

Between Modernization and Stagnation Russian Economic Policy and Global Crisis¹

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ABSTRACT

The paper deals with the trends in the world and Russian economies towards development of a new post-crisis system, including technological and structural transformation. Three main scenarios of Russian economic development (conservative, innovation and acceleration) are discussed basing on historical analysis of Russian economic performance since 1970-s when oil boom started. On this basis key challenges of economic policy in 2013 are discussed.

Keywords: economic growth, global crisis, modernization, structural adaptation, regulation, welfare state.

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Russian economic development during 2012 was influenced to a significant degree by the world economic crisis. The global crisis has now entered a decisive phase in which the shape of the economic system of the future – the new equilibrium that the world economy has been seeking to achieve since the upheavals of 2008 – is becoming apparent. A new economic growth model has begun to emerge. Indeed, this is how global structural crises generally resolve themselves – the crises of the 1930s and the 1970s had a similar outcome. Creation of this new model will involve the formation of a new technological basis for society, an appropriate new system of regulation of socio-economic processes, the overcoming of macro-economic imbalances, the beginning of a new trajectory of growth and the adoption of a new system of global reserve currencies.² Periods of crisis are generally marked by economic and political instability – we should brace ourselves for a turbulent decade.

Analysis of the events of the last year will enable us to trace the emergence of the new technological and socio-economic system. As the new system takes shape, we shall be able to discern the “point of transition”, that is the point of emergence from the crisis. We should emphasise that a structural crisis, unlike a cyclical crisis, is accompanied by a recession: the start of a structural crisis should not be confused with the start of a recession but rather with the end of a recession – with a return to a trajectory of growth. A recession is only a particular episode (or several episodes) in the evolution of a structural crisis: it is not a system-forming or defining characteristic of the crisis.

Global trends

Technological challenges. We are witnessing the appearance of new technologies that significantly increase the productivity of labour and reduce the cost of production. The proportion of labour expenditure on the production of new goods is falling relative to labour expenditure on design. Furthermore, in post-industrial society, technological development is increasingly oriented towards the individualization of production: there is an increasing preoccupation with the needs of the individual consumer both in the production of goods and in the delivery of services. Finally, the increasing complexity of modern products frequently requires that design and production be located in close physical proximity (this is probably one explanation of the economic and technological success of California).

Amongst these recent technological achievements we should include new methods of gas extraction. These are capable in the not so distant future of fundamentally transforming the global system of energy supply and the consequences, political as well as economic, will be significant. Competition for access to fuel and energy resources will not diminish but will change direction. There will be a reappraisal of what is currently understood by the term “energy super-power”.

All of these circumstances, taken together, will make for a relocation of productive forces whereby the high-tech functions of production which were in the past transferred to offshore “peripheries” will be repatriated to the countries of the developed “centre”. This trend will be accelerated by an increasing cost of labour in the developing countries, particularly in those that during the last two decades have succeeded in controlling high birth rates. In other words, labour costs in the new sectors will be relatively low and will diminish, and the individualization of

² The structural crisis and methods for resolving it have been considered in more detail in the surveys of Gaidar Institute for Economic Policy for 2010 and 2011. See *Ekonomika Rossii v 2010 godu* (M.: IEP, 2011): policy in 2010; *Ekonomika Rossii v 2011 godu* (M.: IEP, 2011)

production (orientation on the individual consumer) will require the direct participation of this consumer in the “assimilation” of the goods produced.

Of course, this does not mean a closing down of production in the “new industrial countries”. These countries also constitute important markets for finished goods, high-tech goods included. However, there are a number of important conclusions to be drawn for the post-crisis model of development.

Firstly, competition for investments and the location of production facilities, not only between developing countries but now also between these countries and the developed countries, will inevitably be stepped up. Decision-making as to where production should be located will come to involve a greater number of factors than whether to seek higher profits from countries with low-grade institutions or accept lower profits from countries where institutions are stable.

Secondly, the developing countries will not only have to create conditions favourable for production (cheap labour and viable institutions, which is to say an appropriate environment for investment and enterprise); they will also have to stimulate internal demand. Internal (or regional) demand will become an increasingly significant factor in the taking of investment decisions, especially for global corporations. This will mark a significant departure from the economic policy that has been successfully implemented during the last thirty years (from Germany to China).

Thirdly, it is likely that there will be a “new industrialization” of the developed countries. At the very outset of the present crisis, this possibility was raised by a number of US politicians and economists and the Russian government has also spoken of this from time to time. This “re-industrialization” would consist not so much the revival of traditional industrial sectors but in the emergence of completely new sectors in which intellectual activity and production are closely intertwined. The location of these processes in different countries according to input costs would make no sense. By the same token, under a “new industrialism” there would be no point in pitting the industrial sector against the financial sector, a policy that is increasingly being adopted by left-wing politicians in certain developed countries (during his electoral campaign in France, François Hollande declared a “war against the world of finance”).

This brings us to the fourth point, the consignment to the past of the distinction between backward and progressive branches of the economy. In the modern world, any branch of the economy can be simultaneously high-tech and out of date. The branch structure of an economy will be no guide as to whether the technological base of that economy is backward or progressive.³ The same applies to the relationships between goods and services, in so far as the latter will increasingly become an extension of the former and the distinction between the two will disappear (for example, Rolls-Royce in reality sells not engines, but a period of time during which an engine will enable an aircraft to fly).

³ This was the state of affairs before industrialization, at which time particular branches of the economy were not considered to be either backward or advanced. The most powerful states, economically and militarily, were then not states with developed urban industries and trade but agrarian monarchies. This is also the understanding of the technological base that one encounters in the thinking of the classical *laissez faire* liberals, who exhorted countries to exploit the advantages of free trade rather than force the development of particular branches of the economy. In the nineteenth and twentieth centuries the proponents of industrialization accused these thinkers of perpetuating economic backwardness, but they ignored the fact that for Adam Smith the indicator of progress was not the level of industrialization relative to agriculture, but the division of labour. For more detail on this topic, see Mau Vladimir, *From Crisis to Growth*. London: CRCE, 2005.

Fifthly, governments will have to stimulate economic growth and encourage the creation of high-tech jobs rather than pursue the growth of production and security of employment at all costs. This will require a serious shift in the paradigm of economic policy. Every government, be it of a developed or developing country, would rather support existing enterprises than risky new ventures. Above all, even when a government adopts a particular set of technological priorities it tends to look backwards and select technological trends that have already become established. This greatly increases the likelihood of errors in the setting of budgetary priorities.

Institutional and structural reforms: During the last year or two we have witnessed the beginning of significant changes in the organization of socio-economic processes in the leading countries of the world – developed as well as developing. These structural shifts are part of the gradually emerging new model of regulation.

When the crisis began there was an outburst of left-wing criticism of the economic liberalism of the previous twenty years and calls for a renewal of direct state economic regulation. However, several months later, different voices were heard, warning against “Crass Keynesianism” and arguing that what was needed was, rather, a new model of regulation that took account of the globalization of economies and of the challenges posed by new technology. At present the new model of regulation is evolving along two lines:

On the one hand, national institutions are being consolidated within a context of regional integration. Understandably, these changes are being pursued most actively within the Eurozone, where the problems of a single currency have demonstrated the vital importance of coordinating the regulation of financial institutions and fiscal systems. Processes for integration have also gained momentum in the post-Soviet territories – the formation of the *Customs Union* and of the *Eurasian Economic Community (CAEU)*, although here the principal objective has been the creation of a large market, an objective achieved in Europe several decades ago.

On the other hand, the need for systems capable of regulating financial institutions that operate on a global scale has become apparent. This has become a major topic in the agenda of the “Group of Twenty” (G20) and will be a priority when Russia chairs the Group in 2013. It has to be said that, so far, whilst the need for such systems has been acknowledged, a consensus as to what steps should be taken has not been reached.

The nature of the structural changes that will be needed in the socio-economic life of the developed countries was eloquently described as long ago as 2009 by Larry Summers, who pointed to the importance of bringing socio-economic institutions into line with technological change. In his words, “the new American economy will be in different and better shape than it was before the bust, it will be more export-oriented and less consumption-oriented, more environmentally oriented and less energy-production-oriented, more bio- and software- and civil-engineering-oriented and less financial-engineering-oriented, and, finally, more middle-class-oriented and less oriented to income growth that is disproportionate towards a very small share of the population.”⁴ This agenda for change is of relevance to all of the world’s developed countries.

During the last year we have witnessed a number of positive structural changes in institutions of developed countries that suggest that we are beginning to emerge from the crisis and embrace the new economic paradigm. We should bear in mind however, that a recession as such is not an indicator of the beginning of the crisis or of emergence from a crisis.

In the Eurozone a number of institutional and structural reforms were adopted aimed at overcoming the crisis. These were implemented at Community level and at the level of those countries that were suffering most severely from the crisis. The powers of the European Central

⁴ <http://www.ft.com/cms/s/2/6ac06592-6ce0-11de-af56-00144feabdc0.html>. (Financial Times. 2009. July 10).

Banks have been increased and it is close to becoming a “lender of last resort”. There are movements in the direction of a unified system of financial regulation and coordination of budgetary policies. Growing opposition in Great Britain to this further integration of the Eurozone will make a positive contribution to reform of the European Community in so far as the unity of the Eurozone is more important than the size of the common market. Of course, much still remains to be done, but the momentum in favour of consolidation will contribute to the institutional modernization of one of the largest markets in the world.

A number of cautious steps in the right direction were taken in the countries of southern Europe (“the European periphery”). Against a background of increasing social tension, these countries introduced deep-seated structural reforms that will result in a reduction in costs and increases competitiveness. These changes have already been implemented and have led to a stabilization (and in a number of cases an improvement) in the terms of borrowing for these “countries of the periphery”.

Essentially, what faces Greece and a number of other countries of southern Europe is the experience of Latvia, where the government refused to devalue (devaluation is, of course, not possible within the Eurozone) and went through a period of drastic structural adjustment, recession and high unemployment. The positive outcomes were an increase in competitiveness and a return to economic growth.

Positive steps have been taken in the United States. The existence of a developed private sector and the limited role of the state make possible a more rapid adjustment of the economy to changing circumstances. Here, lessons were learned from past experience and this has facilitated the emergence of a new growth model. The pre-crisis model was based on consumer demand and on a demand for housing, financed by savings from abroad placed in under-capitalized American banks. Such imbalances cannot be corrected in the short term. Even so, the situation has begun to improve during the last three years: housing prices have fallen, banks, at the instigation of the regulators, have sanitized their balances by writing off debts and through measures for re-capitalization. Consumer debt has fallen from 133% to 114% of aggregate income.

The weakening of the dollar has made for a growth of exports and this has made for a reduction in the trade deficit. Meanwhile, China has become the third most important market (after Canada and Mexico) for American goods. As of the beginning of the crisis, American exports to China increased by 150%, notwithstanding a depreciation of the Chinese currency. American exports to the countries of Latin America also increased by 150% and to the OECD countries exports increased by 20%. The composition of American exports has also changed: in addition to such traditional exports as aircraft and computer software, there has been a significant increase in the volume of high-tech services (in architecture, engineering and finance) and in a range of IT products, for example 3D printing.

Finally, high energy prices have stimulated the introduction of energy saving technologies and the development of new methods of fuel production. As a result, in 2012, net import of oil in the USA was at its lowest since the 1900s, whilst America became a net exporter of gas. Meanwhile, also in 2012, the share of shale gas in US gas output increased from 1% in 2000 to 35%. It is worth noting that the implementation of new gas extraction technologies (hydraulic fracturing and horizontal drilling) came from private companies. The role of the state was confined to investment in research.

One feature of structural change is a lag in the recovery of the labour market relative to economic growth. Growth in productivity is reflected in the recruitment of more qualified, higher cost, workers but in fewer numbers. It is for this reason that modernization is often accompanied by a slower growth of employment relative to the growth of the economy. This is what modernization entails and it is precisely for this reason that modernization, especially in the early stages, is accompanied by an increase in unemployment and, it seems, by increased inequality.

This creates a risk that states with strong socialist (or egalitarian) traditions will adopt measures to counteract the short term negative consequences of modernization. Such measures will undoubtedly impede the prospects for technological and institutional modernization.

Modernization of the welfare state: Another major difficulty of the present crisis consists in the need for a fundamental transformation of those branches of the economy responsible for the development of human capital. There will need to be a new model for the functioning of the welfare state.

The crisis of the welfare state in industrial society is one of the fundamental causes of the present global crisis. The imbalances of the developed countries are due to uninterrupted expansion of their budgets for the purposes of redistribution in favour of particular population groups. Whereas at the turn of the nineteenth-twentieth centuries this redistribution was on a modest scale and benefited groups that were small in numbers, by the beginning of the twenty first century circumstances had altered dramatically. Now the overwhelming majority of the population benefits from education, health care and pensions and this provision is funded to a significant degree by a redistribution of resources from the state budget. Furthermore, the demographic development of many developed countries is such that the proportion of the population that provides the resources available for distribution is shrinking, whilst the proportion of beneficiaries increasing.

If we analyse the geographical distribution of the crisis, we note that conditions are most severe in those countries where the burden of state social expenditure is particularly high (that is, in Europe) and amongst these countries there is greatest suffering where social expenditure has to be supported by the lowest productivity of labour (southern Europe). The crisis has had less of an impact in the USA and in the post-Soviet countries where the welfare state is less developed. Finally, the crisis has had least impact in the new industrial countries (we are referring not to a recession but to a deceleration of growth rates) that have not yet had time to create systems of social support on a par with the standards of industrial society.

It is not only the redistributive model of the welfare state that has come under scrutiny during the global crisis: the instability of financial markets has created serious problems in the short and medium term for private savings invested in securities. It is now difficult to find financial instruments that combine reliability, liquidity and satisfactory yields. The decline in revenues from securities has cast doubt over the reliability of existing forms of social insurance and provided grounds for a reappraisal of the insurance model of the welfare state and a search for new ways of funding welfare.

All of the most developed countries are therefore faced with the problem of creating of a new kind of welfare state. And there is hardly anywhere they can turn for advice, for systems that are capable of dealing with the challenges of the present era do not exist in any country. Indeed, a country that succeeds in creating an effective model for the creation of human capital in present circumstances will obtain a powerful competitive advantage in the post-industrial era.

The welfare state in post-industrial society will differ significantly from that of the industrial period and a search for the principles upon which it should be founded is already under way. In all probability, the key features of a new system will include the following:

- continuing and life-long provision, whereby people study and obtain health-care throughout their entire lives;
- the individualization of services, that is the opportunity for individual to define their own educational needs and programmes for health care, choosing from a variety of available educational and medical services. In the sphere of pensions, this will imply a significant diversification of the forms of support available to older age groups;

- a globalization of service provision and international competition for clients, whereby educational and medical institutions compete not with neighbouring schools or hospitals and not even with comparable institutions in their own country but on a global scale;
- the privatization of social services accompanied by an increase in the role of private expenditure on the development of human capital – private payment or contributory payments can be said to be not only the natural but even the unavoidable consequence of the technological modernization of the institutions of human capital and precondition for the growth of wellbeing of the population;
- the creation of new technologies that radically alter the character of the services offered by these sectors.⁵

The choices that will be made by the rapidly developing countries of Asia are of particular interest in this regard. Only now are these countries approaching the level of economic development that enabled welfare state systems based on redistribution to be established in the West and in Russia during the twentieth century. Will these countries look to the experience of the past and adopt the tried and tested model? Or will they attempt to construct a new model based on new principles? Singapore, which has not adopted the Western model, provides an interesting case study. However the experience of Singapore may not be widely applicable, given that it has a population of only 5 million.

Macroeconomic problems: The present crisis in global macroeconomic relations differs significantly from its two predecessors. In the 1930s the main problems were deflation, recession and mass unemployment and during the 1970s the principal issue was stagflation, that is a combination of high rates of inflation, high unemployment and low (or zero) growth. In the current crisis, the main problem is the debt burden, which is limiting the scope of the developed countries for budgetary flexibility and which has also demonstrated the ineffectiveness of exchange rate policy for the stimulation of economic growth. This last is a problem not only for the Eurozone, where adjustment of the exchange rate is clearly impossible, but for a majority of other countries where such adjustments have had no positive impact whatsoever (with the exception, so some limited extent, of Switzerland and China).

Last year, the problems in macroeconomic policy requiring solution if the present crisis is to be overcome, were clearly defined. At this stage there is an awareness only of the problems there are no solutions on the horizon. Clearly, the search for solutions will be a priority for economists and politicians in the coming months and, probably, years.

We need to be particularly aware of the medium and long-term consequences of monetary easing, a policy that is unprecedented in economic history and which has no theoretical justification. Whether this policy has been effective will only be known after several years of implementation. In the leading countries this experiment will severely test the ability of monetary authorities to control inflation.

During the last year discussion of the relationship between budgetary consolidation and economic growth reached a dead end. The discussion in many respects resembled polemics in Russia during the first half of the 1990s over the possibilities for monetary stimulation of growth in circumstances in which profound structural reforms were being envisaged that would inevitably result in the closure of enterprises. Certainly, Russia at that time was experiencing triple digit inflation. In the Eurozone, levels of inflation are not at high and the principal stimulus

⁵ For more detail, see Mau Vladimir, *Social Capital and the Challenges of Global Transformation*, L.: CRCE, 2013.

for growth is provided by budgetary policy, that is with by preservation for an extended period of a high level of government debt. Here, no single outcome can be predicted. Everything will depend upon how far the markets will be willing to bear the risks of countries with high budget deficits and to refinance the debt of countries that have high levels of debt with a primary budget surplus.

For all its importance, the debate over “consolidation or growth” is a debate over tactics. In the long run, decisions will have to be taken to reduce government debt since the experience of the last few years had demonstrated that for an economy relying on debt (upon investors willing to purchase their sovereign debt) the transition from financial stability to financial catastrophe can be very sudden. The problem is particularly acute when the debt crisis cannot be eased by measures of currency regulation. Clearly, the journey of the Eurozone along the path of further budgetary and fiscal integration will require measures to limit the budget deficits of countries that belong to the single currency.⁶

Russia in search of economic stability

Against a background of global instability and by contrast with the developed market economies, the Russian economy in 2012 achieved positive results (See Table 1). The economy continued to grow, albeit at a modest rate – GDP grew by approximately 4% and industry by approximately 3%. One important feature of this economic growth was that it was achieved primarily thanks to internal demand (investment grew by about 7% and consumption by about 6%).

One important development last year was a slowing down in the growth of imports, which increased by only 4% without any noticeable increase in the volume of exports. The reasons are not entirely clear, but three possible explanations have been put forward. Firstly, a floating exchange rate and a nominal depreciation of the rouble may have enabled output to become more competitive in catering for domestic demand. Secondly, a weakening of investment activity and a corresponding reduction in the import of investment goods (primarily of equipment) may have had an effect. Thirdly, the Customs Union may have enabled goods to be brought into Russia through partner countries without being recorded as imports. At present we do not know which of these three explanations is valid, but it is clear that only the first has positive implications for the country’s economic development.

Although inflation increased somewhat during 2012 it remained under control and there are indications that it will decline in 2013. Government debt remains low and the budget is in balance. A positive balance on current account has been maintained. Direct foreign investments are increasing, although there is also a significant outflow of capital.

Amongst new developments we should note the advent of positive real interest rates and the fact that borrowing by the population now exceeds the growth in deposits. This is indicative

⁶ In any reform of the budgetary and fiscal policy of the Eurozone there are lessons to be learned from the experience of the United States, where, following a number of defaults during the first half of the nineteenth century, the government adopted a policy of “no deficits”. This did not mean no borrowing; rather the government borrow not to cover budget deficits but to invest in particular projects. The cost of servicing and repayment of the debts figured as expenditure in the current budget. See K.R.Henning and M.Kessler, *Fiscal Federalism: US History for Architects of Europe’s Fiscal Union*. Brussels: Bruegel, 2012).

of a change in the attitude of domestic households towards savings and of a transition to a model of consumption based on credit.

To sum up, there have been no significant changes to macroeconomic indicators since 2011 but in conditions of global crisis this is no mean achievement. In the world economy, Russia can be seen as a country of stable growth based on internal demand, with a balanced budget, a low level of debt, significant currency reserves and positive real interest rates.

However, despite this favourable picture – and, if truth be told, in comparison with the majority of other countries, the strategic outlook does not provide grounds for complacency or unqualified optimism.

One macroeconomic development has been a slowing of economic growth towards the end of 2012. This was a cause of concern to some politicians and economists who take the view that a level of growth of at least 5% is essential to ensure stable socio-economic (and even political) development. In our opinion, it is not the rate of growth that is critical: for one thing, Russia cannot count upon high growth rates at a time when its principal economic partner, the European Union, has entered into recession; for another, the quality and structure of growth of the economy and the contribution of growth to modernization are more important than growth rates as such. A nervous response to a slowing down of growth rates that took the form of an artificial expansion of government demand, disturbing macroeconomic equilibrium, would be much more dangerous (we consider this problem in more detail below).

It is important to keep in mind *four long-term issues* in the socio-economic development of Russia. These in the final analysis, are associated with low and diminishing growth rates.

Firstly, there is the absence of in-built stimuli acting in favour of modernization. The recovery of the economy to pre-crisis levels was achieved at the cost of a regression of the branch structure of the economy: the extraction of raw materials exceeded pre-crisis levels by 5% and processed output exceeded pre-crisis levels by approximately 1% (See Table 2 and Figure 1). The production of traditional Russian exports (coke and petroleum products, chemical goods, rubber and plastic goods) recovered, but the recovery of metallurgical output was slow, owing to weak demand for metal and a fall in world prices attributable to the lag in the emergence of the world economy from the crisis. There was a marked growth in the production of means of transportation (attributable for the most part to automobiles construction) but this has almost reached its limit.

By contrast, a decline in the production of investment related goods (construction materials, machinery, electrical equipment, electronic and optical equipment) continued. In 2012 output was approximately 14% lower than pre-crisis levels. The value of construction projects continued to be 10% lower than before the crisis.

Secondly, the outflow of capital continues significantly to exceed the inflow. Of course, one can argue that given high prices for Russian export goods the country is generating more capital than it can “digest” – taking into account its limitations in material and human resources. However, in an open economy limited opportunities for the productive use of capital are also an indicator of the poor quality of the investment climate.

Thirdly, the low level of unemployment is unprecedented. Of course, in the current political climate, this makes an important contribution to stability. However, the low level of unemployment is also symptomatic of the absence of meaningful structural change. In conditions of modernization, the growth of employment would lag behind economic growth and for that reason the post-crisis recovery (we are referring to structural crisis and not to cyclical crisis) would be accompanied by continuing high levels of unemployment. This is precisely the phenomenon that we observe at the present time in the USA. The governments of democratic

countries often find it difficult to accept that unemployment can be a consequence of modernization and often adopt measures designed artificially to support high levels of employment, regardless of the negative impact of such policies on the quality of the technological infrastructure.

Fourthly, there is a tendency on the part of many members of the educated strata (the “creative class”) to direct their attention abroad. We are referring here not to formal emigration. Rather, an increasing number of prosperous Russians are seeking medical care and education abroad, acquiring property abroad and sending their children to be educated abroad and reside permanently in another country. According to recent polls, (*Valdai Club*, October 2012) approximately 70% of Russians of above average income would like their children to be educated and work abroad and over a third of those above average income or over a third of this 70% would like their children to reside abroad permanently. From a strategic point of view this trend is harmful, since it means that a qualitatively sustainable demand for education and health care is being directed beyond the frontiers of Russia. As we know, good universities and institutions of health care flourish primarily in places where there is a demand for their services.

It is becoming all the more easy for the élite to pursue this “exit strategy” as the transaction costs of departure continue to fall. The causes are globalization and the growing prosperity of Russia’s citizens. During the last 25 year there have been fundamental changes in the socio-political attitudes of the active citizenry: whereas in the past members of the creative class sought to improve their standard of living within the boundaries of Russia, they now find it easier and cheaper to change their country of residence. This has been made all the more feasible by globalization: it is now possible to earn money in one country and enjoy the advantages of civilization (and create a sustainable demand for these advantages) in another.

There can be no quick remedy for this state of affairs. These are qualitative problems of the development of Russian society and they are indicative of the kinds of impediment that exist to modernization and not least of the difficulty of developing a market for innovation. Finding a solution will require not only time but also the political will to implement serious institutional reforms.

One can obtain some insight into the current problems of Russian socio-economic development and into the difficulties that might lie ahead from a comparison with the macro-economic conditions that obtained in the USSR at the turn of the 1970s and 1980s.

- At that time, as now, the Western world was experiencing a structural crisis. It was described by the Communist Party of the Soviet Union as “the third stage in the general crisis of capitalism”. Towards the end of the 1970s the crisis was coming to an end and a new paradigm for economic policy had emerged, involving deregulation. This policy was most consistently and successfully implemented by the administrations of Margaret Thatcher (from 1979) and Ronald Reagan (from 1981).
- The Soviet economy at this time, unlike the economies of the west, was experiencing growth, albeit a moderate rates of 2-3 percent per annum.
- Oil prices were at a peak, and, in constant prices, were at approximately at present day levels. The Soviet government actively encouraged the growth of energy exports;
- The budget was in balance, but all of the revenues from the export of hydrocarbons were used to cover budgetary expenditures;

- Gas pipelines were constructed for the delivery of gas to Western Europe (the Urenga-Pomara-Uzhgorod pipeline) as part of a new economic model whereby “oil and gas” were exchanged from “food and machinery”;
- There was a low level of inflation, albeit with signs of a growing shortage of goods (where prices are fixed this is a form of inflation), a modest sovereign debt and full employment;
- The Soviet political system was extraordinarily rigid and incapable of reacting flexibly to new global challenges (whether technological, economic or political).

At that time it was thought that the Soviet economy was enjoying stable growth, in contrast with the crisis in the West. Only later did it become clear that the market-based democracies were going through a period of structural and technological modernization and that the foundations were being laid for a qualitative leap forward, whereas the Soviet Union was doing no more than conserving its existing economic structure and becoming a hostage to fluctuations in raw materials prices over which the government had no control.

Current circumstances are somewhat different. Russia has learned the lessons of the past and has accumulated significant financial reserves. Budgetary policy takes into account the risks of fluctuations in the international conjuncture even if, as a result of the crisis, the federal budget has begun almost completely to absorb revenues from the export of energy resources. Sovereign debt is much lower than it was under the USSR. The openness of the economy and the existence of private property are completely new factors. The political system, of course, is much more flexible than during the Soviet period. The government appreciates the need for a radical improvement in the investment climate and the importance of encouraging private enterprise. This has been reflected in the adoption of a target of joining the “top twenty” countries in the World Bank’s “Doing Business” ratings (Russia’s present position is 120th).

However, there are also similarities with the circumstances of thirty years ago. The main problem is a resistance to innovation and, more broadly, to modernization. The availability of natural resources and of financial reserves are a serious impediment to institutional and technological renewal. The most obvious indicators of this are the deterioration in the branch structure of the economy during the last four years and an unprecedented low level of unemployment. As the Soviet experience showed, stability can very easily turn into stagnation and the path from economic stability to economic catastrophe can be very short.

A comparison with the late Soviet period is all the more relevant in that during 2012 the appraisal of political and economic options bore a close resemblance to debates of the 1980s. The draft prognosis of the socio-economic development of Russia to the year 2030 prepared by the Ministry for Economic Development considered three scenarios – one conservative, one based on innovation and a third that was “forced” or goal oriented.

The *conservative* scenario assumed stagnating growth at a decelerating growth rate of 2.7-3.1%. Growth would be based on the exploitation of competitive advantages in the raw materials sector and assumed a continuing lag in the high- and medium- tech sectors of the economy. Macroeconomic stability would be ensured by a conservative budgetary policy. Modernization would be achieved, for the most part, by the import of technology and equipment. Innovation would be achieved mainly in the energy and raw materials sectors.

The “*innovation*” scenario supplemented the *conservative* scenario by proposing a diversification of production and exports. This would require the modernization of institutions and of production. Of vital importance would be an improvement in the investment climate, the encouragement of entrepreneurship, and a marked improvement in the quality of public services and state administration. In the sphere of technology it was envisaged that there would be an active development of the transport infrastructure and development of a number of branches of technology in which Russia, traditionally, has been strong: the aviation and space industries,

atomic technology, services linked to the space industry and so forth. The government would radically modernize the social infrastructure with a view to bringing about a dynamic development of human capital. Under this scenario, budgetary policy would remain conservative. GDP would grow by 4%.

The “*forced*” scenario implied a structural shift whereby the value of gross accumulation of basic capital would increase to 30-33% of GDP from the current 20%. This would be accompanied by a reduction in the share of household expenditure in consumption. There would be an active utilization of national savings and an increase in the inflow of foreign capital to a level of 65% of GDP. State expenditure on production and transport infrastructure would significantly increase. There would be a dramatic diversification of exports accompanied by a 10% increase in the export of machinery and equipment by 2030. However the volume of exports in GDP would fall from the present level of 27% to 19%. There would be a significant reduction of imports for consumption. This scenario envisaged an alteration in demographic trends: an increase in population including an increase in the numbers of those of working age. Clearly, this scenario is fraught with macroeconomic risks in so far as presupposed a stable budget deficit, an increase in government debt, and a deficit in the current balance of payments. As the authors of this scenario themselves admit, it would increase the vulnerability of the economy to external shocks.

Three scenarios, or options, of structural modernisation are deeply rooted in the Russian economic history of the 20th century. One can remember economic policy debates of the 1920ies and 1980ies as well as practical consequences of these debates. At those periods Soviet authorities faced with severe domestic and international structural challenges.

In the 1920ies the key question was about the prospects and patterns of industrialisation, the possibility to solve this task on the basis of market institutions still existed in the USSR. Three main approaches to this problem were developed at that time⁷.

First of all there was a policy of natural (organic) growth when agriculture creates demand and financial resources from grain export for industrialisation. This approach was based on ‘genetic’ system of national planning as extrapolation of growth rates. It was developed by Nikolai Kondrat’ev, Nikolai Makarov, Lev Shanin, Albert Wainstein and other economists mostly concentrated around Narkomfin (Commissariat of Finance) and Institute of Conjuncture. Head of Narkomfin Grigorii Sokol’nikov shared these views since he was concerned about financial and monetary stability.

Another group of economists and politicians (Nikolai Bukharin, Vladimir Bazarov, Aleksander Ginzburg) put forward active policy of industrialization based on development of new social institutions, although they presumed maintaining macroeconomic equilibrium. They recommend combination of genetic and teleological approaches to national planning with more active financial policy stimulating structural change. One may call it a policy of balanced industrialization.

In practice the Soviet government realized the policy of forced industrialization which destroyed economic equilibrium. Radical structural transformation based on forced redistribution of finance from consumption to accumulation and investment, from agriculture to heavy industry. Macroeconomic destabilization was a natural result of this model. The model was

⁷ Jasny Naum. Soviet Economists of the Twenties: Names to be Remembered. Cambridge: At the University Press, 1972.

described by Eugene Preobrazhenski and practically realized by Josef Stalin and Valerian Kuibyshev⁸.

Three scenarios are also familiar to those who have studied the economic policies of the 1980s. At that time they were known as the policies of “stagnation”, “perestroika” and “accelerated development”. “Stagnation” implied a continuation of economic development based on a favourable external economic conjuncture, an expansion of imports of consumer goods and of the means of production. “Perestroika” gave priority to institutional reforms, the development of human capital (the anti-alcohol campaign, “glasnost”, granting more independence to enterprises and labour collectives, the encouragement of cooperative and individual entrepreneurship). “Accelerated development” implied a structural shift based on an increase in the share of accumulation in GDP and a reduction in the share of consumption, as the bases for the growth of investments and technological modernization. The last two scenarios were accompanied by massive external and internal borrowing, at first to promote the export of technology and later and to an even greater extent, of food.

The macroeconomic risks involved in the policy of accelerated development were evident. In the event, the early implementation of structural and institutional reforms coincided with a sharp fall in the very energy prices that had, until that time, guaranteed the stability of the Soviet economy. The consequences followed ineluctably.

Priorities in medium term economic policy.

Irrespective of global instability and macroeconomic risks, it is indisputable that the principal objective of Russia socio-economic policy should be to provide *incentives for modernization*.

Any approach to modernization will have to take into account the multi-faceted nature of the task involved. The following objectives will have to be pursued at one and the same time:

- *Technological modernization.* This will involve the creation of millions of highly qualified (hi-tech) jobs. (Vladimir Putin has set as an objective the creation of 25 million jobs of this kind). This objective is incompatible with a policy that takes the preservation of existing jobs and a low level of unemployment as criteria for evaluating the performance of regional administrations;
- *Economic modernization.* This means a diversification of the economy and an overcoming of our dependence on the fluctuations of world energy prices. There will have to be a reduction of the non oil and gas deficit and a qualitative improvement in the investment climate;
- *Social modernization.* This means that the middle class must become the dominant class in Russian society and that the performance of healthcare institutions and of the pension system must become much more efficient and more equitable;
- *Modernization of the military-industrial and security sectors.* The work of these institutions must be directed towards the effective defence of the rights and freedoms of the citizen, whatever the citizen’s social origin;
- And finally, *political modernization.* This means that access to and exercise of political and economic freedoms must be brought up to Western standards.

⁸ Erlich A. *The Soviet Industrialization Debate, 1924-1928*. Cambridge, MA: Harvard University Press, 1960.

Experience of the last decade has revealed the existence of at least two major obstacles to modernization. These are of a systemic nature and will require special measures if they are to be overcome.

First amongst these is the absence of any demand for modernization. The fact that everyone agrees on the need for modernization does not mean that there are powerful social groups within society who are willing to invest in the process. The attainment of socio-political stability and the availability of substantial financial reserves serve as disincentives to modernize, despite the fact that the advent of a structural crisis has provided conditions that are optimal for this kind of change. What we have learned from the last decade is that the Stabilization Fund (whether it be call “Reserve Fund” or “Fund for Future Generations”) can serve not only as an instrument for macroeconomic stabilization, not only as a “buffer” in the event of a crisis, but also as an excuse for postponing essential reforms.

The government, of course (the top leadership) has a manifest political interest in modernization. Based as it is on the state corporations and other state institutions, the government attempts to nudge society along the path of modernization and innovation, but its efforts are doomed to failure given a lack of support from economic actors. Nor are the policies of the political leadership always consistent: notably, a policy in favour of the creation of millions of new highly qualified jobs is accompanied by an insistence on maintaining high levels of employment. This is equivalent to a veto on the closure of unviable enterprises. Yet it is evident that in a country where the population is, at the very least, not increasing, and where there is no labour reserve in the rural areas, the creation of new jobs must entail a reduction in the number of old jobs.

The second obstacle is the “competitiveness trap” whereby high-cost labour exists alongside inefficient institutions. It is usual for investment activity to be high either in countries where labour is cheap (where high profits permit risk-taking) or in countries where, even if labour costs are high, institutions are effective. In Russia, labour costs are comparatively high (they are amongst the highest in countries with developing markets) but the quality of the institutional environment is relatively poor. This is reflected in Russia’s position in the World Bank rating “Doing Business” and in a number of other indicators of the quality of institutions. This is the background to the fact that the services sector and the raw materials sector (the extraction of raw materials) succeed in being competitive and in dominating Russian development.

There are two ways out of escaping from this trap: either institutions must be brought into line with the labour force or the labour force must be brought into line with the quality of our institutions. Most Russian economists, for understandable reasons, prefer to think in terms of the improvement of institutions. But the option of reducing labour costs should not be ruled out.

The priorities of the government with regard to modernization of the economy are well known and have hardly changed since mid2000ies. These priorities were enumerated in the first decrees of Vladimir Putin on the occasion of his appointment as President of the Russian Federation on 7 May 2012. Let us consider only those tasks that were given special attention in 2012.

Improvement in the climate for investment and entrepreneurship. Russia’s position in the “Doing Business” rating has improved somewhat, from 120th to 112th. This provides some grounds for satisfaction but it is completely inadequate when set alongside the objective of joining the “top twenty” by 2018. The improvement was predominantly due to the score under the heading “Paying taxes”. The score for other indicators taken together reported hardly any improvement (+15 points for improvement; -12 points for deterioration).

Besides, by three criteria Russia scores particularly badly – and these three criteria, which are out of line with other developmental parameters, account for the abnormally low position of Russia in the overall rating. They are “Dealing with construction permits” (178th position amongst 185 countries); “Getting electricity” (184th position) and “Trading across borders” (162nd position). Unless there can be significant improvements under these headings it will be impossible for Russia to rise in the ratings.

At the moment, improvement in the investment climate is an important indicator in the performance assessment of Federal and regional institutions of government.

Of course, it would make sense, while striving for a dramatic improvement in Russia’s position in the “Doing Business” ratings, to improve Russia’s position in other international ratings that more or less reflect entrepreneurial activity: in ratings of government efficiency, economic freedom and so on. All ratings have their drawbacks and limitations but this in itself is an argument in favour of measuring progress in Russia by to a range of international criteria rather by one set alone.

A careful (conservative) budget policy: Discussions of budget policy of late have revolved around the key question, whether the principal function of the budget in conditions of global crisis should be to guarantee the stability of the economy or facilitate structural transformation. Of course, both objectives are desirable but in practice it is a dilemma to know what risks can be taken with the budget even if these are justified by the goal of modernization. This is a difficult question. It cannot be answered theoretically, but only politically.

The lessons of the 1980s suggest that budgetary conservatism is advisable. But the experience of the past is not an infallible guide when dealing with problems that lie ahead.

One important achievement in 2012 was the adoption of a budgetary rule limiting the use of oil and gas revenues in the current account and introducing limits on the parameters of government debt. In a country that is reliant upon rent from raw materials this was a necessary measure and it will reduce our vulnerability to external shocks. At the same time, this measure severely restricts opportunities for assisting those sectors of the economy that have been prioritized for modernization.

Such support can be provided by management of expenditure, by reducing expenditures in some sectors and increasing them in others. However, politically, such decisions are always pointless, especially if the state disposes of substantial resources and has a low level of debt. The temptation of an expansionist budgetary policy is indulged at the cost of a weakening of budgetary control. Such choices are political and in 2013 observance of budgetary rules will be one of the principal responsibilities of the government. Worst of all would be a disregard of budgetary prudence that was not accompanied by a strict prohibition of any increase in government debt.

The management of a floating exchange rate has been one of the most important achievements of monetary policy. The increase in inflation during 2012 was most probably temporary and in the year ahead inflation will fall. A new and very important development was the fact that real interest rates on deposits became positive. In the medium term, monetary policy must aim to create conditions conducive to the adoption of the rouble as a regional reserve currency. This is all the more important given that the global crisis has drawn attention to the need for a reconfiguration of reserve currencies.

The modernization of the welfare state is another priority. It is essential that the welfare state should be reconstructed along lines that correspond to the needs of post-industrial society. This must be achieved while taking into account the imperatives of welfare, fiscal and investment policy.

In 2012 particular attention was given to the modernization of the pension system and especially to the fiscal and socio-political aspects of this question: how could the Pension Fund be kept in balance and under what system (distribute or cumulative) could citizens who had entered retirement during the current political cycle be paid a large pension? In most respects, the government opted for a redistributive system. However, the problems associated with the pension system that we have outlined above, will not go away.

Discussion of the problems of the educational and health care systems got underway. The main objective for both sectors is that they should become internationally competitive.

The open economy: Joining the WTO and the development of a Eurasian economic space have made an important contribution to the openness of Russia's economic relations. The principal purpose of openness is to promote competitiveness as a critically important factor driving modernization. Here we are talking not only of the competitiveness of goods and services but also of the competitiveness of jurisdictions. This last, which is a relatively new consideration and a direct consequence of globalization, occasionally encounters resistance on the part of lawyers and politicians, though from an economic point of view competition amongst jurisdictions can serve as an important stimulus for the improvement of the entrepreneurial environment.

2012 was a turning point in the development of the Russian and of the world economy. No one had foreseen events of such importance. This was a year of accumulation of the resources (material resources and institutions) that will determine the shape of the world system that will emerge from the crisis. In this world there will be a new geo-political and a new geo-economic equilibrium. In two or three years time we shall have a clearer picture of what this world will look like. Critical decisions will soon have to be taken by the national élites of the leading countries and the place that their countries will occupy in the post-crisis scheme of things will depend upon the breadth of their vision and the boldness of their initiatives.

Table 1. Economic development of Russia 2007-2012

	2007	2008	2009	2010	2011	2012
ВВП, рост в % Growth of GDP %	8.5	5.2	-7.8	4.3	4.3	3.9 ⁹
Промышленность Industry	6.8	0.6	-9.3	8.2	4.7	2.7 ¹⁰
Сельское хозяйство Agriculture	3.3	10.8	1.4	-11.3	23.0	-4.2 ²
Final consumption (households)	14.3	10.6	-5.1	5.5	6.4	6.6 ¹
Investments in fixed assets	22.7	9.9	-15.7	6.0	8.3	8.4 ²
Surplus («+») / Deficit («-») of consolidated budget as % of GDP	6.0	4.9	-6.3	-3.5	1.6	3.6 ¹¹
Reserve Fund (from 2007 "Stabilization Fund") end of year, billion \$	156.81	137.09	60.52	25.44	25.21	61.40 ¹²
National Welfare Fund, end of year, billion \$		87.97	91.56	88.44	86.79	87.47 ⁴
Consumer Price Index December to December	11.9	13.3	8.8	8.8	6.1	6.5 ¹³
Producer Price Index December to December	25.1	-7.0	13.9	16.7	12.0	1.1 ⁵
Average interest rate on loans to enterprises in roubles	10.0	12.2	15.3	10.8	8.5	9.1 ¹⁴
Average interest rate on deposit accounts of physical persons (excluding deposits on current accounts)	7.2	7.6	10.4	6.8	5.4	6.5 ⁶

⁹ January-September 2012 relative to January-September 2011

¹⁰ January-September 2012 relative to January-September 2011

¹¹ For January-September

¹² To 1.12.2012

¹³ November 2012 relative to November 2011.

¹⁴ For January to October.

General level of unemployment (MOT methodology), end of period	6.1	7.8	8.2	7.2	6.1	5.3 ¹⁵
Average wages (thousand roubles)	13.6	17.3	18.6	21.0	23.4	26.0 ¹⁶
Level of Savings as % of disposable income	23.0	16.5	22.5	23.3	18.4	16.5 ⁸
Balance of payments, billion \$						
Current account	77.8	103.5	48.6	71.1	98.8	63.9 ³
Balance of trade	130.9	179.7	111.6	152.0	198.2	113.7 ³
Exports	354.4	471.6	303.4	400.6	522.0	435.6 ³
Imports	-223.5	-291.9	-191.8	-248.6	-323.8	-321.8 ³
Direct investments	9.2	19.4	-7.2	-9.2	-14.4	-4.4 ³
In the economy of the Russian Federation	55.1	75.0	36.5	43.3	52.9	33.1 ³
Abroad	-45.9	-55.6	-43.7	-52.5	-67.3	-37.5 ³
Reserve assets («-» - growth)	-148.9	38.9	-3.4	-36.8	-12.6	-21.1 ³

¹⁵ To end October 2012.

¹⁶ For January-November.

Table 2. Results of adjusted growth: growth of industrial output January-September 2012 / January-September 2008 %

Total industrial output	2.7
Raw materials extraction	5.0
Processing industries	1.2
Production of consumer goods (food and goods of national consumption (TNP))	6.6
o food products	9.3
o textiles and fabrics	-9.3
o leather, leather goods, footwear	9.9
o other goods	-0.3
Production of goods of intermediate demand	3.2
o Coke and petroleum products	9.2
o Output of chemical industry	7.9
o Rubber and plastic goods	23.3
o Metal and finished metal goods	-3.5
Output of means of transport and transport equipment	17.0
Forestry, wood processing, pulp and paper industry (LDTsB)	-7.1
o Timber processing and output of goods in wood	-8.2
o Pulp and paper industry: publishing and printing	-6.6
Production of goods of investment demand	-14.1
o Building materials	-10.4
o Machinery and equipment	-19.1
o Electrical equipment, electronic and optical equipment	-13.0
Производство и распределение электроэнергии, газа и воды	0.7
Additionally:	
Investments in basic capital	-6.9
Commercial transport turnover	-0.6
Construction	-10.7

Source: Rosstat, CSR

Figure 1. Recovery of output and price competitiveness

