

Lessons of the Global Economic Crisis

by Prof. Oleg T. Bogomolov

The world-shaking financial-credit crisis sensitively affected the Russian economy. Increasingly being more actively included in the process of economic globalization, Russia has not yet realized all consequences of the mounting interdependence of the countries of the world. It would be however large simplification to explain our difficulties only by negative action from the outside: by the drop in export prices, by the contraction of external commodity and credit market, by the assaults of panic on the world stock and commodity exchanges, under the influence of which domestic businessmen also went bankrupt, by the draining of the foreign capital. Taken by the state some measures for the softening of this action did not remove troubles in the economy. Impulse from the outside bared and aggravated its own Russian problems.

Inflation, gradual devaluation of rouble, coagulation of insufficient developed internal credit market caused by all this decrease in the demand and drop in the production. The degradation of many vital branches, including agriculture, the reduction of employment, a drop in the standard of living of the substantial part of the population, social stratification — all this is chiefly the consequence of errors in domestic policy, aggravated by crisis phenomena in the global economy. Foreign economic policy also proved to be quite short-sighted, as the internal one rested in essence on the neoliberal ideology. The advantages of economic globalization were overestimated and its risks and threats were underestimated.

In a word, Russian economy survives the second crisis after the default and the devaluations of rouble in 1998, but at this time, it is deeper and apparently more prolonged. It seems to be two serious warnings in order to extract the lessons for the future and to correct the economic course.

Under the crisis conditions the deregulation and hope for the “invisible hand of market” increasingly demonstrate their detrimental character. Prominent economists both in the West and in Russia indicated this long ago. Beginning with Keynes John Maynard, the alternative ideas of the functioning of the capitalist economy advanced. Unfortunately, the main stream of economic thought went along another direction. Liberal fundamentalism reigned. The Russian reformers, not without the foreign advice, embraced and gulped it. However, today’s situation in the economy of the leading countries of the West, as in entire world economy, makes it necessary to re-examine the prevailing views. In addition, even from the camp of the convinced liberals critical voices are heard increasingly and more loudly. The publications of the journal *Economist* are exponential on the topic.

In October 2008, the journal spoke ironically on the French President Nicolas Sarkozy’s apostasy from the liberal doctrine, printing caricature of him with a copy of *Das Kapital* by

K. Marx in his hands. Actually at the summit of the European Union in October 2008, Sarkozy admitted that the ultra-liberal capitalism had discredited itself and it was necessary to promote a market social model to the world. Nevertheless, in the following number of this periodical the special report was placed under the title 'When fortune frowned' in which it allowed for changes in the capitalist world order.

In particular, this report said, 'Predicting the consequences of an unfinished crisis is perilous. But it is already clear that, even in the absence of a calamity, the direction of globalisation will change. For the past two decades the growing integration of the world economy has coincided with the intellectual ascent of the Anglo-Saxon brand of free-market capitalism, with America as its cheerleader. Global integration, in large part, has been about the triumph of markets over governments. That process is now being reversed'... The balance between state and market is changing in favour of state also in areas other than finance. "Wall Street, it at the centre of the mess, so America's stature and intellectual authority has plunged" said further in the article, 'More than a new capitalism, - periodical concludes its report, - the world needs a new multilateralism'. Speaking simply, behind this odd word there hides the justification, besides the liberal one, of other models of the development of contemporary economy. In this respect, the experience of European states is completely instructive, especially Scandinavian, where the social orientation of market economy and the state has been practiced long and quite successfully.

The world community must learn good lessons from the present crisis. Many people are inclined to explain its misfortunes by blowing of the financial-credit bubble in the USA that after breaking drew other countries into the crisis. However, the global crisis has not only American roots. Cheap borrowed money, the absence of the proper regulation of money markets, the narrowness of internal effective demand, the disagreement of the anti-crisis policy of leading states, the weakness of international financial institutes — all of these are the result of the serious flaws of the functioning of the global market system. Moreover, this makes necessary to develop the production by the leading countries of joint strategy of the reformation of this system. The new architecture of the world financial system and the role of the collective actions of states in the controlling of the spontaneous forces and the guarantee of stability of the global market have already found place in the agenda of the European Union and at the encounter of leaders of the Group of 20 (the G-20). The dialogue of scientific and public figures can help find ways for the desirable changes.

If the West pulled now into the strip of the search for a new model or paradigm of an economic device, so this is no less urgent for Russian half-baked capitalism that follows the example of the USA. Certainly, our reformers are not yet ready to admit openly the failure of the ultra-liberal ideology. Nevertheless, critical moods in Russia, which have tested all charms of wild capitalism, are perhaps stronger than anywhere else. Therefore, it is possible to expect that the new approaches in the economic policy will lay the road for themselves. The crisis must contribute to the sobering of the promoters of the present market course.

In what main directions is it possible to expect the preconception of economic ideology and policy? One of the acutest problems is the role of the state in the national economy. In mass media the mythology is widely replicated that the state must withdraw from the economy or, at least, reduce itself to a minimal participation in it. One of V.V. Putin's presidential counsellors, for example, attempted to convince the community that the less the fraction of budget in the GDP (Gross Domestic Product) is, the more successfully the economy grows.

Meanwhile universal statistics irrefutably showed an increase in this portion for periods of the whole past century from 10–20 to 50 and more percent.

It is indisputable that the modern state, moreover the social state, such as Russia is according to its constitution, has to represent and to protect the interests of the entire population, but not to be the committee on management of the matters of its most well-off and influential part. However, this assumes not only the valid and effective democratic mechanisms of the society, control over the state bureaucracy, but the significant role of the state in the redistribution of the GDP (Gross Domestic Product). Only under its authority is it capable to counteract with the element of the increasing social stratification, to guarantee the valid access of people to the public goods — information, education, public health, culture. Moreover, quite a lot of states of the world act precisely so. Hence, it is an increase in the share of budget outlays in the GDP (Gross Domestic Product).

The critical functions of averting and overcoming failures of purely market mechanisms lie down on the modern state and not only in the money-financial sphere, that is today so obvious, but in other areas as well. The discussion deals, for example, with the development of science, education, culture, health care and environment protection, modernization of the production, the creation of economic infrastructure, and certainly the guarantee of national safety and law.

The state is capable of playing the significant role in the stimulation of innovation processes, investing budget fund into the key, technically cutting-edge productions, especially in those that are newly created, and participating in the control of them. Its support for agriculture is indispensable in many countries. This is more so urgent for Russia, taking into account not so favourable climatic conditions in the larger part of the country and consequences of the past social cataclysms in the countryside.

Reasons of Russian liberals against the government control are normally reduced to its ineffectiveness because of the insufficient scope of officials, their unlimited corruption and excesses of red tape. The state is charged with the inconsiderateness, non-objectiveness and sometimes deliberately spread false information. Certainly, such kind of reproaches are sometimes adequately substantiated. Nevertheless, is private business so infallible? Its unscrupulousness, dishonesty, contempt for the law, the bribery of officials, and even criminal actions in the indefatigable thirst of the enrichment are well known. Therefore, the dilemma of a free market against the state control appears artificial. A question consists in correct combination of them both in economic development and adoption of measures for guidance of order in each of these two spheres.

First, qualitative improvement in the work of the political system of the state is required for control and cultivation of the class of the incorruptible, honest and highly competent administrators. The selection of personnel must occur not according to their loyalty to authorities and 'responsibility', not on the related proximity, friendship and personal sympathies, but on the level of competence, professional knowledge and working experience, honesty, professional skills, ability to defend public interests. It is understandable that this change cannot occur at once. For a long time Russia will still be inferior to other countries in its competitiveness on the world market because of the ineffectiveness of the state system of the guidance and low quality and the corruption of its officials. However, in order to pull out forward, it is important to solve the problem, taking into account contemporary what the role of state in our economy must be and how to achieve it. It is insufficient to utter diffuse and ambiguous statements concerning this; it is time to formulate the clear concept of the state architecture and its role in economic regulation. In addition, it is necessary to realize it.

In Russia's drift from the wild to the civilized and socially oriented market much depends on the state, those laws and moral standards of the behaviour, whose observance it can ensure with its authority and all acceptable means. Therefore it is necessary to strengthen the state, but not to reduce its economic functions. That means, in other words, that we cannot help restraining private business in its tendency toward the rapid and as a rule, unscrupulous enrichment, and have to push it into the sphere of the interests of general prosperity, we cannot stand its corporate selfishness.

The gigantic losses of the country from the capitals' flight abroad are, perhaps, one of the clear examples of the underestimation of the possibilities of the state, or more accurately, its incapacities to influence the development of the production and to direct existing capitals in the country to the upsurge of its own economy. The Russian Ministry of Finance evaluates the net draining of capital from the country during the entire period of perestroika and market reform approximately at 400 billion dollars. According to the calculations of the Association of Russian banks, this number can reach from 800 billion to 1 trillion dollars, which agrees also with the data of the Basel Bank for International Settlements (BIS). The number of western experts does not exclude that the leakage of capitals could reach even 2 trillion dollars.

The given sums have comparatively modest legal capital export whereas the lion's share comprises their illegal flight, which connects with the tax evading and attempts to cover and to preserve wealth acquired doubtfully. The part of the quick money is stored on the bank deposits (220 billion dollars in 2006; according to the data of BIS, another part is inserted in the shares of foreign companies, in real estate, yacht, soccer clubs and spent on the personal consumption, etc. It is possible of course to doubt the exact estimations, but the order of numbers in any event strikes one with the number of zeros.

Actually, the draining of Russian money abroad is not limited by these data. State currency, stabilizing and other reserves invested chiefly in the foreign stocks and the bank deposits, are always far from reliable. In the first part of 2008, their total sum composed almost 600 billion dollars, which was justified by the need for having the reliable pillow of safety for the rainy day. However, the present crisis shows that this is not an excellent method of rescuing. More reasonable it would be used a substantial part of this money for the development of domestic manufacture.

It is understandable that the inflow of capital into Russia occurred especially in the recent years in the form of direct and portfolio investments, the significant corporate borrowing by our companies. Nevertheless, the total balance added to the preponderance not into our benefit. Because of the unwillingness or incapacity of the state to establish the proper control over the export of capitals, the economy survived monstrous bloodletting. One may only wonder how in this case it coped and survived. Rich natural resources, human capital and the rise of the world prices were very helpful there.

In the years of high prices of natural resources, Russian corporations accumulated the colossal foreign debt which they could not service with the advance of the crisis, and the state was forced to save its financial and industrial magnates. The substantial part of the state foreign currency reserves was wasted on it. It is difficult to find a rational explanation of the policy of the states that on the one hand storages free currency means abroad, giving thus credits to the West and, on the other hand, it encourages domestic companies to borrow heavily from abroad. There is no better confirmation of the short-sightedness and the unreasonableness of the state in economic issues.

If only we, instead of exporting capitals and crediting the USA and other developed countries with hundreds of billions of dollars, had invested the money in the modernization of our industry, transport, agriculture, power engineering, public healthcare, education, science, home-construction industry, etc. then we would not have experienced since 1992 this deep and long-standing decrease in production and the living standards of the population. In addition, we would not be today so vulnerable in the face of the world crisis.

What had happened is, naturally, accounted for by our market economic policy that was and now remains incapable of making use of such colossal money. It was supposed that the money would plunder or squander without the visible return. Such a thing is possible if the state lets out reins from the hands; when it removes itself from any responsibility for the effective and dynamic development of the real sector of economy and allows the allegedly more capable private business to be concerned about it. However, the world practice gives numerous reverse examples. Acceleration rates, for which we strive, assume a notable increase of the portion in the GDP (Gross Domestic Product) of investments into basic productive capital. In Russia, less than half of annually accumulations invest into the real sector of economy. The state policy and influence must be directed to an increase in the portion of investments in the GDP (Gross Domestic Product).

Everything had been done in the other direction. The currency control was weakened and abolished which facilitated the draining of capitals. The exchange value of rouble was consciously supported at the understated level that increases the profitability of the export of raw materials and fuel and raises the price of import. This led to an increase in the prices of consumer goods and food. The domestically oriented productions grew sick and were displaced because of the narrowness of the internal effective demand and low profitability. Some items that we could have easily made ourselves, were bought abroad. This touched not only the textile, shoe-making, sewing, pharmaceutical industry, but also machine-building and many other branches. Commercial and state banks unwillingly gave them credits and even if they did give money then for a short period only and for the exorbitant percentages. The profit was missing for an expansion and modernization of production capacities. Furthermore, inflation and weakness of domestic demand created the ever-increasing investment risks. With the increasing openness of the economy, competition with imported goods became hopeless.

Exporters of raw material, oil and gas industries, metallurgists proved to be in an exceptionally favourable position, in a word, those who fabulously profited from the export. However, other branches did not have this chance. As a result emerged the one-sided structure of the economy characterised by to the hypertrophied portion of primary branches. This led to negative results in the level of the national productivity of labour and competitive ability on the world market. The economy got strongly dependant on the state of affairs in the countries – users of our raw material and natural recourses. The advantages of steady development based on interaction of the extractive and processing branches within the framework of integral national-economic complex were lost.

One cannot say that the negative processes went unnoticed. Scientists and practitioners showed serious uneasiness. However, the state demonstrated helplessness in the attempts to change the situation for the better. As before, hopes were still expressed of the market mechanisms, that were supposed to correct everything. The conviction of the reform architects in the omnipotence of market did not weaken, but it did not come out. Alas, the measures taken by the authorities, resulted in the opposite direction.

Russia's particular feature, as the territorially largest country which is stretched on two continents, with practically all natural resources, high scientific and technical and human potential, consists in the preferred orientation of its economic development to use the advantages of not so much international, as internal and regional division of labour. In contrast to the states which base their strategy of economic growth on the export expansion, it will be more reliable and advantageous for us to make everything for the deepening of the internal division of labour and expansion of the capacitance of the domestic market. This does not indicate the denial of participation in economic globalization and the use of the benefits of a reasonable openness of the economy. This, however, should be done with caution because of the instability and the uncontrolled character of the world financial markets whose fluctuations and periodic crises are capable of inflicting Russia heavy damage. The crises of overproduction are inherent in the nature of capitalism, which are caused by insufficient investment and consumer demand. This was determined by K. Marx and we must take this into account after the approaching building of capitalism.

The persistent wish to enter rapidly the World Trade Organization by no means guarantees us modernization and successful development of our own branches of manufacturing industry and especially high-qualified industry, to say nothing of agriculture. It is necessary to enable first domestic producers to become stronger. Thus acted Japan, South Korea, China, India, Brazil and a number of other countries before many items of their industrial production, on which the state depended, found noticeable sale and competitive ability on the world market. One cannot help noticing that major countries, which have or are creating contemporary industry, export considerably smaller portion of their production, than smaller and average countries. Their production is predominantly oriented on the domestic market. Russia, however, falls out from this regularity having too high specific weight of the foreign trade turnover in the GDP (Gross Domestic Product).

Today it is useless to discuss, if the 'shock therapy' and an avalanche of privatization had any alternative. The country overcame the hardest of times and learned to live anew. However, the ancestral injuries, connected with the passage into another state, remain and can provoke serious complications. We have already encountered them not only in the financial-credit sphere, which draws today concentrated attention. The most perceptible threats are in the deepening social differentiation of the society, the growing unemployment and high inflation rates. They all painfully affect the larger part of the population, which presents low and average-profit layers. Our strongly distorted market relations do not weaken but, on the contrary, aggravate the development of these processes. The selected state methods of opposing them also stir serious doubts. It is necessary to take more radical and more decisive steps.

The flat scale of income taxation of 13 , privilege taxes to the dividends, the holes to escape from the taxation and to transfer capitals of doubtful origin, the use of offshore harbours, the orgy of corruption, the impunity of many economic crimes and machinations lead, in the opinion of specialists, to the colossal shortage of budget and the deepening of the precipice between the rich and the poor.

In our country we still have tremendous poverty and scarcity of consumption of millions of citizens. It would seem that the moral standards of thrift and modesty must be cherished, widely acknowledged and observed in the society. Unfortunately, the cult of wealth and luxury prevails and merchant-like daring. Television advertises the life of the *nouveau riche* in their luxury apartments and villas; it shows their yachts, aircraft and automobiles of the chic class, their revelry at the fashionable foreign health resorts, their overabundant entertainment routs for selected persons. Top managers in large corporations, even in

government-controlled, are more generously rewarded than their Americans and Europeans colleagues. In addition, if abroad the protests of the public opinion are increasingly heard against the unlimited salaries and bonuses of the top managers, and the state begins to interfere with this, but in our country it went without saying and is silently accepted, as if normal reality.

Exceeding all conceivable standards, the social property stratification challenges ideas about social justice, deprives people of moral and economic growth for the honest labour, aggravates the problem of poverty and nourishes misery, generates children's neglect and other social misfortunes and hardships. In the long run, the rates and the quality of economic increase do suffer. The realization of the abovementioned negative consequences calls for the new approaches in ideology and practice, conducted by the state, for the modernization of Russian economy.

The methods of overcoming the inflation also require reconsideration. Unfortunately, our economic and especially financial rulers adhere to the monetarist prescriptions so they stand mainly for the limitation of money and credit emission, the practice of the so-called 'sterilization' of monetary stock, the restraint of the budget allocations on wages and social payments. By the way, during the hard times in the USA and Europe, the states practiced the expansion of money supply in order to increase effective demand and to revive the production. For some reason, with this we only connect the splash of inflation.

The hardening of money policy had the negative side that gives effects now when the state is forced to undertake unprecedented additional infusions from its reserves of money into the companies experiencing troubles. On favourable terms the pecuniary aid was given to *Sberbank*, *VTB*, *Gasprombank*, *RosNefit*, *RusAl* (Oleg Deripaska), *Evrzas* (Roman Abramovich), to industrial corporations and was for the most part converted into the foreign currency and transferred abroad into the liquidation of debts and the creation of reserves. Producers, the real sector of economics won little from that.

Inflation is not reduced to the overcrowding of the channels of circulation by money. It is produced by an increase of costs in the production under the effect of different factors: increase in the cost of raw material and fuel, transport tariffs, wages, rise in price of import, etc. Its size is influenced by corporate conspiracy, inflationary expectations and the degree of confidence to the stability of an economic system, the tax load and other sideline expenditures of producers, compensated by an increase in the prices. Therefore, it is necessary to fight with the inflation along all lines using various methods.

So, in order to have an accurate idea about its consequences it is important to evaluate objectively the scale of inflation, and not only on the average, according to the principle of an average temperature in a hospital, but for different sectors of the economy and strata of the society. Inflation always manifests itself as an additional hidden tax on the population and on the business, but its gravity and chances for compensation are far from identical. The detailed studies, undertaken by a number of specialists, revealed that to the greatest degree it is the poor and an middle strata of the society who suffer from it most. The price of the basket of goods and services consumed by this people grew recently not less than by 25–30 per cent annually whereas for the rich people this rate coincided with the officially admitted 10–14 per cent.

For the branches that work on the domestic market, sales are constantly falling because of the high inflation rates that cut the purchasing ability of population. This results in decrease and even reduction of the production. While the consumption of the upper classes of the society

consists essentially in imported goods, it therefore does not serve for the domestic market of the local manufacturing industry. It only supports foreign producers.

It would be better to control inflation not so by monetarist methods, as by the expansion of the effective demand of the major portion of the society and, respectively, by the stimulation of production and proposal of domestic goods and services of acceptable quality at affordable prices. The underpayment of labour in Russia, in comparison with the countries of a similar level, limits the effective demand of population. The same consequences are caused by difficulties in obtaining credits by the business, especially small and average, and excessively high costs of credit adoptions.

It is not worthwhile to disregard the postulate of the classical political economy: 'the state prospers when it has simple goods'. It is today important, of course, that it should be good quality, saleable and its production constantly increase. Here the small and average business is capable of much, but it does not obtain the necessary support and protection from the state yet.

Certainly, the economy cannot manage without the money. It also is the part of national wealth when it does not lie hidden but works as the measure of value, the means of circulation and the means of accumulation. The last function is the determining one for the economic growth. Naturally, when considerable amounts of money acquired by our state institutions and banks, including the borrowed sums from the West, are used not for the exchange speculations, are not wasted or petrified in the unjustifiable reserves. They are to serve for the increase of the real productive forces of the country, in other words, they should become converted in the investments.

For it to happen, it is necessary to have the favourable investment climate in the country. Its creation and maintenance are the task that is far from purely economic. It depends on the effectiveness of the state administration, on the absence of the unjustifiable bureaucratic obstacles, on the political stability, investors' confidence in the entire economic, legal and taxation system, on the character of business morals and the effectiveness of struggle against corruption. It stands to reason it depends on the prospects of obtaining good profits which are opened by the dynamic and harmonious economic development.

Practical life demonstrates that on the opportunity to snatch a large sum, foreign investors are ready to take risks and to disregard many flaws of our state and market system. However, why must we make it possible to grow rich on our diseconomy and absence of elementary order?

The role of the state in the assistance for the investment activity and its participation in it cannot be overestimated. The state is responsible for the determination of its priority directions, for the granting of guarantees in the case of the risks which a particular business is not ready to take upon itself, for the creation of the privileged conditions of crediting and taxation for the strategically important investments. In addition, undoubtedly, the long-range goals of the development of the country which the President and the Government propose, make it necessary to strengthen the role of the state. This will require appropriate initiatives, great administrative effort and reformatory undertaking that our liberals can misinterpret as the attempts for the nationalization of the economy. But without the participation of the state, without normalizing the partnership between the state and private business any decisive improvement in the investment climate will be unlikely. Consequently, the realization of the ambitious plans of economic prosperity will be hardly possible. One would like to hope that the final moment of the truth has come now that one can learn lessons from the past errors and correct all that hinders progress.

Remarks:

Opinions expressed in this contribution are those of the author.



Prof. Dr. Sc. (Economics) Oleg T. Bogomolov is a full member of the Academy of Sciences, Moscow, Honorary President of the Institute for International Economic and Political Research (the Russian Academy of Science), Head of Department of World Economy at the State University of Management.

*ISPSW Institut für Strategie- Politik- Sicherheits- und Wirtschaftsberatung
Berlin, Germany
www.ispsw.de*