inevitably leads to a discussion of historical precedents and even to a discussion of the **genetic anxieties** associated with these crises. The most obvious precedent is the Great Depression with its long-lasting deflation and a double-digit level of unemployment that was overcome only in the aftermath of the Second World War. Less frequently mentioned is the crisis of the 1970s which gave rise to a new phenomenon – stagflation. It is worthwhile comparing these two historical precedents with the present economic situation, whilst bearing in mind that historical precedents are only convenient instruments of analysis and do not provide us with ready-made solutions.

Judging by the measures adopted by the governments of developed countries in the past, their worst fear was deflation, which usually lasts for a decade or more. This was evident not only in the Great Depression of the 1930s but also in the case of Japan during the 1990s.

Deflation and stagflation are two diametrically opposed forms of economic crisis and that is why the means of overcoming them are also fundamentally different.

If deflation is to be counteracted there has to be stimulation of demand – that is, a policy of budgetary expansionism. In this case, it is permissible to cut interest rates and reduce taxes while at the same time increasing budget expenditure.

In the case of stagflation, the measures required are the very opposite. First of all, there has to be control over the money supply: this means a tightening of budget policy and an increasing of interest rates. After a decade of permanent economic crisis during the 1970s, an exit solution was found only when the Federal Reserve Chairman, Paul Volcker, adopted unprecedentedly tough measures and drastically increased the refinancing rate. As a result, unemployment increased by over 10 % and interest rates rose to over 20 %. The United States entered a period of severe recession which cost Jimmy Carter the Presidency; but in due course it emerged from the crisis with a renovated and dynamic economy.

Of course, any juxtaposition of the two models is subject to qualification and it is unlikely that the present crisis will precisely replicate the one or the other. But it is important to understand that any prescription for treating an illness depends on the nature of the illness and that two different forms of crisis might require not identical but entirely different kinds of medication.

The experience of both crises could turn out to be highly relevant to the present crisis. Strictly speaking, developed economies are now pursuing a policy that they used to consider completely unsuitable for developing markets (including post-communist states) during the 1980s and 1990s.[11].

The massive financial injections being made by the USA and the European Union may indeed prevent the economic situation from deteriorating to a politically unacceptable level. However, great caution is needed in applying such measures to developing economies. This is because the predicament in which the US monetary authorities find themselves is distinctive in two respects.

Firstly, as we have already noted, they have at their disposal a printing press for the dissemination of a world reserve currency, the status of which, even if it was shaken by the current financial crisis, is not really in question. Moreover, the majority of countries across the globe, in so far as they hold their currency reserves in dollars, have a vested interest in maintaining the exchange rate for the US dollar at a relatively stable level.

Secondly, it is precisely because of the special status of the dollar that US firms and households do not look to alternative instruments for hedging currency risks: they are disinclined to exchange their dollars for euro or yens, even if they have some doubts about the correctness of the policy pursued by their financial authorities. That is why, despite the budgetary and monetary expansion of the past few months, the velocity of money circulation in the USA is not only not increasing (as it would have in other countries), it is, as measured by some parameters, even slowing down.

The response to financial expansion in the majority of developing markets, and especially in Russia, will be quite different. In a country where the national currency does not have a long "credit history" and is not a reserve currency any relaxation of budgetary and monetary policy is highly likely to result in a flight from that currency, in an increase in the velocity of circulation of money, and in inflation. In the context of a global recession this will inevitably result in stagflation.

Such a policy is especially dangerous in countries where raw materials are dominant in the structure of exports. The dependence of such economies on the conjuncture of the world market is extremely high: in raw materials exporting countries even a slight drop in demand in external markets results in a significant decline in production. When business activity in

[11] See Ferguson N. 'Geopolitical Consequences of the Credit Crunch' // *The Washington Post*, Sept. 21, 2008; Rogoff K. 'America Goes from Teacher to Student' // *Project Syndicate*, Feb. 2008; Rodrik D. 'The Death of the Globalization Consensus', *Project Syndicate*, July 2008.

developed economies is at a low level and demand for the exports of developing economies is weak, the depression of developing economies can be accompanied by a flight from the national currency. Budgetary expansion is unable to compensate for the drop in external demand, which makes for an inflation that is not accompanied by an increase in productive activity.[12]

In other words, in present crisis conditions it is entirely conceivable that while one part of the world experiences deflation, another will be hit by stagflation. It is stagflation that represents one of the most serious risks faced by present-day Russia.

All of this means that the world might pass through two types of crisis and that these will develop in parallel. Each of the crises will require diametrically opposed remedies. The struggle of the Western World with deflation will generate inflation in the outside world of developing economies. The latter, if they replicate Western methods of combating the crisis, will soon find themselves mired down in stagflation.

It is for this reason that Russia's anti-crisis policy must primarily be aimed at preventing a macroeconomic unbalancing of the system. Even if in 2009 we are to be faced with a budget deficit, we should enlist every possible reliable means of offsetting it and make use of domestic borrowing, without resorting to the printing press. And it would be dangerous to assume that artificial stimulation of demand – 'crass Keynesianism' – will provide solutions to the key problems of Russia's socio-economic development.

Priorities and risks of the 2009 anti-crisis policy

One danger of the crisis is that it can lead to socio-political destabilization and this issue must be given priority attention. In alleviating the effects of a crisis we must give support in the first instance to workers and not to enterprises, managers or shareholders. During the years of the boom a great many structural disproportions developed (many of them survivals from the Soviet era); but all attempts to keep enterprises afloat will simply delay the structural changes that the economy is in need of. The State must provide the conditions for socio-political stability rather than support individual businesses.

In combating unemployment, the authorities should not have high expectations of public works projects. We read much about the value of these in Soviet history books but we should remember that such projects belonged to the era of industrial society, when the greater number of unemployed were "blue-collar" workers. It is unlikely that financial analysts, for example, if recruited into a construction project will achieve much either for themselves or for the project. In the present day what we need is a range of educational programmes that will enable people to reappraise their life strategies and retrain accordingly. The cost of such programmes will be no greater than the cost of public works projects and the benefit will be significant – especially once the crisis is over.

As far as support for individual "system-forming" enterprises is concerned, criteria should be defined for determining admission into this category and there should be a differentiation of appropriate forms of support. We should have specific methods for dealing with company towns where the closure of an enterprise has both a social and political impact

[12] 'There are alarming similarities between countries with emerging economies today and the rich countries of the 1970s when the period of the Great Inflation began.' ('Inflation's back' // *The Economist*. 2008. May 24. p. 17).

(for example. the removal of impediments to the formation of small businesses); and we should have different methods of support for infrastructure objects where direct state assistance could be envisaged.

Most dangerous of all would be, under the guise of assisting ‘system-forming enterprises’, to delay the closure of failing plants and factories. This will only impede the modernization of Russia’s economy. That is why it is essential to minimize the practice of shifting responsibility to the State. If the State is prepared to bail out one business or another, it must do so publicly and in accordance with generally known rules.

Now it is time to formulate a coherent agenda for future privatization. In the course of the current crisis, the State is likely significantly to increase the number of assets under state ownership, but it will not be able to ensure effective management. This could lead to the re-appearance of a phenomenon of the early 1990s, when the so-called ‘Red Directors’ had unrestricted control of their enterprises they – that is, they enjoyed the rights of ownership without having the motivation of an owner. If this is to be avoided, managers must realize that in due course there will be a real owner to whom they will have to account for their performance.

And finally, Russia must as far as possible avoid protectionist measures and restriction of international competition. In present Russian conditions the most effective means of protecting the interests of domestic producers would be an exchange rate policy that avoided an excessive strengthening of the rouble. When compared with import tariffs devaluation has at least one merit: its effects are the same for all and it is not susceptible to corruption by the self-interested lobbying of particular firms.

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The strategic task facing Russia and its government in the current crisis is to create the conditions that will bring about the structural reforms that are required if the dependence of Russia’s socio-economic development upon the dynamics of prices for fuel, raw materials and partly-processed goods is to be reduced. This can be achieved by reducing Russia’s dependence upon fluctuations in the development of the more developed world economies. There must be progress in the following key areas: the creation of mechanisms for promoting internal demand and increasing the role of internal demand in the development of the economy; the implementation of in-depth institutional reforms in the economic and political spheres; a coherent diversification of the economy (followed by the diversification of exports); and modernization in the sphere of education where institutions ought to be inspired by the challenge that the crisis presents.

ENDS