

# Social and economic development of Russia: Finding new dynamics<sup>☆</sup>

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## Abstract

This paper addresses Russian economic development and economic policy in 2015–2016. The analysis focuses on external and domestic challenges as well as the anti-crisis policy of the Russian government. Special attention is paid to key elements of the new model of economic growth in Russia. The paper discusses economic policy priorities for sustainable growth that include budget efficiency, structural reforms and import substitution, the encouragement of entrepreneurship, the efficiency of public administration, and the modernization of the welfare state.

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## 1. Introduction

The Russian economy is undergoing a profound transformation. In the coming years, our country will radically upgrade its economic system to meet the changes and challenges in the global social and economic order happening right before our eyes. The global crisis, which has continued since 2008, is shaping a new agenda for all leading states, developed and developing alike. Certain objectives, which are addressed as part of that agenda, are specific to each country. However, the common element is the acuteness of the issues at hand, which require re-thinking our entire past experience and finding solutions that are often unprecedented.

Russia is no exception. We need to implement a development model that will help our country attain a prominent position in the modern world. This is not

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a trivial problem, though it is not new to Russia, which has successfully found answers to global challenges in the past. There is no reason for the situation to turn out differently this time.

I reviewed the outline of the “new reality” and the key objectives we face on our path to a new model in my previous two articles (Medvedev, 2013; 2015). Time has borne out the conclusions reached in those articles concerning the development trends in our country and the world in general. Now, I would like to share my vision of the current issues facing the Russian economy and the ways to solve them.

## **2. The current situation**

The phrase “economic crisis” has taken on an important meaning for the world’s leading countries. For a number of years, we have experienced increased turbulence that has affected all areas of social and economic life: production trends, foreign trade, general well-being, employment, and financial and foreign exchange markets. Modern economic and technological development is a difficult thing to predict in itself. However, since 2008, we have been witnessing a qualitatively different level of volatility, which has seriously hampered the ability to predict even the near future.

Economic volatility is directly linked to political volatility. The global situation is taking a sharp turn that is leading to the aggravation of political conflicts in certain developed and developing countries. Against this backdrop, the forces (parties) arguing for the abandonment of the framework of the traditional agenda are gaining strength. The political and economic landscape is changing dramatically.

All these factors are also having an effect on Russia. They largely define the nature of our actions in the economic, political, and social spheres. In truth, we are facing several interwoven external and internal crises.

First is the global crisis, which is increasingly being referred to as the Great Recession. It began in 2008 and is comparable in scale to the Great Depression of the 1930s (Eichengreen, 2016). Similar to that period, today’s crisis is causing radical transformations in many economic and political institutions within the modern world order. It has already exacerbated political conflicts, reshaped markets, and led to a re-thinking of the roles and trends of globalization, industrialization, and social inequality.

Today’s crisis has resulted in increased volatility and uncertainty in global markets whose functioning principles are now substantially different from those of recent decades. A global financial market has formed that is able to move enormous sums of money around the world almost instantly. However, no global regulatory system has been created that is adequate for this type of market.

Political bias in economic life, especially at the global level, is becoming one of the most important features of the current stage of development (and the current crisis). Markets are becoming increasingly subordinate to political laws at the expense of economic laws. Political factors interfere with economic policies ever more actively, often being substituted for market competition. The various sanctions are only the most vivid manifestation of this trend. At the same time, oil prices have been more substantially affected by political arrangements than by the balance of supply and demand.

The inequality that has accumulated over the past several decades had not resulted in much anxiety during times of vibrant and sustainable growth. Now,

we are able to observe it becoming a source of economic and political volatility. Inequality is considered a significant factor that hinders economic growth in the modern (and future, post-crisis) world (Piketty, 2015).

In addition to geopolitical and structural factors, Russia's economic development has been impacted by external shocks, which have been persisted steadily since 2014. These include sanctions (mostly financial and technological) as well as the price changes in oil and other goods and commodities that the country exports. It should be noted that the decline in oil prices is not Russia's most important problem, as this has happened more than once in recent decades. The biggest issue facing Russia has been the rate of decline. In 2015, oil prices dropped by nearly 50% in just six months—an unprecedented event in economic history. Discussions about oil reaching a “new flat price,” and claiming that “everything is different this time” (Reinhart and Rogoff, 2012) have come to nothing. Although our government had never relied on favorable conditions and built up reserves, no country can adapt that quickly to such sharply plummeting prices for their main export, resulting in a severe shock to our economy.

While dealing with this issue, sanctions cut the country off from a substantial portion of international credit resources, and artificial obstacles were created for us in the modern technology field.

However, the main factor driving low performance has been structural problems in the Russian economy aggravated by two particular circumstances. First, there is the global crisis that created new, systemic challenges. Second, there is the exhaustion of the economic growth model of the 2000s, which was, in essence, a recovery model based on engaging idle capacity and workers in production and on rapidly growing foreign demand for Russian commodities.

In evaluating the current situation and devising an economic policy for the medium term, we must proceed from a proper understanding of the correlation between these crises and factors. The problems facing the Russian economy have not primarily been caused by external shocks (despite their significance), but have resulted more from the braking mechanisms inherent in the Russian growth model.

One only needs to look at the GDP trend (Fig. 1) to confirm the predominance of internal factors over external ones. This trend demonstrates clearly that decele-

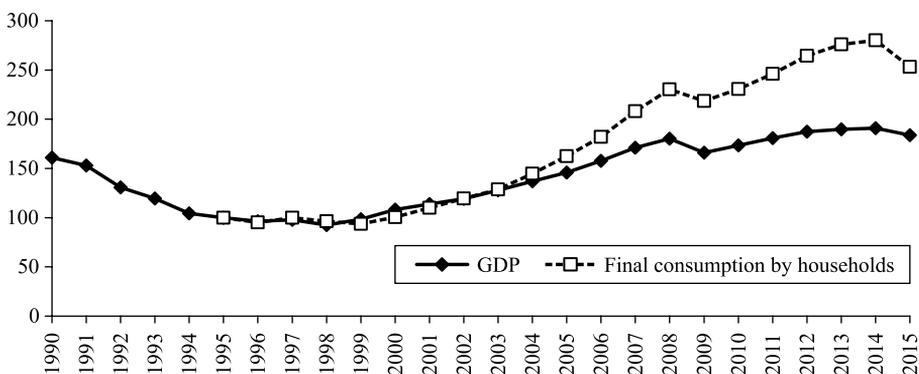


Fig. 1. Real GDP and final consumption by households in Russia (1995 = 100%).

Source: Rosstat.

ration occurred when the pre-crisis level was reached in 2008, followed by a fall and return to the same point in 2012. We can see that growth decelerated significantly long before the decline in oil prices and the imposition of sanctions on Russia, which happened two years later—in 2014.

### 3. Economic crisis: Interim results

The combination of domestic and external problems that Russia faced in 2014 would have been disastrous for the country had they occurred in the 1990s, for example. This test by the crisis has demonstrated that *the economic, political, and social institutions created over the past 15 years are sufficiently flexible, adaptive, and react adequately to various shocks*. Timely anti-crisis measures also played a useful role.

While long-term sustainable growth objectives were mostly clear and required systematic work, the worsening situation during the second half of 2014 called for immediate reaction—immediate but careful. At the end of 2014, we heard predictions of disaster as a famous politician declared that the Russian economy would be “torn to shreds.” They predicted an uncontrollable budget crisis, a plunge down an inflation spiral, a long fall by the ruble, a deep and protracted decline in production, and a surge of unemployment. All in all, a disastrous scenario, which would have materialized had we made the mistake of reacting nervously to the hardships we faced in a populist manner (fixing the foreign exchange rate, increasing government spending, introducing price regulation, etc.).

Instead of implementing outwardly popular but irresponsible proposals, we engaged in the systematic work of both countering the shocks and preparing conditions for a complete upgrading of our economic system. This is why we persevered despite the adversities and external pressures that were clearly aimed at destabilizing Russia.

The results were better than most forecasts predicted, and not only because the external environment improved. In fact, the global situation is even more complex now, and oil prices have fallen considerably below projected levels. We persevered because we succeeded in building an effective system of anti-crisis measures, which allowed us to prevent uncontrollable developments.

*We preserved a foundation for macroeconomic stability.* The budget, although not without losses, is coping with the serious challenges posed by external economic conditions. Russia remains a country with one of the lowest national debts in the world. The budget deficit was at an acceptable level of 2.4% of GDP in 2015, which is 2.5 times lower than during the crisis in 2009.

We have also modified the composition of budget revenues. The share of non-oil-and-gas income is nearing 60%. This is an entirely new economic model that has proven capable of remaining stable without windfall oil rents.

The timely decision to target inflation allowed us to preserve our gold and currency reserves and ensure the stability of our monetary system. Inflation is decreasing steadily and will not exceed 6% in 2016. Additionally, the 4% target, which seemed unachievable to many not so long ago, is taking a discernable shape.

Notwithstanding fluctuations in the foreign exchange rate and unlike all previous crises, there has been no flight of bank deposits or conversions into

foreign currencies: the Russian ruble still dominates retail deposits. Companies, as well as households, have steadily increased their bank deposits. During 2015, household deposits grew by 25% (17% without revaluing foreign exchange deposits), while corporate deposits increased by 20% (11% without revaluation). As of September 1, 2016, household bank deposits exceeded RUB 23 trillion. Elvira Nabiullina, Chairman of the Bank of Russia, was recognized as the best central banker in 2015.

*The banking system* is going through a difficult purification process by closing inefficient banks. In 2016, the Bank of Russia terminated the operations of 68 credit organizations (as of September), following 93 closings in 2015. A total of 279 banking licenses have been revoked, accounting for approximately 3% of the total assets of our banking system. However, although a great number of banks were closed, the Russian economy has not fallen victim to a banking panic. Our banking system is quite stable.

*The outflow of capital has also diminished considerably* and now primarily reflects debt payments to foreign creditors. In 2015, it dropped by more than 60 percent to USD 58.1 billion (USD 153 billion in 2014). During the first 8 months of 2016, the outflow has been USD 9.9 billion, compared with USD 50.8 billion during the same period in 2015. In 2016, the outflow originated almost entirely in the non-banking sector, i.e., from companies repaying their foreign debts. In other words, the outflow is no longer due to capital flight or withdrawal for political or criminal reasons, but rather the movement of funds related to meeting the commercial objectives of businesses. Under these conditions, Russia's total foreign debt has been, quite naturally, decreasing. Since its high point (USD 733 billion) in the middle of 2014, it has fallen by 30% (over USD 200 billion) to USD 516 billion (Fig. 2). Foreign debt in the banking sector has decreased by over 40% from USD 214 billion in early 2014 to USD 128 billion in mid-2016.

*The real sector.* For a long time, we have been complaining about the Dutch disease, i.e., a decline in efficiency and the competitiveness of domestic producers due to a stronger national currency not related to labor productivity growth. The symptoms of this Dutch disease are weaker now, although less due to the fiscal rule “treatment” as to the “surgical amputation” of rent income. The result has

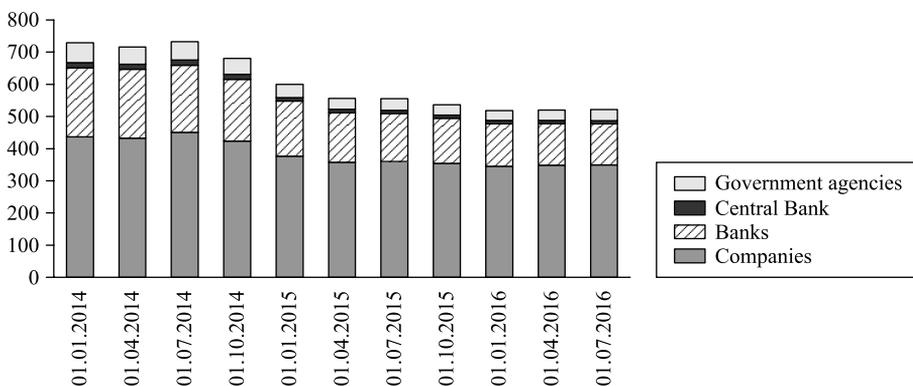


Fig. 2. Russia's foreign debt (USD billion).

been improved competitiveness and increased production volumes in a number of industries, including metallurgy, oil production, chemicals, industries producing general consumer goods (foods, clothes, footwear), agriculture, certain engineering segments, and pharmaceuticals. At the end of 2015, the growth rates for these industries were 2% in food production, 6.3% in chemicals, and 0.3% in oil products. Pharmaceutical production increased by 26%. Oil production has broken a record. Oil and gas condensate production was 533 million tons in 2015, having risen by 1.6%. In 2016, production will exceed 540 million tons. Agriculture is also demonstrating stable positive growth: 3.7% in 2014, 3.0% in 2015, and 3.2% during the first 7 months of 2016.

Many Russian companies managed to cut their costs amidst the crisis. Enhanced by the devaluation effect, this has led to improved efficiency in certain companies and sectors. Russian metal companies are now among the best in the world in terms of direct costs. Amidst falling prices, Russian oil companies have achieved higher corporate ratings than foreign oil producers (according to Moody's). Companies that have successfully raised their efficiency will have significant advantages when the situation begins to improve.

However, industries that could not use imports to substitute for their products and that benefitted the most from growing demand based on rent income are in the worst trouble. This primarily includes construction and services. Exhausting the flow of “cheap money” proved to be an ordeal for them.

We often address the importance of *import substitution*. We are arguing about its real trends and desirable forms. First, we need to recognize two substantial distinctions from traditional import substitution models that were characteristic of the 20th century. Today, imports should not only be squeezed out of the domestic market but also producers and products should be brought out that would be competitive in the global market. Second, the basis of true (rather than artificial) import substitution is not just foreign currency manipulation or administrative crutches for domestic firms. It is the creation of institutional and macroeconomic conditions favoring the emergence and successful development of Russian companies that could become global champions. Both conclusions come not only from our own experience but also from past economic development in various countries.<sup>1</sup>

The government did not initially expect a repeat of the effects of 1998, i.e., a quick rise in production as a result of devaluation. It was clear that the lack of considerable idle capacity and labor resources would limit growth. Today, import substitution requires arduous work to improve the investment climate. Apart from the general rules, we need a set of specific actions and targeted measures to support efficient, competitive producers. Naturally, since we are discussing targeted support, we should specify that it must follow clear and transparent “rules of the game.”

In other words, import substitution is not the buzz-word of the day or a short-term task. Instead, it is a part of our long-term strategy. However, we can observe the effects of import substitution even now in both the domestic market and foreign trade.

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<sup>1</sup> This is a common trait of import substitution today. The absence of its short-term effects has been noted by researchers of the current global crisis (see The Economist, 2016).

Import substitution processes are already visible in various areas of the domestic market. The greatest impact has been achieved in motor vehicle production. Additionally, due to new joint ventures with foreign companies, the annual average share of imports decreased by 22.5 percentage points in 2015. We can see a positive trend in the localization of these producers. For example, the share of imported car parts declined by 5.7 percentage points in 2015. One should also note the lower share of imports in metals and metal ores production (4.5 %), textiles and haberdashery (7.8 %), and foods (4.1 %) (Fig. 3).

The ratio of imported to domestically produced food decreased from 33% in 2014 to 28% in 2015, a significant trend in ensuring the country's food security

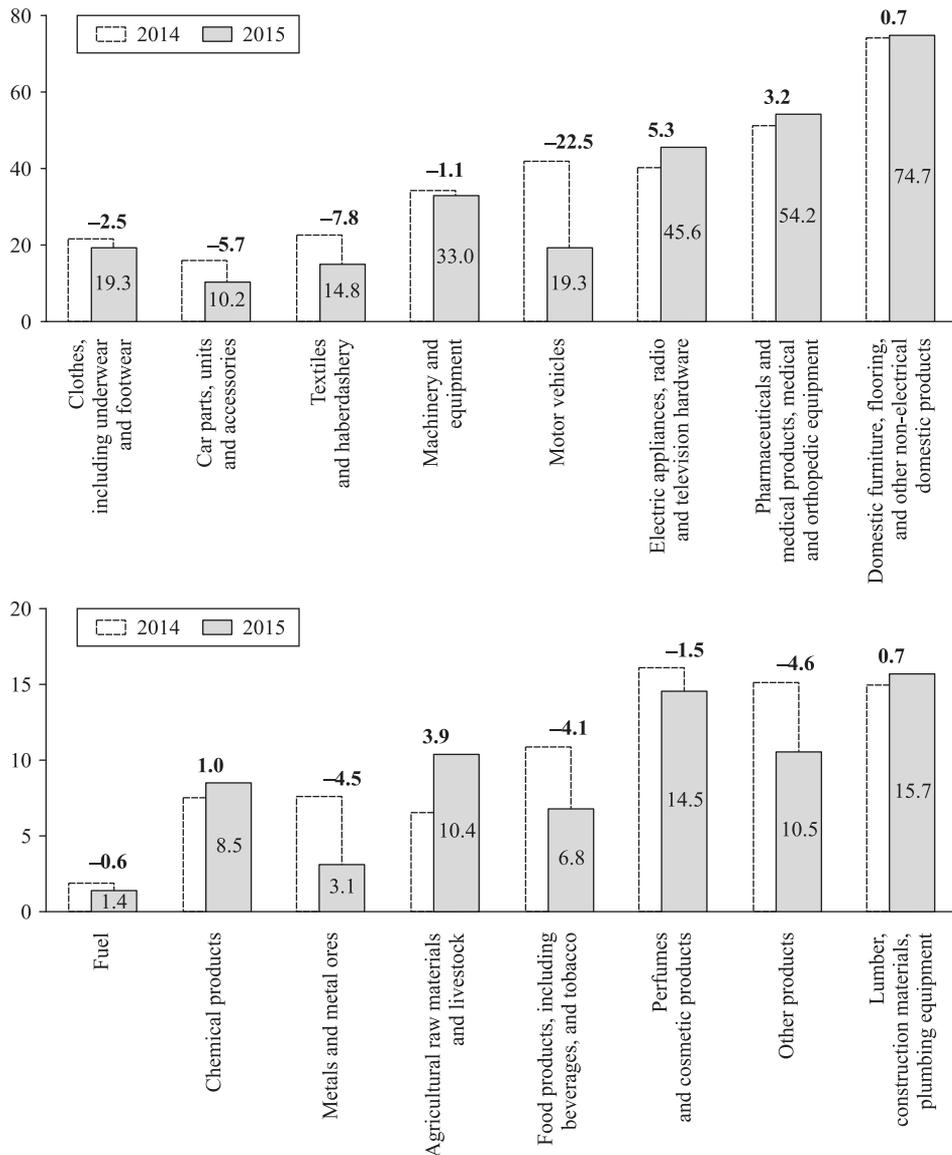


Fig. 3. Share of imported products in total turnover in Russia (%).

Note: Figures in bold are growth in 2015 compared to 2014, percentage points.

Source: Rosstat.

**Table 1**

Share of Russian production in total volume of available resources (%).

	Security threshold	2014	2015	Growth, from 2014 to 2015, percentage points
Grain	95.0	98.9	99.2	+0.3
Sugar	80.0	92.4	93.8	+1.4
Vegetable oil	80.0	84.4	83.9	-0.5
Meat and meat products (expressed as meat)	85.0	82.3	87.4	+5.1
Milk and milk products (expressed as milk)	90.0	77.4	81.2	+3.8

Sources: Rosstat; FCS.

(Table 1). The ratio of imported to domestically produced machinery, equipment, and motor vehicles dropped from 95.3% in 2014, to 89.6% in 2015, reflecting only the beginning of the import substitution trend. Further growth in the demand for domestic products will now become a significant factor in increasing their output.

In terms of export-oriented import substitution, positive trends have been demonstrated primarily by industries involved in exports that are not too dependent on more expensive imports, i.e., metallurgy, chemicals and petrochemicals, leather production, and agriculture. As a result of the ruble devaluation, such industries have increased their competitiveness in foreign markets several fold. In 2015, exports of metals and metal products increased by 3.0%, chemical products by 5.8%, and machinery, equipment, and vehicles by 8.4%

However, these are just the first steps towards import substitution, which should be followed by including other industries and producers in the process. To this end, the respective institutional and infrastructural conditions are being created.

We can clearly see *improvement in the financial position of a number of companies and industries*. Corporate financial results (profits) rose by 53.7% in 2015, which is considerably higher than the inflation rate. Russian companies hold accounts worth over RUB 21 trillion, of which deposits account for over RUB 12 trillion (40% growth in two years). This provides a foundation for improving investment activity.

An important indicator of economic development is the willingness of households to invest in housing. The anti-crisis measures revitalized mortgage lending in 2016. In the first half of the year, the number of approved mortgage loans grew by 39% (390,000 compared with 280,000 during the previous year), while the total amount of loans issued reached RUB 665 billion (+44%). Banking mortgage portfolios grew by 6.7% between January and June (15.9% over 12 months), and the share of assets increased from 4.72% to 5.26%. The share of mortgage loans out of the total number of loans issued to households rose from 36.7% to 39.5%.

However, all of the stabilization measures that have been used to overcome the crisis and recover growth are still unable to compensate for the main effect of the crisis, that is, the damage to the well-being of Russian citizens. Although we managed to prevent a surge of unemployment—not only relative to the 1990s but also 2009 when unemployment exceeded 9% compared to the current rate

of 6%—our people have become poorer over the past two years. Real disposable income and real wages have declined. The poor have been affected the most, while the middle class has also suffered heavy losses.

Undoubtedly, there are external difficulties. However, this does not mean that the government does not need to explore and implement mechanisms to sustain the well-being of the people during this crisis.

We have significantly extended social support. This budget item has grown faster than expenses in most other areas. On the whole, budget expenditures for social policies increased by 0.4% in real terms (adjusted for inflation) in 2015. Expenditures for pensions increased even more, i.e., by 1.3% in real terms. At the same time, total expenses for the consolidated budget have decreased in real terms by 5.1%. Social support will remain a part of the government's focus, although we certainly realize that the best mechanism for improving well-being is sustainable economic growth, highly productive jobs, and expanding business activities.

Thus, while fighting the crises that our country has faced in recent years, we not only managed to persevere but have developed and are moving forward. At this point, the state's capacity for expanding funding to the economy and the social arena and for supporting the banking system is dependent to a certain extent on the terms of foreign trade (commodity exports) and access to foreign credit. However, we have managed to significantly reduce our dependency on these factors.

The most significant lesson from the acute stage of the crisis was learning that we can cope without the powerful inflow of oil and gas rent. The structure of our budget and revenues is changing. This is a painful but unavoidable process. After the past two years, we can safely state that our economy is adapting to the new conditions while improving its efficiency. It was fundamentally different in 2013 both in terms of structure and costs. The economy is diversifying, a necessity that has been a much-discussed topic over the past quarter of a century. Russia's role in the global economic system is also changing. A prototype for the new Russian economy has begun to take shape, and it will fully reveal itself after the global crisis.

We are now facing two principal tasks: ensuring sustainable economic growth and improving the well-being of our citizens. However, these objectives are one and the same, as economic growth provides a basis for improving well-being, while well-being provides a source of demand that makes economic growth possible. A key condition for performing this task is the preservation of political stability within the country. We have just had our parliamentary elections, and it is important for the new State Duma to provide a legislative platform that will respond to the economic challenges facing the country.

#### **4. Economic growth: Objectives, risks, limitations**

Economic growth and diversification of its sources is a crucial task for modern Russia. It is crucial because, among other things, we want to remain a country capable of standing our ground and protecting our national interests while providing decent living conditions for our citizens regardless of their age or social position.

Economic growth is not an abstract idea or a fetish, and it is not a target to be achieved at any cost. Improving growth rates must not be a bureaucratic task for which positions and awards are bestowed.

I have written that what we need is not just economic growth, but growth meeting certain criteria (Medvedev, 2015). Those include the following:

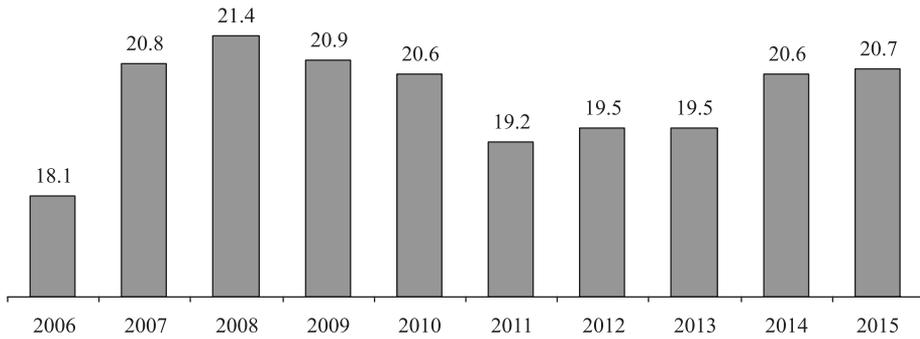
- sustainable growth in both the medium and long term. In other words, we will not accept a policy of artificial “acceleration” that results in a short-lived increase in growth rates followed by a deep economic and political crisis;
- our growth rates should be slightly higher than the world average in the medium term. This falls in line with Russia’s contemporary level of development and ensures that the gap between Russia and the most developed countries will be reduced;
- growth should be accompanied by structural, technological, and social modernization.

The experience from recent years has demonstrated that economic growth may not automatically recover after the recession, at least in developed countries, which is a real new challenge. The sporadic crises of the past used to lead to an economic contraction, but after recovering the balance, economic growth would restore almost automatically. Keynesian regulation also helped reduce these fluctuations, thereby ensuring long periods of sustainable growth.

However, the situation has changed. A living example of this change is Japan, which has been experiencing growth rates close to stagnation for about a quarter of a century, and all of their macroeconomic experiments have failed to turn that tide. A similar scene has unfolded in the euro zone over the past five years as the unprecedentedly mild monetary policy, designed to start the economic engine, may have absolutely unpredictable consequences for the socioeconomic stability of those countries. It is likely that these changes are fueled by the qualitative, fundamental, and structural shifts in the technology and consumption patterns of modern society, as the majority of the population is escaping to areas that are difficult to measure with statistical methods (e.g., online). Under these conditions, products and services are becoming dramatically cheaper.

Thus, the goal of recovering economic growth under today’s conditions should be approached from a completely new angle. This is a requirement of the “new reality” that has been recently taking form. Developed countries are facing the need to devise a growth policy that will meet new challenges. Similar tasks need to be solved by Russia, which is considered a developed country by many economic and social parameters. However, our particular mechanisms and solutions for kick-starting growth will need to be different from those used in Japan or the euro zone.

What is needed to achieve sustainable economic growth? We need to maximize the use of labor and capital and ensure synergy between those two factors. We need investments of all types: private and public, domestic and foreign. Investment should become the driver of economic growth—a more essential one than increasing consumption or export demand. To strike a trajectory of sustainable growth, the Russian economy requires a substantial increase in the share of investments from the current level of 20% of GDP to at least 24%. This is no easy task given that this indicator has been lower even during the best of times throughout modern Russian history (Fig. 4).



**Fig. 4.** Share of fixed capital investments in Russian GDP (%).

Source: Rosstat, [http://www.gks.ru/wps/wcm/connect/rosstat\\_main/rosstat/ru/statistics/efficiency/#](http://www.gks.ru/wps/wcm/connect/rosstat_main/rosstat/ru/statistics/efficiency/#).

Of course, most important are domestic private investments. We need to develop measures that will encourage savings and help them transform into investments. This is not an inherently Russian problem, although there are many barriers that apply specifically to us. A persistent excess of savings over investments has become a basic problem for all developed countries in recent years<sup>2</sup> (Table 2).

Apparently, the problem is not interest rates because they are actually negative in Europe, while investments still tend towards zero. The real problem is the high level of uncertainty that may take different forms in different countries and regions. For some, this uncertainty is technological dilution and the business community's lack of understanding of future demand. For others, it is geopolitical uncertainty and the lack of clear priorities for the activities of national governments. Another cause of uncertainty is what we usually refer to as defects in the investment climate, i.e., inadequate protection of ownership rights, unstable "rules of the game," etc.

While recognizing the importance of encouraging economic growth, we need to understand not only what we need to accomplish (the positive agenda) but also what the government should avoid (the negative agenda). The latter is no less important than the former because of the detrimental effects that good intention can have. Undoubtedly, both the positive and the negative agendas are not permanent

**Table 2**

Savings and accumulation in a number of countries, 2015 (% of GDP).

Country	Gross savings	Gross fixed capital formation
Russia	25.9	21.9
Russia (Rosstat)	23.8	21.9
European Union	21.7	19.6
Japan	24.8	21.8
China (2014)	48.7	44.3

Source: World Bank, World Development Indicators.

<sup>2</sup> Wolf (2016) described the situation in developed countries as follows: "The world economy is suffering from a glut of savings relative to investment opportunities... The savings glut (or investment dearth, if one prefers) is the result of developments both before and after the crisis."

(for all countries and for all times); they can and should be reviewed based on particular circumstances.

First, we need to define the negative agenda. I can identify two limitations that should be imposed when steering the course of structural reforms and economic growth: populism on the one hand and reform at the expense of the people on the other. The first is dangerous and will ultimately lead to the second because it is the people who always end up paying for populism. At the same time, the nature of the necessary structural reforms does not entail high social costs (unlike in the 1990s).

We cannot allow populism either in our language or, more importantly, in our budget. During the most difficult period of 2014–2015, we made no empty promises and took no dangerous actions. We will not choose to turn on the “printing press” and undermine the economic balance, as such measures would lead to catastrophic consequences for which the people would have to pay. If there is not enough money in the budget, we will not print it to make up for the lack of revenue. It is commonly understood that issuing fiat money would be the same as making paper; it would spur inflation and devalue household incomes, wages, and pensions. We watched this happen in the 1980s and 1990s, although under different sociopolitical systems.

Equally unacceptable under current conditions are proposals to introduce rigid regulations on the economy, returning to the Soviet planning model. We should remember that it was the rigidity of the Soviet model that led to its downfall under the conditions of modern (post-industrial) society. There are a number of other ideas as simple on the surface as they are dangerous, from switching to a mobilization economy and nationalizing major companies to a complete sellout of all public property. However, *simple solutions are extremely difficult to rectify in the future when the “errors of simplicity” become evident*. All of these proposals make useful propaganda, but they have no relation to real work or to real improvement in socioeconomic conditions.

Real work—the positive agenda—requires extensive structural reform to ensure economic growth. In 2013, I wrote that the time for simple solutions had passed (Medvedev, 2013). However, difficult solutions are not at all synonymous with social pain. The difficulty with reforms under today’s agenda is that they require everybody to increase their efficiency, from the budget sector to private companies. This is quite a different set of problems compared to the mass lockouts, lost revenues, and degrading social environment that we witnessed in the early 1990s.

Note that the speed of structural reforms is as important as their focus. The government must carefully consider all of the consequences of the measures that they take and establish a better considered, even more conservative, position. This was manifested in how we implemented the anti-crisis measures in 2015 and 2016, which not only alleviated the negative effects of the crisis but also paved the way for new structural transformations.

## 5. Outline of the economic policy for the coming period: Priorities

The government’s economic policy is detailed in the “Main Directions of the Government’s Activity” as well as in the anti-crisis plans for the previous two

years. In this article, I would like to focus on five priorities without which any future development is impossible. Moreover, realizing the government's priority to develop our people and improve their well-being will be equally impossible. These priorities include optimizing fiscal policy, optimizing structural policy (including import substitution and support for non-commodity exports), improving the investment climate and business environment, improving the quality of the state itself, and developing the social arena.

### 5.1. Fiscal policy

An efficient fiscal policy is essential for any economy adapting to a new reality. It is comprised of macroeconomic and structural enablers of economic growth and improved well-being.

Combining the flexibility and stability of the budget process (and the entire budget system) is a highly complicated task, especially amidst a crisis. During its most acute phase, the government returned to an annual budget model, though three-year planning was restored the next year. The government is now in enough control of the macroeconomic situation to afford medium-term decisions.

A vital budget-related objective is defining the balance between the need to live within one's means and creating budgetary incentives to restore growth. This is an issue facing every responsible government during a crisis. Our government will exercise tight control over the budget deficit because in our situation, with our "credit history" of budgetary crises, a well-balanced budget is a factor that will contribute to the country's sustainable socioeconomic development.

"Live within one's means" refers, first of all, to efficient spending. We will continue to optimize budget expenditures by cutting down on less efficient expenses and increasing (if revenues permit) more efficient ones, i.e., the ones driving productivity in the Russian economy.

Such expenditures primarily include investments in human capital (they are investments, not expenses). The second component is represented by investments in transportation infrastructure, which ensures the cohesiveness of our territory and increases the productivity of the Russian economy. These are also global investment trends.

In recent years, we have observed a decline in the situation regarding regional budgets, which manifested itself in the rapid growth of regional debt—mostly expensive commercial debt. We succeeded in stabilizing the situation (Table 3). By increasing easy-term lending to subjects of the Russian Federation, we checked the growing debt burden on regional budgets and refinanced the significantly more expensive debt to commercial organizations through budget loans.

**Table 3**

Debt burden on the budgets of RF subjects, 2008–2015.

Indicator	2008	2009	2010	2011	2012	2013	2014	2015
Debt burden, %	15.3	26.9	27.8	25.1	26.1	33.0	35.4	36.5
Debt burden increment, percentage points	–	11.6	0.9	–2.7	1.0	6.9	2.4	1.2
Deficit, RUB billion	–44.0	–276.9	–88.1	–20.4	–251.1	–599.8	–393.2	–108.2

Sources: Federal Treasury; Russian Ministry of Finance.

Now we face the task of improving the stability of regional and local budgets. We need to ensure their stability and more clearly regulate accountability at different administrative levels. We need to optimize the budget network and connect private organizations to the budget services sector to guarantee that those services are provided in a timely manner and at a high quality standard.

## 5.2. Structural policy

Structural reforms will improve the competitiveness of our economy but will require quite substantial time to implement. We could say that they should continue indefinitely because the task of improving efficiency and modernizing will always be a part of the agenda.

Structural reforms require the implementation of an intricate set of measures, both general and targeted. We hope to efficiently implement the new measures detailed in the law on industrial policy. These include the introduction of a special form of investment contract that will warrant the predictability of investment conditions over a 10-year period. We are optimistic about the Fund for Industrial Development (FID), which recently started its work and has already proven its effectiveness. We will also use other financial support measures for growing firms, including subsidies and state guarantees, co-financing research and development efforts, and measures to encourage demand (including government procurement).

Small businesses can and should be an important factor in diversifying the economy. We have established the Corporation for Supporting Small- and Medium-sized Businesses (SMB). Within the framework of the national guarantee system for SMBs, the amount of guarantees issued has reached RUB 45 billion, which means that the total credit for SMBs amounts to RUB 90 billion. The rates under these programs are between 10% and 11%, and we plan to lower them in the future. The SMB Corporation will support both domestically oriented companies and firms with export potential. Exports are a prerogative of not only major companies but also of small- and medium-sized businesses. We have worked out and launched a mechanism for coordinated support by development institutions for non-commodity exports by small businesses: FID, SMB Corporation, Russian Direct Investment Fund (RDIF), and the Russian Export Center (REC). We believe that these vehicles will help increase the share of SMBs in Russian exports by at least twofold.

The core of the structural reforms is import substitution, by which we mean “smart import substitution,” implying the production of competitive goods and services for global markets. These issues will remain the focus of our attention in the coming years regardless of the geopolitical situation, sanctions, or other similar circumstances.

Diversifying exports and supporting non-commodity exports will not only alleviate the country’s dependence on changes in global commodity markets but will also ensure additional demand for Russian products. Despite the size of our country and the Eurasian Economic Union (EAEU), this market is not large enough to ensure sustainable economic growth.

The ability to export non-commodity products should become one of the main decision-making criteria for granting government support to a project or company. It should become the target of the recently-created export support institutions,

including EKSAR and REC. At the same time, we should also withdraw government support if there are no clear indications of efficiency and no estimable period for bringing products to a globally competitive level.

Foreign economic relations are a way to improve efficiency through competitiveness. We need to develop and implement measures to strike a balance between supporting the competitive performance of our producers and ensuring competition in the domestic market. It is only with their help that we can identify long-term competitive advantages and develop effective, targeted support tools that are compliant with WTO rules. This is how “smart import substitution” should be instituted.

We will have to re-think a number of traditional approaches to foreign trade, including the concept of protecting domestic businesses. Countries in the modern world are facing the challenge of integrating their domestic producers into global value chains. Two conclusions follow from this.

First, the accessibility of imports is as important as growing and diversifying exports. The most efficient and competitive products consist of components (including equipment) produced in different countries. Consequently, import limitations often become export limitations.

Second, gearing industrial policy towards creating our own Russian (or, to be more precise, EAEU) value chains should become a target for government incentives and support.

Russian companies have good export potential in metallurgy, chemicals, transportation engineering, and agriculture. Calculations show that there are great export opportunities (subject to creating our own value chains and integrating them into significant positions within existing ones) in motor vehicle production, office and telecommunications equipment production, pharmaceuticals, electrical machinery and equipment production, furniture manufacturing, and aircraft construction. A number of industries have demonstrated the potential to export provided that international industrial cooperation is enhanced. These include electronic and optical equipment, plastics, rubber, paper production, and vehicle and equipment manufacturing. On the whole, there is hardly a sector in the Russian economy that could not produce export products.

Despite geopolitical complications, Russia will remain on the path to foreign economic openness, creating free trade zones together with individual countries and groups of countries and signing preferential trade agreements. We can see enormous opportunities opening with the liberalization of international trade based on the principles of equal rights. Naturally, the EAEU will remain at the core of our integration agenda.

A number of structural reforms that are expected to be implemented in Russia will improve the stability and growth rates of the economy, its immunity from adverse external events (shocks), and the global competitiveness of the country and its companies.

In the medium term, we will need to tackle more complicated issues of an institutional and structural nature. First, government support must be focused on production in strategic sectors and companies with long-term competitive advantages. Second, a breakthrough is needed in the production of export-oriented, import-substituting products within three to five years with active support for the creation of our own value chains. Third, a significant reduction in the energy

requirements of Russia's GDP is needed. Fourth, long-term regulatory models for natural monopoly sectors of the economy should be developed and implemented to increase the predictability of economic policy and attract private investment. And fifth, efficient transportation and logistical connections should be developed along both domestic and international routes to lower the costs of moving goods and production factors, increase labor and capital productivity, and concentrate economic activity.

Structural reforms will also require *rehabilitating the business climate and improving the quality of public administration*. Both issues are extremely significant for the sensitive undertaking of turning savings into investments and for decision making by businessmen starting to invest.

### 5.3. Business incentives

The main focus here is to ensure full freedom for business operations and the minimization of risks and threats. First of all, we need to overcome the negative expectations of businesses and mitigate their economic, political, and law-enforcement risks. All people need to be given an opportunity to work freely, and they will work—both for themselves and for their country. The willingness of businesses to invest in, create and upgrade facilities will be a decisive factor in the state of both the economy and the social arena in 5 to 10 years. It will also determine the well-being of our citizens, both in the private and public sectors.

The government's ability to honor its commitments will help improve predictability and allay the negative expectations of businesses. In particular, gradually reducing inflation and achieving the target of 4% has both an important macroeconomic and political significance. The monetary system will become more stable than it has been over the past thirty years. This will be followed by the increased accessibility of domestic credit resources that are required for the growth of private investments.

It is equally important to streamline regulatory and supervisory activities to ensure their transparency and predictability and to implement a risk-oriented approach to those respective measures. With the help of roadmaps prepared by the National Business Initiative, we have begun to cleanse the system of barriers, some of which are a Soviet legacy. We have simplified the procedures of construction, title registration, energy grid connection, and tax and customs administration.

Positive shifts in these areas have allowed us to significantly improve Russia's Doing Business rating from 120 in 2012 to 40 in 2016 (World Bank, 2016). However, this is hardly satisfactory, as ratings improvements are an important but insufficient measure. A more careful analysis identified certain bottlenecks, i.e., those elements that have not improved significantly or have deteriorated. Parameters below 100 include trading across borders at 140 (138 in 2015) and dealing with construction permits at 115 (117 in 2015). Apparently, to improve the business and investment climate, we should concentrate our efforts on these weaker items.

One of the most sensitive topics for businessmen is the protection of private property and the relief of pressure on businesses, as this sometimes leads to their liquidation. Businessmen have to be certain that no one will come to them tomorrow and take their business away or instigate an unwarranted criminal investiga-

tion against them. Even if a crime is committed, the punishment should not only be inevitable but also commensurate with the gravity of the wrongdoing rather than an instrument of extortion and unfair competition.

In this regard, I should mention both the adopted and discussed measures for easing excessive regulatory, supervisory, and unlawful enforcement pressure from the business community. Starting in 2016, small businesses have been made exempt from scheduled inspections by governmental and municipal authorities. Measures are being discussed to increase the accountability (including criminal liability) of law enforcement agencies for illegal actions that hinder business operations and destroy businesses. The president has established a working group to resolve conflicts between law enforcement agencies and businesses, primarily through developing recommendations on improving legislation.

Developing competition is an essential part of a healthy business climate. We still need to do much more to support competition and pursue a comparable policy towards monopolies. At this point, we need to fight administrative monopolism and the monopolism of major corporations rather than small firms that manage to occupy dominant positions in their local markets due to their high efficiency. In government procurement (of products and investments), investors and owners should have equal access to funding sources, infrastructure, and sales markets.

We need to improve procurement efficiency by the state, by municipalities, and by state-owned companies. We have nearly completed the creation of the principal institutions of the federal contract system, saving over RUB 300 billion in 2015. We are engaging more small companies through the state procurement system with their share of total participation reaching RUB 700 billion, which is expected to exceed RUB 1 trillion next year. The federal law on public-private and municipal-private partnerships, adopted in 2015, established state guarantees for the main parameters of public infrastructure facilities holding private investment funds.

And there is one other significant point. As experience has demonstrated, the willingness of businesses to invest depends first on the regions. The regions lay the foundation of trust between the government and businesses. The level of and trend in private investments should now become a major indicator in evaluating the efficiency of administrations in the subjects of RF.

For its part, the government is creating additional opportunities and institutions to improve the investment attractiveness of our regions, including proactive development territories, special economic zones, industrial parks, and technoparks. The government will closely monitor the efficiency of these institutions and make prompt decisions, both to close inefficient ones and create new mechanisms where the efficient work of regional administrations is evident.

The investment ratings for the regions also play an important role. This project, supported by leading business associations, has become an effective tool in improving the country's business climate. Today, the Russian Presidential Academy of National Economy and Public Administration, in cooperation with the Agency for Strategic Initiatives, is implementing a program to train regional investment teams based on generalizing, studying, and adapting global and Russian expertise to attract investments as well as improve the standards and quality of the public administration system.

#### 5.4. *Quality of public administration*

While recognizing the importance of solutions related to economic policy, those solutions will not yield the expected results if government institutions do not operate efficiently. We are seeking to optimize and simplify the organization of the government machinery. The 10% reduction in the number of civil servants at both the federal and regional levels, which took place in 2016, was a painful but relatively simple measure to accomplish this. However, we still need to make a number of more complicated steps.

One such step is the creation of a single mechanism to administer taxes, customs, and other fiscal payments. A number of governmental agencies have been consolidated. This work will continue, and we hope that it will spread to the regional level.

The next major step is the actual transition to a bi-modal administration, i.e., allocating dedicated project teams to resolve priority tasks without which it would be difficult to achieve a qualitative change in our society. We already have a positive track record in implementing important national projects. We can use this experience to ensure a new level of quality for public administrative institutions. The Presidential Council on Strategic Development and Priority Projects is coordinating work in this area.

Finally, all these objectives cannot be achieved without radical improvement in the organization of state and municipal services. This requires a new system for training and developing civil servants as well as creating a labor pool.

#### 5.5. *Efficient social development*

Economic policy is not only important in itself; it should also provide conditions for improving well-being to allow our citizens to live a convenient and comfortable life in their own country. The “May Decrees” by President Putin target this goal, which is the main focus of the government’s work. Quite naturally, the development of human potential will be a priority project for the Presidential Council established in June 2016.

In spite of all the hardships in recent years, we have had some important accomplishments that provide the basis for our continued advancement. First, the Russian population has been growing over the past three years for the first time since the 1980s. Second, the share of families with more than one child is also growing despite the adverse shifts in the age structure of society, rooted in the drop in the birthrate during the 1990s. Third, life expectancy has increased to 71 years, and although this is not a high figure for a developed country, it is the first time that this has been achieved in Russia’s centuries-long history (Table 4).

The main objective of our social policy is to help those who need it (primarily retired persons, children, and disabled persons) and to provide earning opportunities for those who want and are able to work. To accomplish these tasks, we need to do the following:

- ensure the targeted nature of social aid;
- expand our social policy tools;
- upgrade the labor market;
- create new opportunities for developing human capital sectors (education, healthcare).

**Table 4**

Life expectancy at birth in the Russian Federation, 2011–2015 (years).

	2011	2012	2013	2014*	2015
Total	69.83	70.24	70.76	70.93	71.39
<i>growth in % y-o-y</i>	–	0.58	0.74	0.24	0.65
Males	64.04	64.56	65.13	65.29	65.92
Females	75.61	75.86	76.30	76.47	76.71
Gap between males and females	11.57	11.30	11.17	11.18	10.79

\* Since 2014, data include Crimea Federal District.

Source: Rosstat.

Families with children will receive active support. The maternal fund has become an important social policy tool. The government has expanded its scope and is extending its duration. We will continue to pay monthly allowance to large families, including subsidies for utility services. Within three years, we should eliminate the queue for land plots for large families or provide them with housing.

We need to develop a comprehensive program to help our senior citizens by giving them adequate medical aid and helping them continue to live an active life. We are going to renew our support system for seniors, which should meet the requirements of a modern, developed society. The dynamic nature of modern life should allow for dynamism in the lives of our senior citizens.

It is important to improve *the efficiency of the labor market*. We should not be happy with the country's relatively low unemployment rate. The ongoing reduction in the working-age population calls for more active measures to engage available labor resources and for their concentration at points of economic growth. To this end, we will need to cut the costs of moving to new workplaces and develop a social infrastructure that will be available across the country.

As economic growth recovers, employment opportunities will expand. However, this expansion is not an excuse for reassuring conclusions if we are talking about a new quality of growth. We are faced with the task of creating millions of highly productive jobs. Addressing this issue will inevitably require massive modernization of production facilities and closing, suspending or reconstructing old ones. Such changes are always connected with redundancies, re-training, or the movement of employees to other jobs. This will lead to stricter requirements in the labor market. For demographic reasons, fewer workers are joining this market now, which solves some of the employment problems that arise during the modernization of the economy. However, this is too simple an equation for real life. Desired professions, specialties and regions will not always match, which may become a serious challenge.

The above issues require increased flexibility and mobility in the labor market. Its geography and segments should be linked together with a database of vacancies, including information about the social capabilities of a company or region. This is a market in which new forms of employment are developing, including remote and part-time jobs, and in which short-term contracts are common. This market also will necessitate the construction of rentable housing and the development of systems for adapting and retraining idle workers. Finally, support for small businesses whose social roles are as significant as their economic roles will be needed.

The most topical socioeconomic problems include the state and prospects for our pension system. These problems go far beyond the issue of the retirement age, which should be resolved only after a deliberate and careful public and expert discussion. A similar discussion is giving birth to various proposals for the development of the pension system, including cancelling the obligatory retirement savings, transitioning to government-encouraged voluntary savings, etc.

Choosing a pension model is a task that is not only extremely responsible but also quite complicated. It is hard to even name the most acceptable model that would be recognized as such throughout the world, even in developed countries with a higher life expectancy. There are countries in which the employer and employee both contribute to the pension. There are systems in which voluntary savings prevail, and there are models with a significant share of government contributions. Finally, there are countries that used to introduce obligatory funded pensions and then gave them up. However, whatever the choice, the distribution of pension resources should be based on the priority of supporting senior retirement age citizens.

Faced with a shrinking working-age population in the country currently, it will become increasingly important to support people who are willing to remain in the workforce. Extending the labor activity of senior generations is both an economic and social goal.

Healthcare and education were among the priority national projects during the 2000s. They remain a priority for us currently. They are included in the list of strategic projects for the coming years.

*High-quality education* is a source of competitive strength for a country and can determine its position in the world for decades to come. The level and quality of education is largely, if not completely, the reason that the economy can be successfully modernized. It also increases its efficiency and presents the opportunity to switch to a new development model. For education to achieve the level of present-day and—more importantly—future requirements, we need to resolve substantial structural problems in this area and improve the educational system's ability to respond to the most serious challenges.

We now need to focus on the affordability of quality secondary education. It is high schools that lay the foundation for the country's intellectual and technological success. While recognizing the significance of universities, they are undergoing a professional fine-tuning, the effectiveness of which is determined to a considerable extent by the effectiveness of secondary education. In 10 years, the number of schoolchildren will grow by 3.5 million, and they will need to attend modern educational institutions.

Professional education is also a priority. The key tasks in this area are to ensure its affordability, quality, and the opportunity to undergo retraining throughout one's professional career (life-long education).

In today's conditions, continuing education is becoming a requirement that defines the success of every individual and the society as a whole. The problem of educating adults and seniors, i.e., re-training, mastering the second specialty, and computer learning, is becoming increasingly relevant. Structural modernization requires broader affordability for additional education. Educational institutions that develop additional education programs for various groups of citizens should receive incentives to increase these activities.

While evaluating the expense and effort of developing our education system, we need to understand that we are exploring a highly competitive area. Intense competition for qualified staff has become more common in the global economy. In the modern world, people now have the opportunity to choose where to study and where to work afterwards. We must not lose this competition.

The development of the healthcare system helps to determine the standard of living. The tasks we are facing in this area are more difficult than those we have already solved. For example, capital investments in advanced medical equipment made in recent years exceed anything that has previously been accomplished. However, a more important issue is rather its qualified use and the effect that we should gain from it.

Any reform in an area as sensitive as healthcare requires that the following condition be met: the state guarantees of free medical assistance must be clearly and transparently formulated. We determined a number of directions—management and technological—along which Russia's healthcare system is developing and will continue to develop. They include the priority development of primary healthcare, telemedicine, and a unified electronic patient file. Our topmost priority is to ensure the affordability and quality of medical drugs, including those for needy patients, the consistent struggle against falsifiers, and improving the efficiency of the control system over the quality of medical drugs and medical equipment. It is all the more relevant considering that we have started the process of import substitution in those areas: our people should be certain of the quality of domestic products.

The health and future of the country, as well as its position among its global peers, depend to a large extent on the level of Russian healthcare development and the state and prospects for the healthcare system. Growth rates, industrial investments, and technological innovations will ultimately be evaluated according to the highest criterion, i.e., their impact on the standard of living of Russian citizens.

## **6. Conclusion**

The well-being of Russian citizens and the country's prosperity directly correlate with Russia's competitive performance in all key areas, from the economy and industry to education and culture. Only our own efforts can protect the interests of Russia in the world and its role and place as a modern, developed state.

In the years to come, Russia will face competition and rivalry between countries for markets, investments, and human capital; persisting trade and financial embargoes; and the instability of prices for its traditionally exported goods. It would make no sense to wait for a favorable commodity situation to return. This strategy would condemn our country to being left behind, lower the standard of living, and block prospects for occupying advanced positions in the world economy and social arena. There are also no prospects for the expectation that economic development problems can be solved primarily via state funds. The government's priority is security, investments in human capital, assistance to the most vulnerable groups within the population, and infrastructure. Russia's budget structure should reflect these priorities.

Under these conditions, it is important not only to restore economic growth but to ensure its long-term sustainable rate. The new model of economic growth is first

about growing private investments by creating a favorable business climate and encouraging business initiative. We need to ensure the attractiveness of the Russian jurisdiction for businesses. If the business community trusts the government, it will work not only for itself but for the entire economy as well.

The complexity of tasks to be solved and the scale of challenges to be met, especially with limited resources, require very precise actions from the government. We have no opportunity to experiment or make mistakes. All decisions must be made as efficiently as possible. Only in this case can we see in the not-too-distant future both the outline of the new economic structure and quite noticeable results that people will feel first of all. These results will enable Russia to occupy a leading position in the global economy. They will be results that we all can be proud of.

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