GAIDAR INSTITUTE FOR ECONOMIC POLICY

RUSSIAN ECONOMY IN 2010
TRENDS AND OUTLOOKS
(ISSUE 32)

Gaidar Institute
Publishers
Moscow / 2011

UDC 338.1(470+571)
BBC 65.9(2Рос)-04

Agency CIP RSL

R95 **Russian Economy in 2010. Trends and Outlooks.**
(Issue 32) – M.: Gaidar Institute Publishers, 2011. 544 pp.

ISBN 978-5-93255-316-9

The review provides a detailed analysis of main trends in Russia's economy in 2010. The paper contains **6** big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts

This publication is made possible by the generous support of the American people through the United States Agency for International Development (USAID). The contents are the responsibility of the Gaidar Institute for Economic Policy and do not necessarily reflect the views of USAID or the United States Government.

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ISBN 978-5-93255-316-9

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Russia's Economic Policy in 2010: Quest for Innovations[1]

1.1.1. The global economic crisis in 2010

While the end of 2009 and the beginning of 2010 was the time of optimistic expectations and hopes that the global crisis would be soon overcome, early 2011 is characterized by restraint and a reluctant acceptance of the fact that economic difficulties may indeed last for a relatively long period of time. In late 2009 the world gave a sigh of relief after having realized that the worst had not happened and a global economic catastrophe had been avoided, that the financial system had survived and economic growth rebounded, and unemployment had not become disastrously rampant. There was then a widespread and increasingly growing hope that the crisis would soon be over, and the stable positive dynamics of socio-economy development typical of the previous decade would rapidly resume.

By contrast, our estimates were rather more moderate[2]. We affirmed that the crisis which began in 2008 was a systemic one, and that it would be over after a structural transformation of the world economy, including the formation of a new model of economy regulation and a new model of world economic links and international currency relations. We predicted that such a transformation would take a relatively long period of time, and involve the working-out and materialization of economic development institutions and mechanisms. We expected that this would be a time of instability and fluctuations that could be described as a *turbulent decade*.

The year 2010 confirmed the correctness of our conclusion – with regard to both the world economy and Russia. Economic growth has indeed rebounded, although its rate is now significantly lower than it used to be before the crisis (with the exception of Germany). However, an end of a period of recession does not necessarily mean that a crisis is really a thing of the past, because in the current case the onset of the crisis took place long before the beginning of the recession. The economic growth achieved over the past year resulted, in the main, from the governments' efforts – that is, from a rise in budget expenditures. In the USA, the policy of large-scale money injections is being pursued on an unprecedented scale, and the vagueness of its medium- and long-term prospects has given rise to doubts as to the stability of the global monetary system. Despite its recent revival, private demand has so far failed to become the main locomotive of the economy, which also raises difficult questions about the prospects of the macroeconomic stability of the world's leading countries. However, the situation on

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[1] The author wishes to express his sincere gratitude to O. V. Kochetkova, A. V. Moiseev and S. G. Sinelnikov-Murylev for their considerable assistance in the preparing of this section of the review.

[2] See *Russian Economy in 2009: Trends and Outlooks*. Moscow: IET, 2010; *Mau V., Global'nyi krizis: opyt proshlogo i vyzovy budushchego* [Global Crisis: The Experience of the Past and the Challenges of the Future] // Ekonomicheskaia Politika (Economic Policies). 2009. No 4; Mau V., *Ekonomicheskaia politika 2009 goda: mezhdu krizisom i modernizatsiei* [The Economic Policy of 2009: Between Crisis and Modernization] // Voprosy Ekonomiki. 2010. No 2.

many developing markets is rather more optimistic; economic growth, rise in employment, and capital inflow are factors that have a cumulative positive effect there.

The financial crisis in a number of Eurozone countries entered an acute phase when Greece and Iceland applied for international assistance (from the IMF and the EU). A number of other EU economies (Spain, Portugal and Italy) continue to be under threat, though, which casts doubt on the prospects of the euro as a single European currency. From a macroeconomic point of view, the current crisis in Europe has been increasingly resembling the 1980s crisis in Latin America, when many countries of that region fell into the insolvency trap because of their uncontrolled borrowing. Moreover, at that time the brink of bankruptcy was approached not only by the borrower countries but also by their creditors – the largest American banks. That crisis was eventually overcome through the systemic and interdetermined efforts of both the borrowers and creditors, when the former took obligations to radically change their economic policies, and the latter agreed to write off part of the debt (and sometimes a significant part of it)[1].

The struggle against the crisis in developed countries has been carried on in two major directions. The USA, as the owner of the main reserve currency and the 'debt creator' for the rest of the world, chose the way of an unprecedently soft monetary policy by issuing dollars to finance its state budget. In other words, the USA embarked on a policy which directly contradicted its own traditional recommendations offered to countries hit by a financial crisis. (However, it should be acknowledged that a country that issues a world reserve currency could indeed afford, with considerable justification, to pursue some unorthodox budgetary and monetary policies.) In fact, the USA continues to adhere to the high-demand policy by stimulating expenditure on the part of both the state budget and households.

By contrast, European countries on the whole embarked on a policy of budget tightening. This is typical of both the relatively stable Germany and the crisis-ridden Portugal or Greece. Such policies include state budget expenditure cuts (and, correspondingly, budget deficit cuts) and the simultaneous introduction of tax incentives for businesses. Thus, under this scenario, the emphasis is shifted to supply-side economics.

It is now safe to say that 2010 marked the end of the first phase of the crisis (the phase of preventing the economic collapse) and the beginning of the second phase – the phase of working out a new model of socio-economic development. On the completion of the first phase, the world economy found itself to have been weakened and not yet renovated (*Table 1*). The leading countries and their institutions responsible for economic and monetary policies have learned how to take coordinated anti-crisis actions. Now they are facing the task of jointly working out a growth model focused on stable and sufficiently dynamic growth that would be primarily based on private demand and not on state expenditures.

One of the major results of the year was the seemingly final repudiation of the illusion as to the possibilities and prospects of state regulation of economy. The shock of the first phase of the crisis made it popular to accuse the liberal economic model of being a vehicle of state economic regulation and to call for a return to the ideology and practices of the Big State, meaning active government interference in the management of national economies. It became fashionable to juxtapose the vulgar interpretation of economic liberalism (neo-liberalism or

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[1] For an interesting comparative analysis of the current crisis in a number of European countries and the Latin American crisis of the 1980s, see: Rathbone J.P., *Eurozone can learn grim Latin lessons* // Financial Times. 2010. Dec. 22.

supply-side economics) and the newly revived vulgar interpretation of Keynesianism (demand-side economics). However, it soon became clear that the crisis could be equally attributed to a *lack* of state regulation and the *inability* of the State to provide adequate economic regulation. And it became clear that the crisis should be responded to not by increasing state interference in the economy (let alone in production), but by working out new instruments of state regulation. Such instruments should be globally coordinated and primarily focused on financial market regulation.

Table 1

GDP growth rate (percentage change on previous year)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*	For reference: 2010 as compared to 2007
Russia	**10.0**	**5.1**	**4.7**	**7.3**	**7.2**	**6.4**	**8.2**	**8.5**	**5.2**	**– 7.9**	**3.8**	**0.6**
USA	4.1	1.1	1.8	2.5	3.6	3.1	2.7	1.9	0.0	– 2.6	2.7	0.0
Canada	5.2	1.8	2.9	1.9	3.1	3.0	2.8	2.2	0.5	– 2.5	3.0	1.0
UK	3.9	2.5	2.1	2.8	3.0	2.2	2.8	2.7	–0.1	– 5.0	1.8	– 3.4
France	4.1	1.8	1.1	1.1	2.3	2.0	2.4	2.3	0.1	– 2.5	1.6	– 0.9
Germany	3.5	1.4	0.0	– 0.2	0.7	0.9	3.6	2.8	0.7	– 4.7	3.5	– 0.6
Greece	4.5	4.2	3.4	5.9	4.4	2.3	4.5	4.3	1.3	– 2.3	– 3.9	– 4.9
Spain	5.0	3.6	2.7	3.1	3.3	3.6	4.0	3.6	0.9	– 3.7	– 0.2	– 3.1
Japan	2.9	0.2	0.3	1.4	2.7	1.9	2.0	2.4	–1.2	– 5.2	3.7	– 2.9
Mexico	6.0	– 0.9	0.1	1.4	4.0	3.2	4.9	3.3	1.5	– 6.6	5.0	– 0.4
China	8.4	8.3	9.1	10.1	10.1	11.3	12.7	14.2	9.6	9.1	10.3	31.9
Euro area	4.0	1.9	0.9	0.8	1.9	1.8	3.1	2.8	0.3	– 4.1	1.7	– 2.1
Total OECD	4.2	1.2	1.7	2.0	3.2	2.8	3.1	2.7	0.3	– 3.4	2.8	– 0.3

* Preliminary estimate.
Source: OECD.

In order to resolve the difficult economic problems faced by the world (and first of all by developed countries) it is necessary to introduce deep structural reforms, to overcome the disbalances accumulated in the world, and to develop a new growth model. 2010 was the year when an active discourse on this new model was started on the global arena, and a special term – *New Normal* – for defining the subject of that discourse was coined in the USA[1].

Among the issues to be tackled are the ratios and relationships between Western and Eastern economies (first of all, the USA and China) and between Northern and Southern ones (especially within the framework of the EU). If these issues are to be resolved, it is necessary to rectify the world's macroeconomic disbalances (and first of all those affecting the international balance of payments).

An adequate model of global financial regulation should be developed, because it has now become clear to everyone that the biggest threat to global stability comes from the financial sphere. And it is equally apparent that, in conditions of globalization, financial flows cannot be regulated exclusively under national jurisdictions.

[1] See Yudaeva K., *New Normal Dlia Rossii* [A *New Normal* for Russia] // Ekonomicheskaia Politika [Economic Policies]. 2010. No 6.

The powerful social sectors of developed countries (including Russia) should be restructured, starting with their pension and health care systems that were established and took shape in conditions of the Industrial Era. These systems have proved to be inefficient in face of post-industrial challenges (both demographic and purely economic ones).

A new international currency system should be formed, and it should be clearly understood which currencies should play the role of world ones. Meanwhile, when resolving this issue, it would be necessary to avoid currency wars and a currency-devaluation race – something that very nearly happened in the autumn of 2010, when the world was teetering on the brink.

To provide adequate solutions to all those problems will be a time-consuming process. It must be admitted that more time will have to be spent on intellectual comprehension of the adopted decisions and on mapping up some alternative action plans than on the actual decision-making. It is precisely these issues that will become the focal points during the new phase of the crisis – the phase that began in 2010 and will continue throughout 2011.

1.1.2. Russia's economic policy between crisis and modernization

In 2010, Russia in the main continued its economic policies pursued over the previous year. However, this time the emphasis was made not on the bailing out of some individual economic agents (enterprises or banks), but on the maintenance of general economic and social stability. Banks and firms began to repay their debts to the State. At the same time, there was a resumption of growth in the size of external debt of big businesses (unlike the situation observed in previous years, credits were predominantly drawn by non-financial enterprises).

Russia once again experienced economic growth, although its rate was much lower than in 2000 – 2010. As in the previous years, Russia's growth rate was higher than in developed countries but lower than in the other BRIC countries – China, India and Brazil. To be fair, the severe slump at the peak of the crisis (9 % of GDP and almost 15 % in industry) made the issue of economic recovery much more urgent than before. The task of making Russia one of the five world leaders in GDP volume by the year 2020 also became much more difficult.

Below, we will focus our attention on the most grave problems that were influencing the economic development of Russia during last year. Accordingly, these problems will necessarily become the focal points of Russia's economic policy both at present and in the nearest future.

First. We are faced with a considerable aggravation of the financial (budgetary) situation. After nearly a decade, Russia once again has to deal with budget deficit. After the 1989-98 financial crisis which culminated in the 1998 default, the RF Government started to treat budgetary issues with extreme caution. As a result, it succeeded in achieving a balanced budget. Among the factors conducive to this achievement, there was a steady rise in oil prices. For some time, a balanced budget was the symbol of post-communist Russia and almost a rallying point for the new elite. By the time of the onset of the crisis, the intensive repayment of the external debt had made Russia one of the least indebted countries of the world. Certainly, there existed certain political forces in Russia that insisted on an increase in budget expenditures, but their political influence was negligible.

Now the situation has changed. The country experienced a budget deficit in 2009, but no catastrophe took place. The elite understood that it could gain access to far greater profits than those generated by advances in labor productivity and a favorable external market environment. As a result, there has emerged a paradoxical situation: we have a budget deficit despite the average annual price of oil having climbed to almost 80 USD per barrel, while several years ago, when oil was traded at 30 USD per barrel, the federal budget was implemented with a surplus.

From a formal point of view, the situation by no means looks alarming. State debt levels remain low, and the country has ample room for borrowing – both in rubles and foreign currencies. In comparison with developed countries, Russia's budget deficit of 3.5 – 4 % of GDP is not very high. However, if we eliminate the rent component of the federal budget, the budget deficit will stand at about 13 % of GDP. Which means that the country depends extremely heavily on the fluctuations of world prices for energy resources – that is, on the factors that are completely beyond Russia's control?

The situation is quite comparable with that of the early 1980s. At that time, the Soviet system seemed to be absolutely stable, and the USSR economy was slowly but steadily growing (at an annual rate of 2 – 3 %). State debt levels were not high. Proceeds from the sale of energy carriers were spent on covering budget expenditures (first of all, military expenditures, purchases of foodstuffs and consumer goods, and purchases of imported equipment for the purposes of further development of the oil and gas sector). That model was considered to possess a long-term – if not altogether permanent – potential for stability, and in accordance with their knowledge of the world's historical experience with oil prices the Soviet authorities were confident that the price of oil could only be on the rise. However, when oil prices demonstrated a six-fold plunge, it took only five years for the cherished stability to turn into a complete financial disaster. The same risks are still very real today. The only difference is that, unlike in the early 1980s, we are now well aware of the fact that oil prices are capable of moving in both directions.

Second. After the rate of inflation dropped in 2009 and in the first half of 2010, the CPI resumed its growth and reached 8.8 % by the end of the year. In other words, Russia's inflation rate remains one of the highest in the G-20. It is comparable only with the rates of inflation in India and Turkey (*Table 2*).

Table 2

Consumer Price Index, as a percentage of the previous year

	2007	2008	2009	2010
Russia, ***according to OECD***	9.0	14.1	11.7	…
Russia, ***according to Rosstat***	11.9	13.3	8.8	8.8
G7	2.2	3.	–0.1	…
Turkey	8.8	10.4	6.3	8.6
India	6.4	8.3	10.9	
China	4.8	5.9	– 0.7	4.6 (RBC)
Brazil	3.6	5.7	4.9	5.0
Spain	2.8	4.1	– 0.3	1.8
Greece	2.9	4.2	1.2	4.7
USA	2.9	3.8	– 0.4	1.6
UK	2.3	3.6	2.2	3.3
Canada	2.1	2.4	0.3	
France	1.5	2.8	0.1	1.5

Sources: OECD, IMF, RBC, Rosstat.

To some extent, this is a absolutely natural process following a resumption of economic growth. Although the dynamics of prices began to decelerate at the peak of the economic slump, the Russian economy continued to be highly inflationary – the bottom point of the slump saw the rate of annual inflation dropping to 8.8 %. As the recession abated, it was from that lowest point that Russia's inflation resumed its climb.

However, Russia's inflation is also fed from two other – so to say, negative – sources. One of them is the factor created by the drought and the extremely poor harvest of cereals, which reflects on the whole index of agricultural production. The second source is the factor of budgetary policy, because the current very strong rise in expenditure cannot but boost prices. The current wave of inflation has also had some monetary sources, for the budget deficit was financed from the Reserve Fund and by foreign currency interventions during the capital-inflow period at the beginning of the year. Some contributions to the rise in inflation also came from the inflationary expectations inevitably produced by an expansionary budgetary policy.

Given the current situation in Russia, a rise in inflation has created more problems for this country than for its developed counterparts. In developed countries, inflation would have become a factor (and indicator) of a rebound in production, and even the subsequent tightening of monetary policy would have been limited to only a few percentage points. In Russia, inflation must inevitably raise interest rates to double digits, thus creating a serious obstacle to economic growth.

In this situation, it was only reasonable to expect that Russian firms would considerably increase borrowing on external markets that offered cheaper loans. Such expectations indeed proved to be well-substantiated. In 2010, foreign borrowing began to climb, especially on the part of non-financial institutions (unlike in the pre-crisis period).

Third. Russia has been hit by massive capital outflow. In this respect, the situation in Russia is totally different from that existing in the other BRIC countries, because Brazil, India and China are experiencing strong capital inflows. In both cases there emerges the issue of advisability of restricting the freedom of capital movement, although the purposes of such restrictions would be diametrically opposed to each other – to reduce the impetus for capital inflow for the purpose of lowering the level of volatility in one case (e.g., Brazil has already introduced a Tobin tax), or to do this for the purpose of preventing a dangerous capital outflow in the other.

Capital outflow from Russia was taking place despite that fact that the Russian stock market was one of fastest growing stock markets in the world. However, its small size (the inflow of portfolio investments constitutes only a small part of capital flows), small depth and extremely high volatility (it can fluctuate many-fold) have made big international investors lose interest in it. To make matters worse, the amount of direct investments registered last year was negligibly small.

Apparently, the current capital outflow from Russia has several causes. One of the reasons is the general uncertainty concerning the forthcoming Russian elections. Another reason is persistently high corruption, when part of the funds spent by budgets of all levels of government remains in the hands of 'officials' who prefer to transfer their loot to safer havens (as is confirmed by the relatively small money transfers abroad typical of the past year). As far as the latter tendency is concerned, it can be said that corruption is visibly evolving from being a microeconomic phenomenon into a macroeconomic factor.

At the same time, the current account balance rapidly has been decreasing due to a considerable rise in imports caused by a rise in the social expenditures of the budget. High effective demand transforms into demand for cheap goods. Currently, Russia is importing most of such goods. It has become clear that a 1999-like situation – when growth in nominal payments to the population turns into growth in demand for domestically produced goods (import substitution) – can be possible only in the event of a radical devaluation of the national currency (many-fold, as in 1998, and not by a few percent only (as it is done now))[1].

This brings us to the following general conclusion: last year has clearly demonstrated that Russia is no longer the cheap country that it used to be in the 1990s and early 2000s. This applies to the value of assets, the value of goods, and the value of services. Both the crisis and the relatively stable exchange rate of the ruble maintained in crisis conditions had a considerable impact on the risk/return ratio due to the persistence of high risks and a fall in profitability, because other developing countries have proved to be more reliable than Russia, while offering a comparable level of profitability. As regards the price/quality ratio, Russian domestically produced consumer goods, as a rule, have also been failing to adequately compete with imports. These circumstances have caused capital outflow from Russia, and so put a downward pressure on the current account balance.

The fear of the current account balance becoming negative is not groundless. But such a course of events is not inevitable, because the rise in demand for imports has resulted in weakening of the ruble – which, in its turn, can become an import-restriction factor. This will depend both on the actions of the monetary authorities and on the fiscal policy of Russia. The Central Bank is capable of influencing the exchange rate of the ruble by gradually weakening it in order to restrain the inflow of imports. It is true that such policies would be contrary to the aim of inflation targeting, and so would once again prove that the issues of domestic production remain more important for the Central Bank than those of the achievement of price and currency stability.

The prospects for the balance of payments also depend on the character of Russia's budgetary policy. Unrestrained budgetary expansion (especially in the part of social allocations) can become a factor of steady demand for imports, and so lead to the emergence of a double deficit (of both the budget and the current account balance).

Fourth. By the end of 2010, the situation on the labor market had become considerably better than what was expected at the beginning of the year. By December 2010, the total number of unemployed persons (calculated under the ILO methodology) had dropped by 0.7 million to 5.7 million, while the number of officially registered unemployed persons had dropped by 183.1 thousand to 1.9 million. It can be said that the jobless recovery phenomenon (which means that the growth in employment was abnormally weak during the recovery given the growth in output) has failed to materialize in Russia. From the point of view of social and political stability, such a situation can only be greeted warmly. However, it has two possible explanations which actually prevent us from assessing the recovery of the labor market with unreserved enthusiasm.

Firstly, the phenomenon of jobless recovery is the reverse side and indicator of a structural transformation of the economy. It means growth in structural unemployment, i.e., the emergence of new jobs and a lack of persons qualified to fill these jobs. In other words, jobless recovery is a mandatory factor of a comprehensive modernization of the economy which determines its exit from a crisis. The absence of this phenomenon requires a specific discussion of the issue of whether or not modernization is present at the exit phase of the crisis. A similar

[1] In this regard, in November 2010 Alexey Ulyukaev stated that, if the policies aimed at boosting social expenditures were to be continued, this could result in the emergence of a structural deficit of the current account that would be almost impossible to control through monitoring the ruble's exchange rate. (See *Gaidarovskie Chteniia* [The Gaidar Readings]. 13 October 2010. http://www.iet.ru/images/READINGS/ulukaev.pdf)

effect on the economy can be produced by political pressure exerted on businesses and the regions urging them to maximize employment.

Secondly, given the specific demographic situation in contemporary Russia, the fact that the growth in employment is not lagging behind the recovery of the economy may be suggestive of a higher rate of retirement, which would mean that unemployment in Russia drops not only due to a rise in employment but also due to a reduction in the size of the potential workforce (able-bodied persons of working age).

These two explanations do not contradict each other, and, most likely, both of them had some practical influence on the course of events in 2010. Certainly, from the point of view of social stability, such a course of events was useful. However, from the point of view of the need to achieve the goals of modernization, the situation on the labor market has so far been impervious to unambiguous interpretations.

Fifth. Russia has made several important steps towards international integration – both along the lines of the Customs Union and the Common Economic Space initiatives, and also with regard to the issues of Russia's accession to the WTO. Considerable progress has been achieved in both directions. And in both cases the top issues are not economic or technical, but purely political ones. Will Russia become a member of the WTO, and will the institutes of integration work in the post-Soviet space? The answers to these questions depend on the decisions that are being made by the political leaders of the countries involved in the aforesaid processes. For Russia, both processes are important instruments for the stimulation of competition between commodity producers and jurisdictions[1].

In an attempt to combine anti-crisis measures with modernization, the Russian government, in the past two years, began to introduce some new elements in its economic policy that were considerably different from those typical of 2000-08.

First of all, it was *a new macroeconomic reality* – a stubborn budget deficit and persistent growth in government borrowing. The rise of these phenomena was facilitated by the existence of huge reserves and a low level of state debt on the eve of the crisis.

Another political novelty (stemming from the previous one) was the government's *U-turn towards heavier taxation.* Throughout almost all of its post-communist history, since the imposition of a fundamentally new tax system in 1992, Russia was only cutting taxes (unlike the excises on carbohydrates, tobacco and alcoholic beverages). A number of decisive measures designed to reduce taxes were implemented in 2000 – 2001. It should be taken into account that one of the important – although not declared – reasons for reducing taxes was the government's desire to set them at a level and under a model that could be truly administered by the state – that is, to set the tax rates as close as possible to the effective level.

Now the trend has changed. Recently, there occurred a significant rise in social allocations (first of all, those to the Pension Fund) and in taxes on carbohydrates. The fiscal logic of these moves is sufficiently clear – with budget expenditure being increased it is practically inevitable that taxes will go up as well. According to Russia's minister of finance, tax increases should be continued for the time being. However, it is also apparent that the imposition of heavier taxes on labor de-stimulates structural modernization, because tax hikes are most painful for labor-intensive industries, while raw-materials industries are less responsive to them.

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[1] For the competition of jurisdictions, see Shuvalov I., *Rossiia na puti modernizatsii* (Russia on the Way to Modernization) // Ekonomicheskaia Politika. 2010. No 1.

In a bid to mitigate the negative impact of the rise in taxes, the authorities have begun to more actively resort to *discrete (pinpointed) measures of economic policy*. The most vivid example of this trend is the establishment of the *Skolkovo* innovation zone, whose residents are granted an unprecedented range of tax and administrative benefits – from a very low rate of social contributions to the introduction of their own (detached from the general system) law-enforcement, tax and customs bodies. In effect, the Skolkovo initiative is an effort to create a center for innovation and growth administered in a manner befitting a contemporary post-industrial society. This experiment is very important, because its outcome will have some far-reaching consequences for the economic and social life of Russia.

In fact, the government has embarked on a course of singling out and selectively assisting 'national champions' – individual industries and sectors that, for one or other reason, are considered to be promising. Actually, this trend had begun well before the crisis, with the establishment of the State Nanotechnologies Corporation *Rosnanotech*, when the government came to believe that nanotechnologies were the crucial determinant of scientific and technological progress 'that should be bolstered at all costs'[1]. Those initial steps were followed, already under crisis conditions, by the creation of the Commission for Modernization and Technological Development of Russia's Economy headed by Dmitry Medvedev. At its very first meeting in the autumn of 2009, the Commission singled out five priority areas for science and technology development (energy effectiveness and energy saving, including development of new types of fuel; space technologies, first of all in the field of telecommunications; medical technologies; strategic information technologies, including supercomputer and software development). In March 2010, the Government Commission on High Technology and Innovation was established under the chairmanship of Vladimir Putin. These two commissions were designed to address general issues of innovative development and modernization, and to supervise the implementation of pinpointed projects – 'national champions'.

The same logic can be applied to the recently initiated transformation of the model of special economic zones (SEZ). Initially, SEZs were interpreted as the growth points established by way of a competitive tendering process designed to define an optimum region for business and innovation activities. On the contrary, the present trend is to establish special economic zones 'by decree' – that is, to create them at a place considered to be feasible from the point of view of forming one or other technological cluster. One of the examples of this approach is the proposed *Titanium Valley* special economic zone in Sverdlovsk Oblast.

In late 2010, in order to compensate small businesses for the rise in social taxes, the government, being well aware of the fact that some businesses would go into the shadow, took the decision that for the next two years insurance contributions to the Pension Fund should be reduced from 26 % to 18 % for small enterprises and individual entrepreneurs engaged in production and rendering of social service to the population.

Finally, in 2010, the issue of privatization was again put on the front burner. The government adopted a large-scale program of privatization that envisaged the sale of stakes in enterprises with minority shareholding by the State, as well as minority stakes in some of the biggest state-owned companies decisively controlled by the State, such as *Rosneft*, *RZhD,*

[1] There were apparent similarities between that course and *The Plan for the Electrification of Russia* (GOERLO). Decades ago, Lenin said that 'Communism is Soviet power plus the electrification of the whole country'. In other words, electrification, coupled with political stability, was perceived as a key factor of the political and economic breakthrough that was being attempted by a country recovering from a revolution.

Rusgidro, Sberbank, VTB, and a number of other giants. Apparently, the objectives of this privatization initiative are to attract strategic investors (and so to obtain investment resources and improve corporate governance), and also to increase budget revenues. In the present circumstances, the former objective should be regarded as a crucial one, although only time will show whether or not it can actually be achieved in practice[1].

1.1.3. A quest for a new growth model

One of the illusions usually cherished at the beginning of a structural crisis is the expectation that the good old days will return – that the turmoil will be overcome and the old growth model will be restored. Such a strategy is erroneous, though. A crisis like the present one necessitates the formation of a new model of economic development. Only after this requirement has been met, a recovery from crisis can begin. At the stage of exiting the crisis, the advantage will be on the side of the countries capable of building that model and then most consistently and resolutely implementing it in practice. So, the specific role of a structural crisis is t o stimulate the building of a new growth model and to provide individual countries with the chance to achieve a breakthrough in their development.

At present, Russia has to make a choice between two alternative strategies of socio-economic development. This choice must be made by the country's political elite in the nearest future.

The first strategy envisages the development of the existing growth model and its adaptation to challenges as they come. Under this arrangement, the State represents the main source of growth – in the triple role of the provider of key financial resources, the neutralizer of market anarchy, and the holder of the key institutions that are necessary for economic growth. The State designates priorities and concentrates the political and economic resources that are necessary for achieving them, builds the financial system on the basis of state-owned banks and exchanges, and directly manages key production companies (controls the 'commanding heights'). Under this system, state demand not only for goods and services but also for institutions turns out to be system-forming. Household demand for goods and services also depends to a great extent on the State.

The second strategy envisages a rise in the importance of private sources of growth (private firms and households). They should gradually squeeze the State out of the business sphere. The State should create maximally favorable conditions for the functioning of private economic agents, and stimulate their interest in development, i.e., stimulate the supply of goods and services.

This dichotomy is well known, for it is frequently encountered in economic history and economic history. It had emerged long before the current global crisis. The choice between demand-side economics and supply-side economics forms the basis of the century-long discursive contest between the Keynesian and neoclassical models of economic growth.

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[1] In principle, privatization can pursue three goals: political, economic and fiscal. The first goal consists in strengthening the existing political regime through widening its social base. The second consists in attracting efficient owners and in improving the quality of economic growth. The third consists in increasing state budget revenues. In the situation of the 1990s, just as it happened in every major revolution of the past, the first goal was absolutely predominant. In conditions of political stability, the economic goal comes to the fore, although the other two goals also play their part, being quite congruent with each other. (For mare details, see Mau V. *Ekonomika i revoliutsiia: uroki istorii* [Economics and Revolution: Lessons from History] // Voprosy Ekonomiki. 2001. No 1.

This issue is even more pressing in developing countries (or in the countries pursuing catch-up modernization). In his analysis of the developmental experiences of Germany and Russia in the late 19th and early 20th centuries, Alexander Gerschenkron has shown that, in conditions of catching-up development, the State should take upon itself the responsibility to compensate for market uncertainty, and especially for the weakness of the nascent market institutions[1]. However, the subsequent course of events has indicated that such an excessive state interference in economic matters can cost society dearly – both in economic and political terms. The Big State ossifies and, at some point, becomes an obstacle to modern economic growth. The overcoming of this obstacle always requires a large expenditure of resources and, sometimes, a heavy loss of life.

The existing growth model – demand-side economics

The major elements of this model are as follows: the high levels of social and political stability as the key aim of the government; the continually growing prices for hydrocarbons; budget expenditure growth as the principal source of demand; a gradual increase in taxation; the continuing existence of a potential for inflation; the increasing role of narrowly targeted decisions, and the reluctance to set up the 'rules of the game'.

The existing growth model which emerged in the 2000s is based on the presence of significant, cheap and untapped financial resources that owe their existence not to labor productivity growth but to a favorable external market situation. In fact, Russia has had a version of this model since the 1970s, and its popularity is almost as high as it was in the first decade of its existence. The rapidly rising expenditures of the state budget make it necessary for Russia to further accelerate the climb in prices for energy resources in order not to end up with a massive budget deficit.

Under the existing model, the State is the most important source of demand. The major part of demand is coming from the medium and low-income strata of the population (pensioners, unemployed persons, civil servants, military personnel, and workers of state corporations). An important role is played by the funding of the power structures in the part of arms purchases and the upkeep of military personnel. (However, in this regard, 2010 was a watershed year for Russia, given the Russian military's announcement of big military purchases from NATO countries.)

Another important sphere of state-generated demand is investments in infrastructure. However, being well aware of the high levels of corruption in this sector, the government has become much more circumspect about investing in infrastructure than in the social sphere.

It is not easy for a government to decide whether the priority for investment should be infrastructure or the social sphere. Social expenditures are oriented to a more competitive market, and they are really capable of generating a rise in consumption. The infrastructure sectors are more heavily monopolized, and investments therein result in a rise in prices (or tariffs) rather than in a rise in demand for the relevant goods and services.

At the same time, social expenditures considerably boost inflation and increase demand for cheap imports. The experiences of the past few years indicate that a rise in demand for cheap commodities and services is satisfied not by the domestic producer but through imports from

[1] Gerschenkron A. Economic Backwardness in Historical Perspective: A Book of Essays. Cambridge, Mass.: The Belknap Press of Harvard University Press, 1962.

cheap labor countries (first of all, from Asia)[1]. This circumstance considerably reduces the potential impetus of budget expenditures.

To a certain extent, this demand could be compensated for by means of exchange-rate policy, that is, by restraining the process of the ruble's strengthening. However, the monetary authorities have a very narrow scope for action in this direction, especially given the current high level of prices for hydrocarbons.

Yet another problem associated with social expenditures is their irreversibility. Once social obligations have been assumed, they can be safely repudiated only in conditions of a severe political and economic crisis. The insufficiency of budget revenues will not be accepted as an excuse by the population. From this point of view, expenditures on infrastructure are much more politicized, and therefore are easier to give up.

Under this model, the priority of social stability will prompt the government to pursue conservative policies in the labor market – the policies aimed at preventing the release of excess workers, and therefore obstructing structural innovation. To be condoned by the authorities, the release of excessive labor should be done very cautiously and under the control of the State. This approach can be very fruitful, as is exemplified by the 2010 experience of *Avto-VAZ*. However, this example cannot be replicated on a massive scale.

If structural reforms are abandoned, the maintenance of macroeconomic and social stability will require a steady rise in taxation – that is, a revision of the policies pursued in the past 15 years.

Finally, an economy based on state-generated demand is, in principle, more prone to the preservation and protection of monopolies. In response, the monopolies will indeed ensure economic and political stability, but at a price. The price will be a lower quality of goods and services, and a higher rate of inflation.

The predominance of state-generated demand will lower the need of economic agents in bringing down the inflation rate, because state investments will then become more important than private investments – but it is the private investor who is more interested in the inflation rate being lower as a stimulus for bringing down interest rates.

Apparently, the State will increase the pinpointedness of its decisions by creating incentives for some categories of investors and producers that will compensate them for tax hikes, high interest rates and high administrative barriers.

Growth for the sake of structural modernization – supply-side economics

Modernization should put the main emphasis on the quality of growth rather than on its rate. This approach necessitates the creation of a new growth model based on stimulation of the supply of goods and services, i.e., on ensuring adequate conditions for successful functioning and development of economic agents.

This model has the following three major elements.

Firstly, a steady decrease (instead of an increase) in the budget burden as a percentage of GDP, i.e., a decrease in both budget expenditure and taxes. Practically all successful examples of catch-up development in the post-industrial world took place in countries with budget

[1] According to Aleksey Vedev's estimates, 75 % of growth in domestic demand resulted in inflation and a rise in imports, and only 25 % stimulated domestic output. (Alexey Vedev et al., *Na puti k deshevym den'gam* [On the Way to Cheap Money]. *Tsentr strategicheskikh issledovanii Banka Moskvy* [The Center for Strategic Research of the Bank of Moscow]. 2010. June.).

loads that were smaller than those in the most advanced countries. (This is the principal difference between contemporary catch-up development and catch-up development in the industrial epoch of the 19th and 20th centuries. It is especially important to prevent a rise in taxes on labor: instead, such taxes should be gradually reduced;

secondly, the restoration of the macroeconomic balance, i.e., the budget deficit decreases, while budget expenditures become more rational and efficient;

thirdly, currency policy should be investment friendly. This means that the ruble should be transformed, step by step, into a regional reserve currency. As the efficiency of domestic output stimulation by means of restraining the strengthening of the national currency considerably decreases, it is necessary to start inflation targeting, which will make it possible to keep interest rates at a level acceptable to investors;

fourthly, maintenance of economic openness as the most important condition for stimulating domestic competition, development of the Customs Union and the common economic space, accession to the WTO and the OECD, and, later on, movement toward the creation of a common economic space with the EU that can be considered to be a strategic goal of the country's external economic policy. All this does not exclude the implementation of measures designed to boost non-primary exports on a day-to-day basis;

fifthly, neutralization of opportunistic incomes, which means a return to the initial ideological and practical design of the Stabilization Fund which was formed in order to accumulate revenues from the sale of hydrocarbons at a time when their price exceeded the cut-off price set for a number of years;

sixthly, a profound reformation of every branch of the social sector, first of all the pension and medical care systems, which should be brought into line with the demographic and financial realities of the post-industrial time; strengthening of the private and individual principles of the functioning of these branches, and bringing their development to conformity with the formation of sources of long-term investments;

seventhly, a consistent implementation of privatization with the emphasis being put not on fiscal tasks but on social and political objectives, such as the formation of a broad stratum of non-oligarchic owners of means of production (medium-sized and big businesses), the formation of a middle stratum, and the attraction of strategic investors. This type of privatization would generate demand for modernization, macro-economic resurgence and the above-mentioned structural reforms. (This is exactly what happened in the 1990s, when the beginning of privatization opened the way for macroeconomic and political stabilization.)

Of course, the above conclusions are not meant to minimize the importance of reforms in the political and law-enforcement spheres, which are designed to protect property rights, develop competition, and overcome corruption, i.e., to provide solutions to the acute problems that have been so widely discussed in recent years.

1.1.4. The key challenge: structural modernization in conditions of a rent-based economy

Figures for 2010 indicate that the resurgence of economic growth has failed to become synonymous with an exit from the economic crisis. The economic situation remains unstable and highly dependent on state-generated demand. The necessity to maintain a high level of expenditure despite the impossibility of a significant increase in taxes suggests a rise in borrowing as the only possible solution. In its turn, borrowing creates a number of immediate and long-term problems for the governments of all countries, because all those debts will have to be repaid. Moreover, their repayment will become a major drain on the state budget for years to come.

The governments of the leading countries of the world are faced with a hard choice, which is of a fundamental importance for the prospects of global economic development. They are to chose between the tightening of budgetary policy and the continuation of budget incentives. The first approach will conduce to macroeconomic resurgence in the future, but can cause recession in the immediate term. That will be very unpleasant, both in economic and political terms, and can threaten the ruling parties with the loss of their mandate. The second approach will maintain the current level of economic growth. However, it is fraught with the danger of the emergence of some serious problems that will take at least a decade to overcome.

Both approaches are based on the experiences of the previous two great crises. An attempt to tighten budgetary policy in the mid-1930s resulted in the resurgence of a recession, which was brought to an end only by the Second World War. On the other hand, an attempt at growth stimulation in the 1970s caused a fall into the trap of stagflation, which the economy was able to disentangle itself from no sooner than the early 1980s – after passing once again through a deep recession.

The austerity vs stimulus discussion among economists and politicians is gaining momentum. Not surprisingly, both parties are actively appealing to the memory of John Maynard Keynes who, indeed, put forth the idea of economic stimulus but never recommended that it be used on a scale as massive as that in the 1970s, when Richard Nixon declared himself a 'Keynesian' and pursued state intervention policies under the guise of Keynesianism.

Given all the importance of this discussion, it fails to precisely reflect the essence of the current problem. Its main shortcoming is the discussants' attempt to find a solution in the old logic of business as usual, i.e., an attempt to revive the pre-crisis rules of the game and to blissfully continue pre-crisis economic policies. For them, the only question is in funding the best way to weather the current storm by sacrificing either growth or financial stability.

In essence, this polemic replicates on a national level the logic of the behavior of large enterprises – you should bide time, receive and restructure credits, and then it will be business as usual.

The key problem of such an approach is the actual abandonment of the modernization component of anti-crisis policy. Waiting for growth to recover on the micro or macro level makes governments prone to maximally safeguard stability and to condone nothing that could undermine their electoral prospects.

However, the problem is much deeper than that. A systemic crisis always has a strong modernization component. The crisis – or, better to say, the process of its overcoming – implies the potential achievement of new levels of competitiveness and promises some new economic and technological solutions.

The overcoming of a crisis does not reflect on growth figures, like its beginning did not coincide with the beginning of recession. The case in point is the emergence of a new quality of growth, a new growth model, and a new model of socio-economic regulation, this time apparently on a global scale. To achieve these ends, governments should pursue a conservative budgetary policy that would stimulate innovation instead of helping traditional enterprises to preserve their market share and profits.

In other words, the choice between austerity and stimulus is not reduced to the question of whether preference should be given to an expansionist or conservative budgetary policy. The case in point is what signal should be sent to economic agents – to remain as they are, or to modernize. However socially and politically problematic they might be, tough budget constraints create conditions for innovation, while soft budget constraints that can mitigate many current problems will lead to a severe structural crisis in the future. In the mid-1980s, the Soviet Union gave preference to stimuli, and the consequences of that choice are well known.

In contemporary Russia, the situation is aggravated by the country's half-century-long dependence on the inflow of cheap money. Resource dependence is extremely dangerous, because it leads to a gradual degradation of social (political and economic) institutions and the education system, thus creating barriers to modernization. This resource dependence is quantitatively different from the raw-material character of the Russian economy of bygone days, when agricultural products accounted for the lion's share of Russia's exports. The core issue of how this dependence can be neutralized – thus stimulating demand for modernization – must clearly become the focal point of the ongoing political and economic discourse.