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The drama of 2008: from economic miracle to economic crisis

Electronic Publications of Pan-European Institute 11/2009

ISSN 1795 - 5076

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11/2009

Electronic Publications of

Pan-European Institute

www.tse.fi/pei

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Foreword

The main characteristic of 2008 – the one that will make it stand out in the economic history of both Russia and the world - is the rapidity with which the current economic crisis was developing, as well as the rapidity of the initial euphoria being replaced by the anticipation of doom. It took only several months for Russia and a number of other developing markets to travel all the way from the expectation of an economic miracle to anticipating an economic collapse. Over the past year, we traversed three stages of understanding the crisis which had began a year earlier in the USA.

Stage 1. The first months of the year demonstrated stable (and even growing) rates of growth, which was taking place against the background of booming prices for major Russian exports and low interest rates at the international financial market. While the financial crisis in the West was pushing down interest rates, there was an impression that a new powerful long-term factor of growth had come into play alongside the unshakably high prices of energy carriers. One of the hobby-horses of the Russian political elite was to discuss the issue of Russia's prospects by the year 2020 and to muse whether by that time the country would become the fifth or six largest economy in the world in terms of the volume of GDP.

Stage 2. The spread of the crisis from the USA to Europe, with the rates of growth remaining high in China, India and Russia, conduced to the theory of decoupling rapidly coming into fashion: according to this theory, it is the developing countries that would become the motor capable of stopping the crisis and to pulling out the developed countries from the situation of the already apparent deceleration of economic growth.

Stage 3. In August – September it became clear that the financial crisis was developing into an economic and global one, which meant that it would envelope all the major economies of the world – both in developed and developing countries. The situation of most of the economies, recently so proud of their successes, turned out to be shaky and fragile, and their political prospects – rather vague.

It cannot be said that the crisis was completely unexpected. In early 2008, we pointed to the instability of the two major factors forming the basis of Russian economic growth: the high prices of energy resources, and the presence of cheap money on world financial markets. And it should be remembered that the institutional environment - that is, the only thing that could create a stable foundation for economic growth, is still rather undeveloped in Russia, which means that Russian political institutions are unlikely to be able to soften and alleviate the consequences of a worsening economic and political situation.

Among the major sources of the crisis, one could single out the following factors: the beginning of global deceleration of economic growth; the fall in the prices of oil and other Russian exports; the emergence of deficit in the balance of payments, which resulted in the country's growing dependence on the inflow of foreign investments; the rapidly increasing external debt of Russian companies and a high probability of them becoming incapable of repaying their debts without being helped by the State in the event of a crisis; and also the dubious efficiency of many investment projects that had been started on the crest of the boom wave and were unlikely to survive a trial by crisis. Finally, in the course of its eight years of plenty, Russia produced a generation of politicians accustomed to 'managing the growth of affluence" and quickly forgetting anything concerned with crisis management, and similar attitudes were on the rise among the general public.[2]

Suddenly the pessimistic forecasts became the reality. Moreover, the toughest scenario came true as well: the two main sources of Russia's economic growth evaporated simultaneously – prices for major Russian exports collapsed, and cheap financial resources disappeared from the world market.

The crisis has begun. Were we ready for it? If yes, to what extent?

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

1 The peculiarities of the present crisis

First of all, it would be necessary to address the nature of the present crisis. Of course, all the assessments we are going to offer are only preliminary, because the events are unfolding very rapidly and require constant reconsidering.

Over the past eight years, the Russian political and economic elite was busily bracing up for a crisis modeled on the one experienced back in 1998, so as not to repeat their previous mistakes. To a considerable degree, the lessons of the past were well learnt. But the situation turned out to be different. The crisis which unraveled ten years ago was brought to life by internal factors, such as the weakness of the authorities incapable of pursuing a responsible macroeconomic (first of all, budgetary) policy. Nowadays, Russia – for the first time in a hundred years – is confronted with a world crisis as a part of the global economic and financial system. Thus, Russia is gradually becoming a normal market economy.

However, the crisis unraveling in front of our eyes clearly falls outside the scope of a common cyclic one. What makes it unique is its thee specific features.

Feature one. The scope of this crisis which has begun in conditions of globalization is unprecedented, for it involves practically all the countries and regions which have been demonstrating dynamic development over the past ten years. We can see one important regularity: the countries most affected by the crisis are those that were the most successful ones in the previous decade, while stagnant countries and regions, on the contrary, suffer much less from its effects. This phenomenon is also typical of the internal-economic situation in individual states including Russia: the most serious problems are observed in the regions which underwent an economic boom, while the depressed regions experience practically no changes in their situation. This significantly complicates any exit from crisis: it is unclear as to who will be capable of becoming the locomotive of growth recovery.

Feature two. As the current crisis is structural by nature, it can be inferred that the structure of the world economy and its technological basis will be significantly renovated in the future. It is still too early to specify what structural changes are to be expected, but it is already clear that they will result in a redistribution of forces between industries and regions.

Feature three. The crisis has an innovational character. In recent years, a lot has been said about the necessity of innovations and the importance for the economy to be switched over to the innovational way of development – which has, in fact, already come true in the financial space. However, the crisis actually happened as a result of the emergence and widespread use of financial innovations – or, more particularly, new financial market instruments (which, as some believed at the time, would indeed be able to create appropriate conditions for endless financial growth) – but it has turned out so that many leaders of the financial world had only a rather vague idea as to what they would really be like. The consequences of this approach were of two kinds.

On the one hand, the introduced financial innovations have considerably transformed a number of commodity markets, primarily those of the most important raw materials. Since the early 1970s, the behavior of the price of oil has been an absolutely unpredictable phenomenon. Nevertheless, it has been dependent, to a certain degree, on demand and supply, and therefore oil producers could control it – also to a certain degree. Among the indisputable historical facts one could refer to are the sharp rise in oil prices in 1973, organized by the Arab oil-exporting countries, and the calculated (and also politically motivated) actions aimed at drastically cutting oil prices in 1986. However, the subsequent development of secondary financial instruments markets has radically changed the situation. Nowadays, the price of oil has almost no relation to any actions on the part of oil-producers, and is almost irresponsive to the efforts of the OPEC and the countries linked with it. At present, the price of oil is formed at financial markets and exists inside the minds of financial brokers trading in the secondary financial instruments related to oil supplies (it should be noted that these instruments have practically nothing to do with the actual shipments of this commodity). The world is becoming not only flat, as T. Friedman put it, but also virtual, because the most important economic indicators are now formed at derivative financial instruments markets. It is unlikely that such a situation is going to last for ever, for a real deficit or surplus of material values will sooner or later manifest itself all the same. However, for the time being the fact of a considerable strengthening of the role of virtual factors in forming the most important economic ratios should by all means be taken into account.

On the other hand, the economic and political elite clearly lost control of the movement of financial instruments in the situation of the past economic boom. Therefore the current crisis could be defined as a “revolt of financial innovations” – a revolt against their own creators. Although very unpleasant, this phenomenon has repeatedly happened in history. Now it has become clear that the collapse of Barings Bank - which was ruined single-handedly in 1995 by Nick Leeson, a young trader working for its Singapore branch - was an omen of the impending crisis, a message sent to the world of finance. This message passed unnoticed.

To sum up, we should note the following.

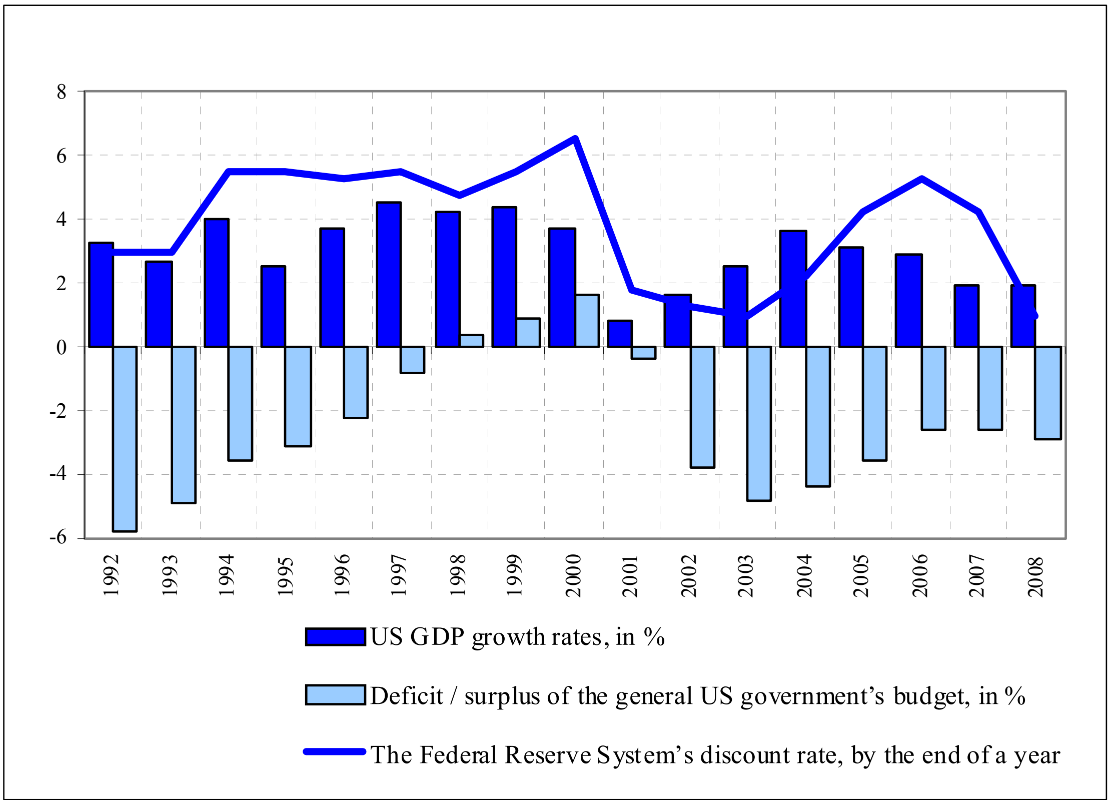
The nature and mechanisms of great economic upheavals, such as the phenomenon we are confronted with, are always mysterious and not totally explainable. Great crises are debated for decades by economists, politicians and historians, with hundreds of dissertations and thousands of scholarly articles being devoted to them. It should be said that even economic historians invariably fail to give single answers to the questions raised in connection with such crises. The phenomenon of the Great Depression of the 1930s is not completely understandable even today: the debate regarding its causes and the adequacy of Franklin Roosevelt's measures designed to exit the crisis is still far from being over.

2 The causes of the crisis

When analyzing the crisis unraveling before our eyes, it would be sensible to separately consider the three groups of causes which have made it inevitable. Firstly, there are the specific problems of the American economy; secondly, the systemic fundamental problems of current economic development; and thirdly, the specific Russian circumstances. As these factors act in different directions, and so anti-crisis measures should be designed with all the three groups being taken into consideration.

So far as the causes of the crisis are concerned, it has become a rule to criticize the activities of the US administration with regard to its inadequate budgetary and monetary policies. First of all, the case in point is its pursuance of a pro-cyclic policy after the 2001 recession, when the country continued, in conditions of economic growth, to increase its budget deficit - instead of returning to Clinton's policy of achieving a budget surplus. This was reflected, in particular, in the interest rate policy aimed at keeping interest rates low in conditions of economic growth (Figure 1).

Figure 1 The indicators of economic growth and the US budgetary system



That was a policy of artificial growth–stimulation, especially important for developed countries in connection with the double-digit economic growth of China. As a result, the governments of many countries took measures to spur growth, and the problem of overheating the economy started to look unfashionable: we have now gone too far from the Great Depression and, as it seemed, have also outgrown it intellectually. This logic was clearly shared by the Russian leadership when it set the goal of “doubling the GDP” in ten years’ time, which also fixed attention on achieving predominantly quantitative, voluminous results. But while in the case of Russia this policy was based on the presence of the capacities left spare after the crisis of the 1990s, as well as on the enormous inflow of petrodollars, the American economy had to develop in conditions of two simultaneously waged wars which could not be financed without incurring a budget deficit.

There was also an independent crisis factor, namely, the unprecedented rates of economic growth which made it possible to increase world GDP by one quarter in the course of years. Such a rise inevitably generates systemic contradictions which remain unseen due to growing well-being. And most importantly, even if the existence of these contradictions is recognized, it is very difficult to interfere in the course of events and to correct anything: why should we take any restrictive or corrective measures when everything looks great all the same? Each time when somebody starts to express doubts in the correctness of the chosen course of action or to come up with warnings in such situations of economic boom, we will hear the confident statements that “this time it is different”[3].

Globalization has yet another aspect (apart from the new instruments), which was believed to be a source of perpetual financial success and steady growth. Niell Ferguson named this phenomenon *Chimerica* (China plus America). The case in point is the formation of a global disbalance which for decades was considered to be a source of stability of economic growth. As a result, there emerged an economic regime diametrically opposite to the model of globalization which existed at the turn of the 20th century: one hundred years ago capital was moving from the center (developed countries) to the periphery (the emerging markets of that time), while nowadays it is the

[3] Kenneth Rogoff and Carmen Reinhart paid special attention to the fact that this trap for policymakers, an illusion that “this time is different” dates from England’s fourteenth-century default (See Carmen M. Reinhart and Kenneth S.Rogoff, *This Time is Different: A Panoramic View of Eight Centuries of Financial Crises*. NBER. 2008. No. 13882).

developing markets that have become savings centers, with the USA and other developed countries predominantly playing the role of consumers.[4]

Finally, the spreading crisis has the following fundamental and most important cause. The case in point is the target function of business development, which in my view has undergone a serious transformation over the past two decades. Capitalization growth has become the key orienting point for corporate development. It is this index that shareholders are now most interested in, and it is by this index that the efficiency of management is evaluated. However, the tendency to achieve maximum capitalization inevitably comes into contradiction with the real basis of socio-economic progress - that is with increase in labor productivity. Of course, capitalization growth is linked with labor productivity, but only *in the long run* - while the shareholders must be given an account annually. And for an attractive annual report to be composed, its author needs something absolutely different from the things which secure productivity growth. Your reports will be good if they reflect mergers and takeovers, because the volume of assets is conducive to capitalization growth. And it is clear that you should not shut down backward enterprises because their closure will lead to a drop in capitalization in the current period. As a result, many big industrial corporations still keep open their old and inefficient plants and enterprises.

This situation was widespread in Soviet times, though it was then called "struggle to fulfil the plan". Enterprises preferred to produce outdated products rather than to switch over to producing new ones, because innovation would have resulted in a numerical (in kilograms, meters, rubles) fall in output, thus making it impossible to fulfil and over-fulfil the plan. Some economists characterized this attitude as *planning fetishism*[5].

Apart from the general factors of the current crisis, there are some specific reasons why it is now rapidly developing in Russia. The crisis quickly spread across a country which was characterized by an especially favorable macroeconomic situation - a country which had a double surplus (of its budget and balance of payments).

[4] Ferguson N. The Ascent of Money: A Financial History of the World. Penguin Books: New York, 2008. See also Martin Wolf's comment: "In the 19th century, the world's then most advanced country ran a savings surplus (out of national income), which was invested in the fast-developing countries of the time (mainly the countries of new settlement). Now, however, the world's most advanced country has been importing savings from poor countries and using them for public and private consumption. It doesn't seem very difficult to see that this process is at best stupid and at worst unsustainable. In my view, this system - sometimes called Bretton Woods II - is at the root of today's financial crisis".

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

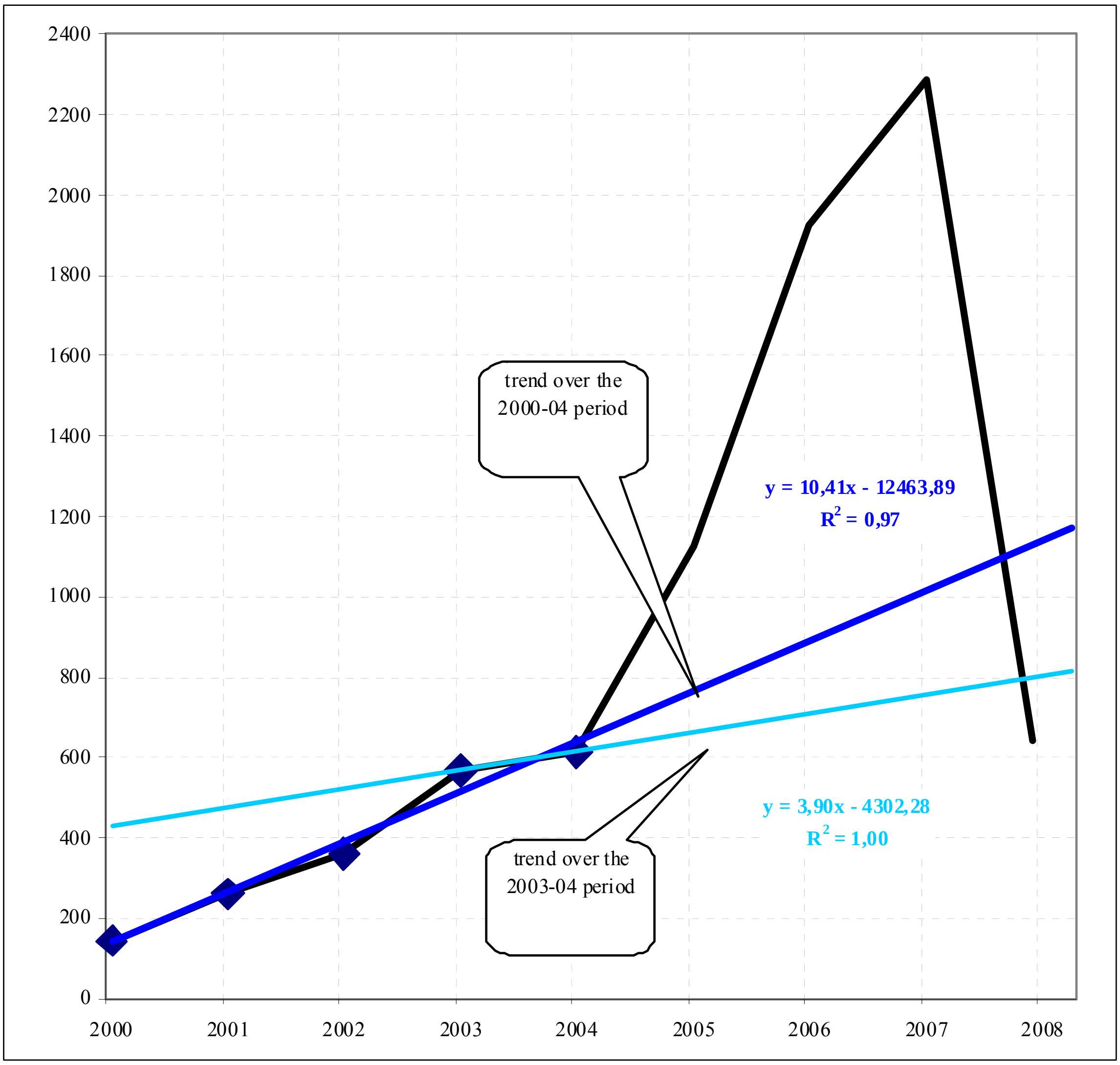
First of all, this phenomenon was the seamy side of the afore-said favorable environment. The double surplus was becoming a factor of attracting capital which actively flowed into the country - thus widening the “arm” of borrowings. And it was only natural that at the beginning of the crisis this “arm” contracted, which immediately resulted in a contraction of the stock market.

At the same time it turned out that, despite its tremendous growth in 2004 – 2007, the Russian stock market was still rudimentary, and its indices were thus capable of shrinking to a minimum. This fall in value, however dramatic it may be, has a certain internal logic. As is seen from Figure 2, the collapse of the market resulted in the stock market indices coming approximately to the point where they could have been if the 2005 leap had not taken place. The roughly triangular curve in the graph is a graphic representation of the financial market bubble produced by the boom which led to a growth of disproportions.

The inefficiency of the branch structure of the economy and exports has also contributed to the aggravation of the crisis. The predominance of primary goods within the structure of exports makes Russia’s balance of payments more dependent on cyclic fluctuations than if would have been in a country with a diversified economy. Once the multicative effect sets in, a reduction in the rate of growth and a drop in investment activity in importer countries can result in a sharp deceleration of an economy dependent on export of raw materials, and to launch the “crash-landing” scenario. This is the mirror effect of the phenomenon already experienced by Russia after the 1998 crisis. As the world economy was growing, there emerged demand for Russian products, which resulted in a boom as soon as prices for energy carriers started to rise. Naturally, much was said at the time concerning the necessity to carry out structural diversification, but nobody took the trouble of tackling this issue in earnest while the economy was booming.

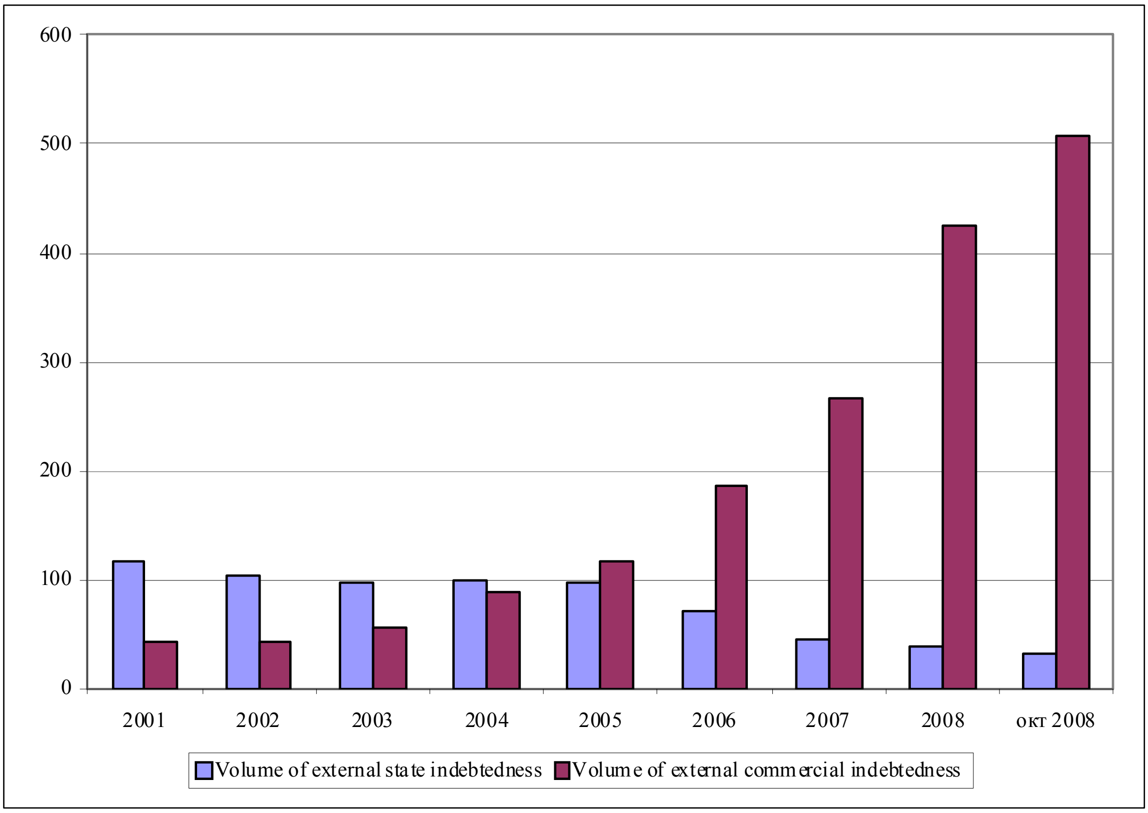
The rapid growth of external corporate borrowings became one of the most serious problems. Another problem resulted from the fact that most of those debts were, in fact, quasi-state borrowings. Many borrower enterprises have close links with the State, which reflects on their logic characterized by the motto: “privatization of profits and nationalization of losses”. That is how they are seen at the financial market, whose agents understand that, in the event of a crisis, the biggest Russian borrowers can always rely on assistance from the federal budget. Thus, there emerges moral hazard - the situation known since the 1997 Asian crisis, when some players can irresponsibly borrow money, while other players can lend it without sufficient reasons. But it is the State that will have to save the debtors in the event of an economic crisis. If we turn to the example of South-Korean *chaebols* – the firms actually existing under state control and dedicated to the same principle of "privatization of profits and nationalization of losses" - we could notice a growing tendency towards "chaebolization" on the part of a number of leading Russian firms.

Figure 2 The dynamics of the RTS index (as of the end of a year, closure)



The year 2007 saw a major change in the trend of the dynamics of external indebtedness: previously, the aggregate debt burden (both state and corporate) was decreasing, whilst now it began to grow. This considerably increased the dependence of Russia's economic situation on the fluctuations of the world financial market and rapidly led to the unraveling of a full-scale crisis. (Figure 3). A few words should also be said about yet another mistake made by Russian borrowers: they easily accepted various pledge schemes, although the successes achieved by the Russian economy in recent years frequently made it possible to refrain from resorting to pledges. As a result, when the crisis set in, these borrowers run into the problem of their pledges rapidly losing in value (i.e., the margin-calls mechanism was triggered), and were faced with a real threat of losing their assets.

Figure 3 The volume of RF external indebtedness, billions USD



This situation had a major impact on the development of budgetary and exchange-rate policies. On the one hand, the considerable indebtedness of prominent (including budget-connected) players, some of them owning strategically important assets, narrowed the possibility of lowering the exchange rate of the ruble, which would have inevitably increased the cost of servicing their debt. On the other hand, it was necessary for the State to render financial assistance to the borrowers in order to repurchase or repay their debt.

3 Reaction to the crisis

The world economic and political elite were deeply shocked by the crisis. The initial reaction to it was rather chaotic, with the governments of developed countries desperately trying to slow down its rapid development. Their attention was focused primarily on resolving two sets of problems. Firstly, to avoid the collapse of the credit system - that is, to save financial institutions. Secondly, to prevent recession or at least to weaken it, to avoid a deep slump in production.

At ideological and conceptual levels, this policy was manifested in a Renaissance of Keynesianism. The popularity of Keynesianism was rising as rapidly as the crisis was unraveling. The unexpectedness and the abruptness of the descent into catastrophe resulted in the adoption of a number of incoherent anti-crisis measures, most of which contradict many economic doctrines and political traditions – which until quite recently were deemed to be perpetual and indisputable.

The phrase “We are all Keynesians now”, placed on the Time magazine cover in the early 1960s, is once again becoming popular. As it was nearly half a century ago, the name of Keynes is bandied about as a symbol of state interventionism, which is opposite to economic liberalism -irrespective of what the great economist actually wrote and thought on the subject. In any case, when Richard Nixon repeated this phrase, he used the guru’s name in order to to give weight to the introduction of state regulation of prices, although it is unlikely that Keynes would have given his blessing to the economic policy of the US administration of that time. Meditation-prone policy makers treat this “collective Keynesianization” with skepticism and ridicule: the German Minister of Finance (a Social Democrat, by the way) characterized the actions of his EC partners as “crass Keynesianism”.

Leave the consecrated term “Keynesianism” aside, and the majority of the decisions being made will certainly fall, one way or another, within the concepts of *dirigisme, socialism* and *populism*. These concepts are interrelated but not synonymous.

The *dirigistic* measures include the taking of individual decisions by institutions of state power, the deciding by them (and not by the market) as to who is innocent and who is guilty, and also the readiness of the State to dictate to the economic agents as to which services and goods they should render and produce. The situation with Lehman Brothers on the one hand, and with Bear Stearns, AIG and Citibank on the other, is very difficult to interpret from a market perspective. Some bigwig has decided to call to account one player and to help another – as it always happens in a centrally controlled economy.

The next - very logical - step is the adoption of government decisions concerning the activities of the actually nationalizes institutions. UK Prime Minister Gordon Braun has repeatedly stated that he would encourage the banks which have got under his control to invest more money in small businesses. Similar demands are being made to Russian state –owned banks, irrespectively of how this measures would reflect on the quality of their portfolios. Of course, support for small businesses is the sacred cow of every contemporary government. However, the consequences of such decisions are predictable: if the authorities instruct their bank where to invest its money, they would have to render assistance to this bank when the said politically motivated investments turn out to be inefficient. That is, the assistance of the State and the inefficiency of investments form a vicious circuit.

The *socialist* measures include the collectivization (or nationalization) of risks. By saving the borrowers, by pumping capital into the banks, and by increasing guarantees for private deposits, the State assumes the risks related to the decisions of all the major participants of economic life, including the bankers, the investors and the borrowers. (The more so because in practice they are the same person). Thus, the fundamental principle of capitalism – personal responsibility for the decisions taken – is put in question. So far as the Russian situation is concerned, one could assert that the risks of nationalization would become inevitable already at the next stage. This process is also beginning in the banking sector, which will result in the guarantees being extended to all the other companies and sectors.

Property relations - the holy of holies of every socio-economic system - are also undergoing a very serious transformation. What is under way is a de-facto nationalization of troubled corporations by way of rendering to them financial assistance. Their nationalization is carried on via at least three channels: through repurchasing the debts of individual firms; through recapitalization in exchange for shares; and through the inflation of accumulated liabilities. States are usually ready to assume all the liabilities of financial institutions – by way of rendering guarantees and by directly injecting capital. Thus, private property rights are immediately put in question.

The risks of *populism* are clearly on the rise. As usual, a drop in the rate of economic growth triggers calls to help commodity producers. It is amusing to read the analytical reports of Western banks, which contain exactly the same recommendations as we used to incessantly hear in Russia in the 1990s: what is necessary is to carry out massive budgetary and monetary expansion, which “could help to sustain the stability of aggregate demand”. If Russia or any other country with developing markets had voiced such proposals just a few months ago, the only answer on the part of analysts would have been rigid – and well-founded – criticism.

In this situation, the handout of cheap money to commodity producers would have had dire consequences because it would result in increasing the rate of inflation. By the way, therein lies the difference between the situation in Russia and that in the USA. Russia (like most of other countries) does not have a printing press churning out the world’s reserve currency. Therefore, monetary populism in our country would provoke a flight from the ruble - rather than stimulate growth.

The “turnabout” observed in the countries most deeply entrenched in capitalist tradition resembles the sharp switchover from “Military Communism” the NEP. As early as March 1921, nothing pointed to the impending rejection of the rigid model symbolizing the beginning of the realization of the Communist Dream. Suddenly, only a few weeks later, there was an abrupt turn towards the restoration of market relations. What had happened? The Soviet regime had found itself on the verge of destruction, and the Bolshevik leadership had clearly understood the message of the Kronstadt Uprising. The new economic policy was designed to defuse conflicts, to weaken social tensions, to decrease social tensions and to restore economic growth. According to Lenin, the NEP was “in earnest and long term”, “but not for ever”.

The turn to socialism is undoubtedly an attempt to get a respite in order to reappraise old values. It is still too early to say whether this turn will be long-term or not. But it is clear that it will not last for ever. Any excessive state regulation contradicts the flexible and dynamic character of modern productive forces, as well as the challenges of the post-industrial epoch - exactly as the chaos of market competition was in rather poor agreement with the goals of rapid industrialization in the early 20th century. That is why the market model of the NEP was scrapped only a few years after having been launched. And that is why it would be preposterous to affirm that the present statist-socialist tendencies “are in earnest and long term”.

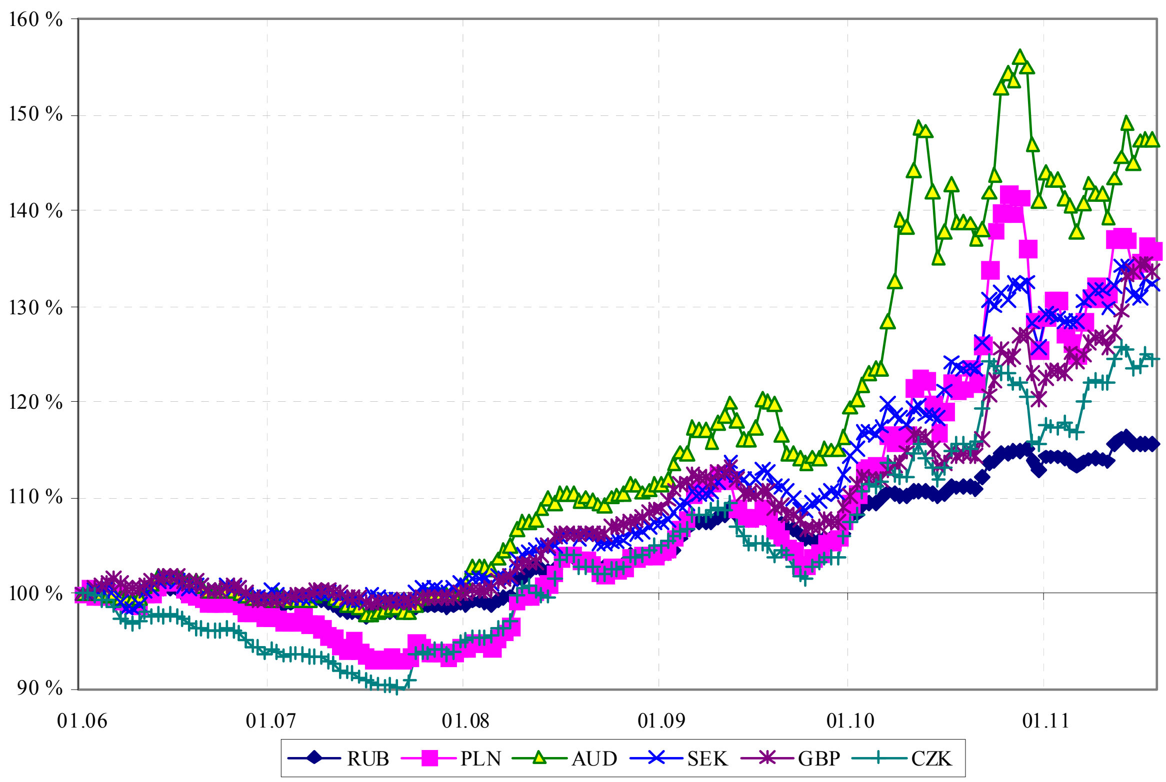
The longevity of the statist neo-NEP is difficult to predict as yet. A rapid exit from the crisis would apparently make most of the state regulatory measures unnecessary. If the crisis is long term (which is more likely), everybody will be rapidly cured of any illusions that state intervention in the economy ("crass Keynesianism") can remedy market falls. The logical inconsistency of the affirmation that the crisis has confirmed the necessity of further intensifying state regulation is already clear: the State *did regulate* these markets but this regulation was a *failure*. According to one US Congressman, there are absolutely no reasons to believe that the same state will henceforth begin to better regulate financial markets.[6] It is another matter that we need new institutional decisions which would increase the transparency and stability of financial markets.

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

4 Russia's struggle against the crisis

Fearing the collapse of the banking system and a deflationary shock, economically developed countries resorted to a number of aggressive measures designed to support the banking system and to stimulate production activity. The most important measures include the allocation of liquidity, the expansion of the deposit guarantee system for physical persons, the buy-out of some of the banks by the State, the aggressive reduction of refinancing rates, and the adoption of "stimulus plans" (envisaging budget injections into the real sector of the economy designed to stimulate demand therein). At the same time, the governments of many countries have resorted to lowering the exchange rates for their national currencies against the US dollar (see Figure 4). This measure was designed to preserve those countries' foreign currency reserves and to become an additional factor of stimulating internal production. An analysis of the logic and the efficiency of these measures is beyond the scope of the present article. However, the key problem consists in the fact that these measures can indeed bring about a serious macroeconomic destabilization.

Figure 4 US Dollar. The interbank exchange rate (1 June 2008 – 100%)



The Russian authorities also offered a number of sufficiently radical measures to soften the crisis. To a certain extent, those measures were similar to those taken by the governments of the most developed countries, but in some important aspects they considerably differed from the latter's initiatives.

Collapse of the credit system was prevented. Considerable financial resources were allocated to banks in an attempt to overcome the liquidity crisis. On the one hand, these measures were designed to sustain productive activity. It is the availability of credit resources and not the stock market that constitutes the vehicle of growth of the real sector of Russia's economy. On the other hand, the stability of the banking system is also directly linked with the task of safeguarding socio-political stability in the country. Losses incurred by citizens because of bank failures would be incomparably more painful and politically dangerous than any losses resulting from a fall of stock indices.

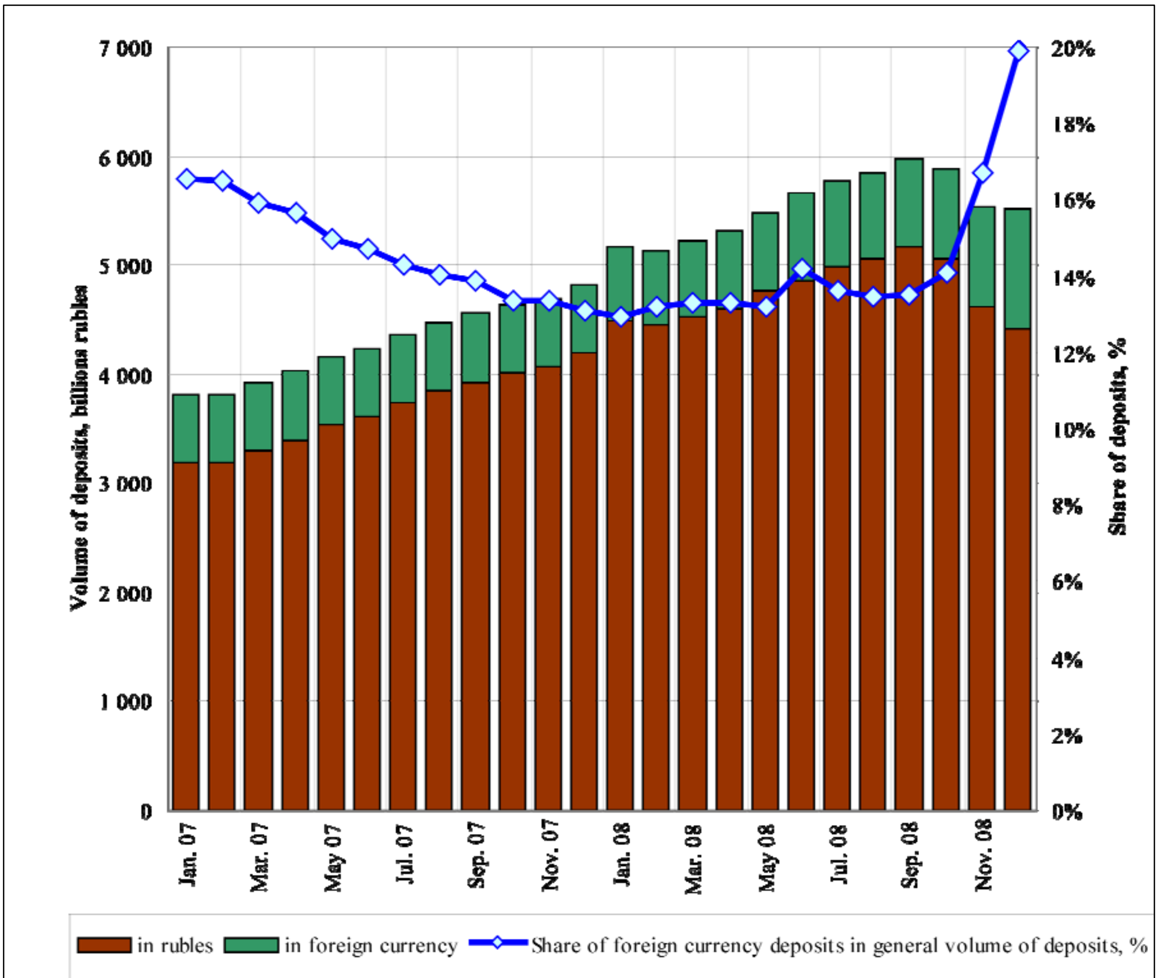
Naturally, there were some unavoidable dubious schemes. The banks which received liquidity from the State preferred to convert it into foreign currency as much as they could - in order to insure themselves against currency risks or to repay part of their debts to foreign creditors. From the point of view of economics, this behavior was quite reasonable, although it did not correspond to the intentions of the monetary authorities who had allocated the funds. Also, there emerged some situations when the re-allocation of state-allocated funds involved bribe-taking, which is not surprising when a resource in short supply is being allocated at an underestimated price. (It was expected that the monies received by primary recipients would be allocated to second-level borrowers not at the market rate but at a much reduced one, which would only slightly exceed the interest rate at which the initial allocation of funds had been effected).

The State made a half-hearted attempt to prop up plunging stock indices, but quickly abandoned this initiative. Although the dynamics of stock indices is breathtaking and dramatic, this is not the sphere where the State's resources should be concentrated today. Any attempt at supporting the stock exchange in the present situation would mean only one thing: helping the fleeing investors to sell their shares at a higher price and to depart with the money. Of course, it is very unpleasant for shareholders to see that the value of their shares is falling. It is also true that the collapse in share prices has produced a sharp rise in margin calls, but the solution of this problem lies in quite another sphere.

Decision makers have started a discussion on the ways of preventing a production crisis. The rapid economic growth achieved in recent years was caused to a major extent by the world market being awash in cheap money which was eagerly borrowed by Russian companies. However, the cheapness of money does not conduce to their effective investing, especially when the case in point is companies linked to the State especially favored by creditors who understand that come hell or high water, the State will never let these companies perish.

Now the situation has changed. There are no available credits, and the securities placed as collateral for credits are rapidly loosing in price. Of these debts, about 43 billion USD had to be repaid by the end of the year. The State expressed its readiness to allocate, via the Russian Bank for Development, a sum of 50 billion USD for eliminating the bottlenecks.

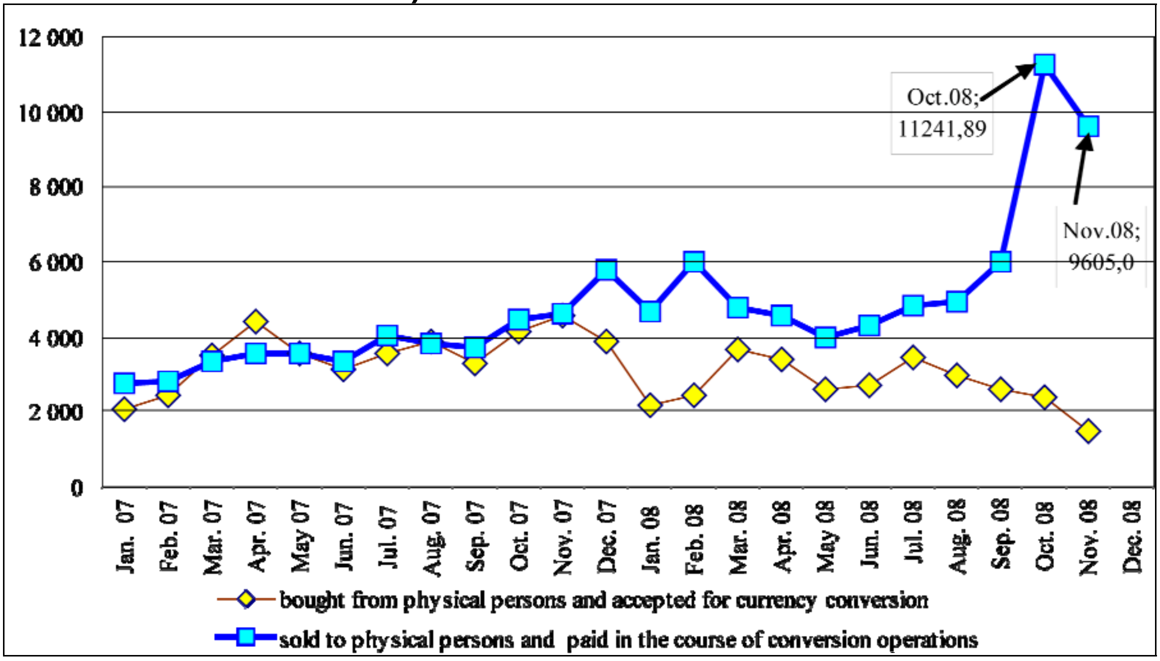
Figure 5 Data on the volumes of deposits of physical persons, attracted by credit institutions



Sourse: RF Central Bank, the author's estimates.

The currency policy was rather ambiguous as well. For political reasons, the authorities did not dare to completely abandon control over the ruble's exchange rate and therefore resorted to a gradual devaluation of the national currency. The causes of their circumspection in this matter are clear: with ruble savings being devalued for the third time in twenty years, confidence in the national currency could hardly be expected to rise. The population was given a chance to insure itself against a depreciation of the ruble. Practically everybody who wanted to exchange the rubles into dollars or euro could do so (Figures 5 and 6).

Figure 6 The volume of transactions with currency holdings between authorized banks and physical persons (all kinds of currency, in millions of USD)



Source: RF Central Bank, the author's estimates.

However, the smooth devaluation of the ruble has increased panic on the market and caused a considerable depletion of the gold and foreign exchange reserve, which may result in the emergence of a new equilibrium level of the ruble's exchange rate than in the case of its abrupt devaluation. Also, the uncertainty about the ruble's exchange rate has nearly completely frozen the activity of credit institutions. Expecting the exchange rate to drop, banks were not inclined to grant ruble credits, while potential borrowers, for the same reason, did not want to take foreign currency credits.

Moreover, a sharp devaluation of the ruble would have become an additional factor of supporting domestic production and of protecting the Russian market from imports, would have supported Russian exporters and created additional stimuli for the future inflow of foreign capital in the form of direct investments.

Finally, the government put forth a broad package of incentives - primarily in the sphere of taxation, which are designed to encourage the development of actual production, including tax cuts; initiated a number of measures aimed at supporting small businesses; and composed a list of the system-forming enterprises enjoying special attention on the part of the State. Some of these measures are rather ambiguous.

Support for small businesses is undoubtedly crucially important for both economic and social reasons, because this sector can play a significant role in reducing unemployment by absorbing the most active groups of the population. However, it should be borne in mind that in Russia, the problems of small businesses lie not in the economic sphere or the domain of law, but in the law enforcement and political spheres. Traditionally viewed with skepticism, small businesses in Russia have always been the most defenseless one when confronted with bureaucratic lawlessness and extortion. Small businesses will be capable of developing only on condition that the value orientation of Russian society and especially its elite would undergo some far-reaching serious changes.

There exist serious doubts as to the effectiveness of direct assistance to big enterprises. The main problems of production development consist not so much in the lack of money as in the mysfunctioning of economic mechanisms, and in the final account, in the inefficiency of many production sectors. Lavish financial injections will not solve the issue of increasing the effectiveness and the structural renovation of the economy, without which an exit from the crisis will be delayed. Nevertheless, such measures could certainly alleviate the current social problems.

5 Some lessons of the past anti-crisis experience

The discussion on the issues of the present crisis in one way or another revolves around historical precedents, including the genetic fears engendered thereby. First of all, it is the Great Depression, with its lengthy deflation and double-digit unemployment which was eradicated only in the course of the Second World War. Less frequently mentioned is the 1970s crisis, which brought to life a new phenomenon – stagflation. As a matter of fact, it is those two historical precedents that should form the basis of any debate on the present economic situation. However, one should always bear in mind that historical precedents are nothing else but instruments of analysis, which cannot offer any ready solutions for a researcher.

Judging by the measures being taken by the governments of developed countries, their worst fear is deflation - which invariably takes a decade or more to struggle out of. Apart from the 1930s, this was exemplified by Japan in the 1990s.

In fact, the deflation and stagflation models of a crisis are alternatives. That is why they offer principally different mechanisms for overcoming it.

What is required to resist deflation is, first of all, growth stimulation - that is, an active budget policy and budget expansionism. In this case, it is permissible to cut interest rates and reduce taxes, and at the same time to increase budget expenditure.

In the case of stagflation, the set of measures to be applied is directly reverse – first of all, it is necessary to establish control over money supply - that is, to toughen the budget policy and to increase interest rates. After a decade of the permanent economic crisis of the 1970s, the exit was found only after FRS Chairman Paul Volcker had dared to resort to unprecedently tough measures and drastically increased the refinancing rate. As a result, the unemployment rate shot to over 10%, and interest rates climbed to more than 20%. The USA entered into an extremely severe recession, which caused President Jimmy Carter to lose his bid for reelection paid with his presidency, and in due course exited it with a renovated and dynamic economy.

Of course, any juxtaposition of these two models is a matter of convention, and it is unlikely that the present crisis will faithfully replicate any one of them. But it is important for us to understand that the prescriptions for treating an illness must always depend on that illness' nature, and so successful treatment sometimes requires prescribing medications characterized by their absolute dissimilarity rather than similarity.

The experience of both crises could turn out to be perfectly applicable in the present situation. Strictly speaking, developed countries are now pursuing a policy which they considered absolutely unsuitable for developing markets (including post-communist countries) in the 1980s and 1990s.[7]

The massive financial injections being carried out by the USA and the European Union may indeed prevent the economic situation from worsening to a politically unacceptable level. However, great caution is needed when such measures are attempted in developing economies. The thing is that the US monetary authorities have two powerful tools at their disposal. Firstly, they have the printing press churning out the world's reserve currency – and nobody questions the status quo in earnest, despite its having been relatively shaken by the current financial crisis. Moreover, the majority of countries (which keep their currency reserves in dollars) are interested in preserving this state of affairs.

Secondly, because of the special status of the dollar, US firms and households do not have any alternative instruments for hedging currency risks, and it is unlikely that they might rush to exchange their dollars for euro or yens - even if some doubts were to arise about the correctness of the policy pursued by the monetary authorities. That is why, despite the budget and monetary expansion of the past few months, the velocity of money circulation in the USA does not increase - as it would have been in other countries: instead, it slows down.

The majority of developing markets, and especially Russia, would respond to financial expansion absolutely differently. In a country whose national currency does not have a long credit history and, quite naturally, by no means constitutes a reserve currency, any relaxation of the budget and money policies is likely to result in an escape from the national currency, in an increase in the velocity of money circulation, and in inflation. When taking place against the background of a global recession, this course of events would inevitably lead to stagflation.

Such a policy would be especially dangerous for countries where the exports structure is determined by the predominance of by primary industries. The dependence of such economies on the world market situation is extremely high, because even a slightest drop in demand on external market immediately translates into a considerable

[7] *Ferguson Niall*. Geopolitical Consequences of the Credit Crunch, September 2008, and Kenneth Rogoff, America Goes From Teacher to Student, February 2008, and Dani Rodrik, The Death of the Globalization Consensus, July 2008.

production slump in primary exporting countries. If business activity in developed countries remains low and demand for exports from developing economies does not recover, those economies' depression could start to suffer from yet another calamity – an escape from the national currency. As budget expansion cannot compensate for a drop in external demand, inflation will go up without being accompanied by intensification of productive activity.[8]

Thus, the present crisis conditions are such that it is not unthinkable that one part of the world will experience deflation, while another will be hit by stagflation. The latter represents one of the most serious risks faced by present-day Russia.

All this brings us to a principally important conclusion concerning the unraveling crisis and the ways to get out of it. In essence, the world could encounter two crisis models materializing in parallel. The two versions of the crisis will need diametrically different approaches. The Western World will struggle with deflation thus pushing inflation out into the outside world, the world of developing and emerging economies. While repeating the Western approaches to combating the crisis, the latter will soon find themselves in the trap of stagflation.

Thus, Russia's anti-crisis policy should be primarily based on preventing its economic system from becoming macroeconomically unbalanced. Even if we are to be faced with a budget deficit in 2009, we should make use of all healthy resources to cover it, first of all domestic borrowing, without resorting to the printing press. And it would be extremely dangerous to hope that the artificial stimulation of demand, "crass Keynesianism", could resolve the key problems of Russia's socio-economic development.

[8] In May 2008, The Economist wrote in this respect: "There are alarming similarities between emerging economies today and the rich world in the 1970s when the Great Inflation lifted off." (Inflation's back // *The Economist*. 2008. May 24. P. 17).

6 The priorities and risks of the 2009 anti-crisis policy

Apart from the issue of safeguarding macroeconomic stability, we should specify a number of additional issues which will have to be resolved by the government in its struggle with the crisis.

As the crisis is most dangerous in its capacity to bring about socio-political destabilization, it is this issue that should be given maximum attention. Therefore, when it comes to alleviating the effects of the crisis, the first ones to get assistance should be workers - not enterprises, managers or shareholders. During the years of boom a lot of structural disproportions have been accumulated (many of them being survivals from the Soviet epoch), any attempt to keep enterprises afloat would simply delay the urgently needed structural changes in the economy. The State should safeguard socio-political stability, and it should not assist individual businesses.

When struggling with unemployment, the authorities should not vest much hope in public works. Although we have read a lot about the public works system in Soviet textbooks (“how it was in their case”), we tend to overlook the fact that it was a phenomenon of industrial society, when a significant percentage of redundant workforce were blue-collar industrial workers. It is unlikely that financial analysts recruited into public works would do much good either to themselves or to construction projects. Instead, various educational programs - enabling people to take advantage of the crisis in order to rethink and reassess their life strategies and then to retrain accordingly - can (and should) find broader application in today’s world. Although the cost of such programs is smaller than it was in the case of public works, their effect will be highly significant - especially once the crisis is over.

When discussing the prospects of rendering assistance to individual (“system-forming”) enterprises, it would be necessary to formulate some coherent criteria for entry into this category, and to distinguish between the various forms of assistance to be rendered to enterprises. Distinction should also be made between company towns - where the issue of closing an enterprise is primarily a social and political one (removal of obstacles in the way of developing small businesses), and infrastructure objects – when direct state assistance to enterprises is permissible if it can make them function properly.

But the most dangerous thing to do would be to use the pretext of assisting “system-forming enterprises” in order to prevent closure of failing plants and factories and to resist modernization of Russia's economy. That is why it would be necessary to drastically cut the practice of shifting responsibility to the State. And if the State is ready to save one or another business, it must to it publicly and in accordance with generally - known rules.

Now, it is time to immediately formulate a coherent agenda of future privatization. As a result of the current crisis, the state is likely to significantly increase the number of assets in its possession, but it will not be able to adequately control the quality of their management. This could lead to the reemergence of the situation typical of the early 1990s, when so-called red directors had a free hand to do whatever they wanted at the enterprises they managed – that is, they enjoyed the right of owner without having owner motivation. This can be avoided only if the manager knows that he will be taken to account by the actual owner.

Finally, Russia should do its best to avoid the adoption of protectionist measures and the curbing of international competition. So far as the present Russian situation is concerned, the most effective measures aimed at protecting the interests of domestic commodity producers would be a currency-exchange policy preventing an excessive strengthening of the ruble. By comparison with tariff measures, devaluation has at least one plus: its effects are the same for everyone, and it cannot be corrupted by lobbying for the import tariffs more profitable for private gains.

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