

# A new reality: Russia and global challenges

Dmitry Medvedev

*Government of the Russian Federation, Moscow, Russia*

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## Abstract

The article considers social and economic challenges that Russia faces in the context of present-day global transformation. Key technological, economic, and social trends, which determine the contours of the post-crisis world, are analyzed. A long-term agenda for the country's development aimed at securing a new quality of economic growth is proposed.

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## 1. Introduction: Structural crisis and the Russian agenda

The modern age is characterized by new priorities and challenges and by new approaches to problems facing Russia and other countries. This article attempts to analyze extensive changes taking place in the global economy that are directly affecting the situation in our country. They are creating new opportunities for accelerated growth while imposing restrictions that cannot be ignored.

This article does not offer a detailed action plan, nor does it describe a set of particular economic tools. There are other purposes for this article. First of all, decisions are prepared and adopted by the Russian President and Government on an almost daily basis. Of course, while Key Areas of Government Activity until 2018 is a major policy document, we focus on the Plan of First Priority Actions to Ensure the Sustainable Development of the Economy and Social Stability of 2015, which is often referred to as the Government's Anti-Crisis Plan.

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*E-mail address:* [mail@vopreco.ru](mailto:mail@vopreco.ru).

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Due to the presence of various points of tension and of local, regional and other crises, the world remains unstable, and there is no fast and easy way out. As for the situation in Russia, it is not likely to deteriorate swiftly (in spite of recent predictions) or quickly regain the growth momentum of the previous decade. Geopolitical conditions and sanctions are not the only reasons cited here. These factors only account for part of the problem, which has resulted from broader and more fundamental processes, i.e., a profound transformation of the world order.

The present situation is not unique to human history. Similar crises have occurred in the global economy and in individual countries quite recently. The crises of 1997–1998 and 2008–2009 are still fresh in our memory. Moreover, Russia's experience in the 1980s, when the country plunged into macroeconomic and structural crisis, is still relevant—unless we wish to repeat the mistakes of the past.

However paradoxical, statements that the world has more than once passed through a number of various crises and transformations (including deep and lengthy ones) and that we now find ourselves in a unique situation whereby we must solve completely new tasks are both true and correct.

Old problems and circumstances are re-emerging in a new guise. On the other hand, completely new events are occurring that sometimes take on an old appearance. Today, as in the past, controllable factors are being interlaced with those beyond our control. It is important for us not to mistaken one type for the other and to not back down in the face of external circumstances.

What are the specific complexities of challenges facing Russia today? The problem not only lies in overcoming new or long-standing difficulties, crises, deficits, or disproportions. Without belittling the significance of these tasks and the gravity of today's challenging circumstances, we must still formulate strategic goals and objectives that we ultimately want to achieve. That is, goals must be clearly articulated, even if some goals appear very distant and even when solutions are difficult and complex. On the other hand, a goal can be stated quite simply: join (“bridge-head establishment” comes to mind, although military terminology does not seem suitable here) the group of states with the highest standard of living. To become a member of this group, a country must meet certain levels of per capita GDP and economic efficiency, which are manifested, first of all, in labor productivity.

In regards to many social and economic parameters and to the development level of human capital and culture, Russia is ranked among developed countries of the modern world. However, the Russian economy still remains largely inefficient and lags, for instance, in terms of labor productivity behind leading countries, and this gap is measured by time rather than by percent levels. This problem has existed for longer than a few years or decades. In 1880, Nikolai Bunge (academician and later Minister of Finance) wrote to Alexander II: “Russia is half a century behind Western Europe” (Bunge, 2007, p. 208). Of course, history has not been so straightforward since then, with Europe trailing behind Russia in key industries such as nuclear energy, space exploration and rocketry over a lengthy period of time. However, our economic efficiency has remained backward throughout history. Neither the centralized administrative economy with absolute state domination (despite sacrifices made) nor the subsequent inertial commodity-based model have succeeded in closing this gap, although it has indeed been reduced over the past 10–15 years.

Against this historical and economic backdrop, the above-mentioned strategic goals can be regarded as unprecedented. They are not likely to be achieved by applying the essentially inertial development model or by reacting to external factors to only a certain extent. As experience shows, there is no so-called “catch-up development” along this path. On the other hand, the gap may expand and is bound to if our main efforts are only directed at explaining current problems and difficulties based on objective factors (e.g., long borders and distances, climates, and low population density levels in certain areas). These challenges are not insurmountable, as the global experience shows. Canada and Australia have become highly developed nations despite their small populations and vast, unpopulated areas. Japan, on the other hand, has a huge population and no free territory or abundant natural resources. One can build an endless chain of “objective factors” in any situation, in any position, and with any amount of resources: access to large stretches of land is undesirable because such land is difficult to cultivate; access to few land resources is undesirable because insufficient land is available for settlement and for growing crops; access to few mineral resources is undesirable as this results in high dependency on expensive imports; access to abundant resources is not preferable because the rest of the economy does not develop; a small population means a shortage of labor; a large population leads to food scarcity, etc.

Our goals cannot be achieved without conducting substantial reforms. This is an obvious fact to everyone today. We must adopt a development model that will allow for more successful competition than before. This is unlike the previous paradigm of “catching up and overtaking” via meat, milk, tractors, or metal. *We must learn to be better and faster, as this constitutes the only way that we can achieve our goals in this fluid modern world.*

Another problem relates to the fact that we must exercise prudence and care in reforming a commodity-based economy when commodity prices are so low. First of all, we must consider the impact that reforms may have on people’s lives. The government should—frankly and without any illusions—evaluate its capacities to support those who find it difficult to adapt to new conditions.

Situations are changing very rapidly, and some people are not equally prepared to accept such changes quickly—some for psychological reasons and others for objective reasons. Children, disabled persons, the elderly and low-income families are the social groups that we must consider first when planning our future decisions.

Indeed, structural shifts in the economy, social sphere, and labor market are always painful to undergo. However, additional difficulties related to external factors have emerged, and the government is now facing processes of “double complexity,” i.e., to prevent a dramatic deterioration of living standards when structural transformations are made under challenging conditions.

Russia’s development constitutes an essential component of global processes. The global agenda cannot be shaped without our country. However, Russia also cannot shape the global agenda alone and cannot ignore it while focusing solely on its own understanding of success and fairness.

## 2. The world we live in

The term *new normal* has been used increasingly often in discussions on current and future global development issues. The term was coined five years ago

following the acute stage of the global crisis and is quickly gaining popularity.<sup>1</sup> The term *new normal* is interchangeable with the term *new reality*. It covers key characteristics that will determine the development of the global economy over the coming period—in fact, until the next major structural crisis. While the correctness of the term may be questioned, it has achieved considerable recognition in economic and political discourse over the years. It has also been extended with respect to geography and content. Perceived at first as a purely economic term applicable only to developed countries, *new normal* now refers to the global space (both developed and leading developing countries) and carries political, social, and even ideological meaning.

It is becoming ever more evident that the world's leading countries are entering a new growth trajectory. This not only involves new growth rates but also the quality of growth and the emergence and geographic distribution of new industrial sectors. The term *re-industrialization*, which refers to an increasing share of industrial activity in developed economies, serves as an important manifestation of this trend. The above is also of relevance to Russia.

Developing countries are also entering a new growth trajectory. They are making dramatic changes to the architecture of the global economy. For example, whereas in the past almost every crisis in the American economy had an effect on the entire world and all attention was therefore focused on the American market, crises now occur without the presence of recession in the U.S. (e.g., in the case of a severe slowdown of the Chinese economy).

It is highly probable that we are now witnessing the first stage of such a crisis. Chinese and global economy developments over the past few months serve as convincing evidence of this. All global stock markets and the national currencies of many countries showed an explosive reaction to the state of the Chinese stock exchange and to the devaluation of the yuan. Volatility in the global oil market is also playing a role, although it is partly related to the role of the Chinese economy in the global economy. It is already becoming clear that attention to developments in the Chinese economy is going to increase.

China's economic transition to a new development stage is particularly being manifested in the slowdown of its growth. The economic model itself is changing. First of all, the importance of domestic demand for Chinese products is increasing relative to foreign demand, constituting a reflection of the growing wealth of the Chinese population. These changes occurred in other developing countries when they reached a certain wealth level. A more balanced growth model (in terms of relations between exports and imports, industrial and service sectors, and between investment and consumption) will be shaped in other economies.

We must also note that when analyzing economic processes in developing countries, many of which are becoming our principal partners, we must remember that stages and models of development may vary considerably. While China, for example, has witnessed excessive investments and shares of savings in its GDP, we struggle with their scarcity. While China anticipates growing domestic

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<sup>1</sup> One of the first to analyze the phenomenon was renowned economist M. El-Erian, who noted that the 2008–2009 crisis would be followed not by a recovery of the old economic model, but by a complex and lengthy process involving the shaping of a new model (El-Erian, 2010, p. 12). Several other studies have also described the involvement of individual countries, including Russia (Yudaeva, 2010) and China (Mozias, 2015), in the new normal.

consumption, in Russia, domestic demand, formerly the main driver of development, is losing its significance.

Despite generating mounting dangers of being left far behind or of the existing gap becoming wider, structural crises create opportunities to improve a country's position in the economic and political arena. Crises always generate risks and opportunities. Using a phrase by Lee Kuan Yew (2000), who led Singapore to success, breakthroughs “from third world to first” typically occur during structural crises, when opportunities to notice and introduce innovations emerge. This includes *not only technological but also institutional innovations*. The above point is especially important, as the experience of the XX century presents convincing evidence that for a country to qualitatively improve its situation, it must be able to combine advanced technologies with institutions and “rules of the game” related to those technologies. This approach may be referred to as Marxist in its support of consistency between productive forces and relations of production. It is, however, confirmed by the practical experiences of countries that have achieved breakthroughs: Germany, Japan, the USSR, Finland, South Korea, and Singapore.

Modernization is a very complex process that does not always lead to success. Previous experiences show that “cases of successful modernization are far fewer than attempts at such a breakthrough” (Mau, 2009, p. 387).

One can judge the magnitude of changes in the global sphere based on Russia's sensitive energy sector.

That which used to appear exotic, an advertising campaign or local event, is now changing the global economy and transforming the global political balance. The massive transportation of liquefied natural gas has connected formerly isolated markets on various continents, while shale production has turned fuel importers into exporters. The work of hundreds of small and mid-sized innovative companies now likely has a stronger effect on this market (as well as the economies of many countries) than major energy corporations. Moreover, such companies are proving to be quite stable: the almost three-fold decline in oil prices has not led to their mass bankruptcy. Of course, this situation may change if prices continue to fall. However, the efficiency of new technologies has turned out to be much higher than expected by many. This serves as an important lesson: one must not obstinately assert that the Earth still rests on three whales when the outline of the fourth can be seen clearly.

We cannot ignore opportunities generated by a sharp improvement in solar energy efficiency, which used to be looked down upon with skepticism, or by unrelenting advances in electric, hybrid and hydrogen engine technologies. If these sectors continue to progress at the same pace and if oil and gas prices do not drop, the world may experience an even more significant breakthrough than the shale revolution.

Another vital trend has been identified: several well-known energy companies have begun to revise their strategies, preferring to create relatively small facilities that are cheaper and more flexible in the market. Large and expensive energy facilities take many years to build and decades to generate profits. During such a period, dramatic changes may occur in terms of demand, energy prices, or in terms of state policies employed where a construction site is located. In the past, all of these parameters appeared to be more stable, whereas now plan-

ning and forecast horizons are much shorter. As strategists say, “the world has become faster.”

*Innovations are penetrating all spheres of society: technological, economic, and humanitarian.* We must heed these trends in order to develop a strategy for achieving our goals. Such trends are becoming the subject of deep analysis and discussion in political circles and expert communities. While a single article can only name these trends, each deserves separate research and discussion.

The following can be referred to as *technological* innovative trends:

- growing levels of technological unpredictability, sharply reducing the capacities of centralized technological (scientific and technical) forecasting;
- the dissolution of boundaries between the physical and digital, i.e., the penetration of digital technologies into all spheres of the material world and, if you will, the virtualization of the real lives of people, companies and entire nations;
- new industrialization, i.e., the emergence of industrial technologies and sectors where labor costs are less significant than access to high-quality R&D and customer intimacy, which encourages product individualization;
- and innovative technology transfer of increasing intensity from civil to military sectors, a process that used to be directed otherwise (innovations appeared in the military-industrial complex first).

The above point to a very important conclusion: that the modern world literally lacks industrial priorities in terms of innovation and backwardness. No industry can currently be regarded as an advanced or backward sector, though this was characteristic of the XIX and XX centuries. There may be supermodern as well as backward technologies in every sector or industry. Thus, questions concerning opportunities for technological or innovative breakthrough have been transferred from industries to companies.

It should be noted that countries with dominant agricultural economies used to be referred to as backward not long ago. However, today agriculture is becoming one of the key industries for innovation. For example, the highly developed state of the Netherlands is one of the top three countries in the world in terms of agricultural exports. We should also take into account an increasingly obvious trend: demand for agricultural products (mainly from developing countries) is growing and is very likely to grow at a more stable rate than demand for mineral resources. There is an explanation for this: as the world’s poorest regions struggle with famine and still require significant agricultural product imports, rapidly developing countries are also generating increased demand for food, transferring this additional demand to the global market. Accordingly, countries capable of increasing their export potential in the agricultural sector can seize these new opportunities.

We must closely monitor development trends in the *social* sphere, which determine the quality of human capital and country competitiveness. Such trends are as follows:

- global competition for human capital is becoming the decisive factor in achieving strategic objectives of any country. This form of competition is intensifying. One can predict even now that it will reach new levels in the near future, e.g., in resolving issues of machine translation quality. The removal of language barriers will sharply increase the dynamism of labor resource movement between countries;

- this creates a new social state that can cope with challenges faced by modern developed countries. Its key feature is the individualization of services (primarily education and healthcare);
- positions and prospects of the middle class will constitute some of the most compelling issues of long-term development as modern technologies become able to replace human labor not only in material production, but in the service sector as well.<sup>2</sup> The answer to this question is not likely to be a simple one. It will most likely be associated with the development of human capital and with improvements in labor market flexibility;
- finally, growth in inequality is coming to the forefront of the economic and political agenda as a factor that is directly influencing levels of social and political stability and as a possible constraint on economic growth.<sup>3</sup>

The following constitute important *economic* innovations:

- the individualization of products and services is replacing standardized mass production. Of course, this is a new form of industrialization rather than a return to pre-industrial handicraft development. This involves production based on the needs of a particular consumer;
- the emergence of new funding instruments allows for an expansion of investment limits of new projects. Financial innovations partially precipitated the global crisis. However, countries will inevitably master increasingly fine-grained regulation tools rather than simplifying or prohibiting them;
- the emergence of industrial sectors with faster capital turnover rates than those of companies engaged in the same industries but with traditional technologies is drawing capital expenditures closer to operating expenses. This generates a dramatic increase in the flexibility of reactions to changes in markets and technologies, with shale production serving as a good example;
- a new globalization model and relevant model of protectionism is emerging. Regional (international) associations of free trade are coming to the foreground, identifying solutions to issues that remained unresolved in the WTO for decades. Foreign exchange rate movements are becoming a more powerful market protection tool than customs duties. Rather than the protection of customs territory, the protection of added value chains generated by national businesses is now becoming the state's priority.

Macroeconomic challenges deserve special attention. Here, as in the case of technologies, we clearly observe a sharp increase in uncertainty levels. This is also related to still unobvious solutions to problems associated with the avoidance of high inflation caused by anti-crisis policies pursued by many countries in the form of powerful financial therapy since 2008 (while inflation minimization constitutes a topical issue in some countries, other countries struggle with deflation). The future of monetary stimulus itself raises questions: it is unclear how to get rid of this “addiction.” Meanwhile, in a number of countries, while money

<sup>2</sup> Randall Collins, one of today's leading sociologists, commented on this process: “A long-term structural weakness of capitalism is now coming to the fore. It is the technological displacement of labor by machinery, which for the last twenty years has taken the form of computerization and information technology. This displacement is now accelerating and threatening the existence of the middle class” (Collins, 2013, p. 37).

<sup>3</sup> Inequality is likely to become one of the key issues of economic discourse in the foreseeable future. This is evidenced, for example, by the popularity of Thomas Piketty's (2014) *Capital in the Twenty-First Century*, which has become a worldwide bestseller.

is now offered at unprecedentedly low rates, businesses are reluctant to take it. At the same time, large multinationals have accumulated vast reserves that they are not investing in projects. That is, we now find ourselves in conditions of uncertainty and waiting and amidst concerns regarding the new reality to come (the *new normal*). The problem now is based less on the debts of companies and banks than on those of entire countries. While debt repayment prospects of countries that are able to issue reserve currencies look—to put it mildly—hazy, the debts of countries with no such opportunities have already become bad ones. There is still no honest and convincing answer as to how the global economy and monetary system will behave in this extraordinary situation.

How should society and the state react to all of these challenges? What should we do, not only to keep pace but also to become a leader? How can we combine our own historic advantages with general global trends?

The key condition, without which there can be no adequate answer to current challenges and to growing uncertainty and variability levels in development, is the encouragement of creativity and entrepreneurship and the continuity of education. This applies to states, businesses, and each individual person. People are naturally inclined to be creative, and the state's foremost objective is to encourage creativity in all spheres of life.

It is these features of the modern stage of technological progress that have formed key trends towards the global liberalization of economic life and towards the reduction of red tape in modern societies. This becomes inevitable when we realize that the “world is becoming faster.”

The attempts of developed countries to respond to the global crisis via stronger government intervention were short-lived and took place primarily in 2008 and 2009. Many of these countries are now trying to overcome the consequences of excessive regulation. China is lifting more and more barriers in its economy, and Mexico is even amending its constitution to allow foreign investors into its oil and gas industry. The above is relevant both to trade and industry. Most countries that have achieved breakthroughs (South Korea, China, Brazil, Indonesia, etc.) have succeeded by taking advantage of free trade in order to strengthen specialization and the international division of labor. They have used global demand and exports for their own growth by increasing productivity levels through competition with imports and by identifying the most efficient companies. On the other hand, it is difficult to find a country that has achieved sustainable progress through long-term trade self-restrictions.

Of course, in numerous countries, existing policies and specific decisions are not in line with this agenda and even contradict it. Such measures include sanctions; however, they have rarely been effective and have seldom produced expected results. For example, sanctions against Cuba, which were directly aimed at deposing its government, actually encouraged its political longevity. Sanctions against the construction of the gas pipeline from Siberia to Europe led to the USSR creating the world's largest gas transportation system. Sanctions against China failed to isolate it or upset its economy. On the contrary, Beijing responded with market liberalization, which did much to enable the PRC to reach its current position in the global economy (see, e.g., Kadochnikov and Ptashkina, 2014). Those who have imposed such sanctions can be said to have encouraged the growth of their future global competitors. Sanctions are lifted sooner or later,

and relations between countries get back on track. When responding to sanctions, it is important to address them pragmatically. They must first be turned in favor of a given country and to boost its domestic industries.

This also applies to our current relationship with the West. Notwithstanding the existing nature of this relationship, which has been critical for the most part, cooperation is bound to be restored. Russia is not going to leave the European continent economically, politically, or mentally. A full 250 years has passed since Catherine II stressed in her “Instruction to the Committee Charged with Drafting the New Code of Laws” that “Russia is a European power” (Catherine II, 2000, p. 38). This remains and will remain true despite vast changes that have occurred in the world. Nobody will succeed at detaching us from the European civilization with all of its cultural diversity. Relations may change in the future, but strategic directions will remain the same, i.e., cooperation, partnership, and given the favorable development of events, a single economic space.

Russia’s geographic and geopolitical position not only allows but also in a sense requires that we more actively encourage cooperation in the “eastward direction” (i.e., countries such as China, Vietnam, Japan, and Korea and the Asia Pacific region as a whole) and with SCO and BRICS member countries located in various parts of the world. It would be a mistake to interpret such activities as Russia’s intention to find a new “bearing.” In speaking about the importance of this vector of cooperation, we refer not only to historical ties, to our common history with many of these countries, or to the current global political situation. The global agenda itself; market trends; and the directions of financial, commercial and technological flows clearly point to the strategic implications that an underestimation of relations with these countries and regions may lead to.

As has occurred in the past, Russia is certainly using the present situation to upgrade its economy amidst growing international tensions. However, the best outcome for all would involve modernization based on cooperation rather than adversity.

### **3. Growth quality: Strategies, focuses and priorities**

Many of key parameters, focuses, and risks related to Russia’s social and economic development are covered in Main Areas of the Government’s Activities until 2018. Long-term objectives and ways of achieving them will be addressed in the Strategy of Social and Economic Development until 2030.

First of all, our objective is to ensure dynamic and sustainable mid- and long-term economic growth. From the start, we must take note of two risks that are opposite in terms of form but that are similar in essence.

One refers to risks of artificial acceleration. We know from our own experience in 1986—1989 how the desire to quickly heat up the economy may lead to disaster, even when growth rates increase for a year or two. The Soviet Union had to pay for its short-lived acceleration with a sharp increase in foreign debt, which Russia had to pay out after the USSR collapsed.

On the other hand, there are risks of psychological adaptation to low and even zero growth rates and of a willingness to accept them as inevitable. This tendency has been central to economic and political discourse of the past few years. Not long ago, the objective was to achieve a 5% GDP growth rate, while 2% was

regarded as low and even dangerous (though it was quite satisfactory for Europe and Japan). This year, after the initially predicted 5% decline, predictions that the economy would slow down by a “mere” 2% or 3% were welcomed as favorable forecasts, denoting the end of the acute stage of the crisis. If this psychological attitude becomes prevalent in society, it will pave the way to protracted recession. This is why the key objective today is to ensure not only rates but also a new degree of economic growth quality.

Much is being said about the need to build a new growth model. This is a sound statement, as both external and domestic conditions of Russia’s development have changed dramatically and even fundamentally in some respects. Enough has been said about the exhausted opportunities for successful development dependent on the inflow of financial resources from foreign markets, resulting in the rapid growth of domestic *demand*. We can only add that this form of growth is not especially sensitive to the investment climate.

The stage is now being taken by factors that determine *supply*: operating conditions of our companies and organizations, labor productivity incentives, and conditions of human capital growth. A comfortable environment for economic entities, or rather a favorable investment climate, constitutes the general facet of a model that should ensure a new level of growth. To this end, we must consolidate efforts in four areas that determine the nature of a country’s social and economic development: macroeconomics, structural policy, human capital development, and the public administration system.

### 3.1. Macroeconomic prerequisites of economic growth

The creation of comfortable conditions begins with *ensuring macroeconomic stability*. Low inflation and a well-balanced budget remain as priorities for a country’s sustainable development.

Over the next three years, inflation must be decreased to 4%. This is essential to ensuring household wealth growth, affordable credit for businesses, and to increasing the predictability of the economy in general. Decisions needed to achieve this goal have been made at the political level and by the Central Bank management.

It would be dangerous to get used to living under conditions of high inflation or to even get caught in an inflation spiral. We already have a mature population that has not experienced a stable national currency and has psychologically adapted to rapidly increasing prices. “Only people older than 50 may remember the times when the money circulation system was in order. The rest of the population has a quite vague notion of it,” S. Witte (2006, p. 107) said when presenting his views on monetary reform to the State Council in 1895, and these words are quite applicable to the Russian economy today. We must get rid of this vicious macroeconomic tradition.

We need to preserve the two most important macroeconomic achievements of the past fifteen years, i.e., a well-balanced budget and a low level of national debt. This has had to do with both the federal and regional budgets, which are now under a debt load. This challenge is not exhausted through the mere maintenance of positive macroeconomic indicators. The structure and efficiency of budget expenditures is as important as the budget balance.

First, we need clearer priorities in terms of the effects of expenses on long-term economic growth. Research and the experiences of many countries show that priorities here lie in investments in people, including investments in health-care, education, science, and infrastructure. While budget constraints certainly do not allow us to achieve these priorities in a sufficient manner, this does not diminish their significance. Therefore, achieving a well-balanced budget through the substantial deterioration of its quality should be deemed unacceptable.

Second, problems associated with growing budget expenditures, which are not novel per se, have become even more relevant. The objective, set by the President of the Russian Federation, to reduce inefficient budget expenditures (at least by 5% in real annual terms until 2018) must be achieved through structural reforms rather than through budget cuts. This first and foremost requires the formulation of improved budgeting procedures and of an optimized network of state-funded organizations.

On the other hand, under conditions of slower economic growth, budget problems cannot be solved by increasing tax burdens. A decision has been made to not increase taxes over the next few years. Tax cuts are possible, albeit selectively, and they are already occurring or are being discussed. In addition, we must abandon non-tax revenue duties, including environmental and transport charges. All of these decisions are difficult to make given the presence of shrinking export income levels. However, we believe them to be justified.

### 3.2. Structural reform priorities

Macroeconomic stability constitutes a necessary but insufficient prerequisite of successful development. Low inflation and a healthy budget do not automatically lead to growth, as indicated by the current situation in the Eurozone and in some other Western countries that already exhibit a negative rate, or essentially an interest-free loan. However, credit activity levels remain low, as does economic dynamics. High degrees of uncertainty and risk serve as the culprits. Russia's experience is also illustrative. In 2012 and 2013, the discount rate was lower, credit was more affordable, international markets were open, and oil prices were high. However, investment growth slowed down, followed by a decline in investment. It is obvious that structural reforms and investment incentives that involve reducing risk and uncertainty have made it onto the agendas of many countries (including Russia), although specific objectives may be formulated quite differently.

We must create *modern mechanisms of funding economic growth* and modernization. This is quite important in any situation, and especially in the current one. Russia is facing the closure of many external funding sources and falling oil prices. The assumption that the oil market will remain “low” or even “extremely low” for a long time appears to be the most reasonable. This inevitably requires greater attention to internal funding sources, domestic savings, and an increased economic savings ratio. The share of investments in Russian GDP (saving ratio) must be increased to 22–24% by 2020 against the 17–18% expected in 2015.

Government investments must undoubtedly make their own contributions and especially now, as they can support demand in the economy while to a certain extent compensating for low private investor activity levels. We are following this

path now by allocating additional resources, providing state guarantees, and by using special-purpose funding vehicles (e.g., the Fund for Industry Development, a funding project supported by the Central Bank, etc.). We are using the National Welfare Fund and are resorting to government incentives such as investment credits and investment contracts.

However, government investments cannot serve as the primary source of growth forever, nor can the state use the printing press as a source of growth, as the freedom of uncontrolled money emission is one of the most dangerous freedoms of all. References to the Western experience of monetary stimuli are not applicable here. First, they are used under conditions of deflation (directly opposite to Russia's situation). Second, the results obtained do not signify that this mechanism is highly efficient. Third, these measures have already generated a problem for which nobody knows a solution (suffice it to mention apocalyptic forecasts of the fate of the U.S. dollar).

Moreover, a large share of the government in the economy becomes in itself a reason for limited access to resources available for investments. Companies with government participation are typically plagued with expenses growing at a rate exceeding those of the private sector and with investment projects with negative cash flows.

The engagement of private investors should come to the foreground of governmental efforts at all levels. This problem has received insufficient attention over the years due to a powerful inflow of financial resources. Federal authorities, regions, and municipalities will now have to carefully analyze what they can do for entrepreneurs who wish to invest—first of all in their territories. The national rating of investment attractiveness and work aimed at creating regional investment teams have been designed to facilitate this process.

Domestic savings constitute the most important source of investments. It is from this point of view that we should consider the development of the pension system. This constitutes one of the key issues related to the functioning of the economy. Retirement savings and life insurance may become vital sources of “long-term money.” In this regard, we must not ignore the reliability and efficiency of private pension funds, which have been a subject of vigorous discussion lately. Undoubtedly, private pension funds form an important part of the financial infrastructures of nearly every developed country. However, past experience tells us that these organizations do not only strive to derive profits, and much less so over short-term periods. We must learn to utilize retirement savings while ensuring their long-term efficiency, and this is quite difficult to do in our country, given its relatively short “credit history” of market institutions. Therefore, pension funds are receiving extra attention from the state, while organizing supervision over private pension funds constitutes the most important task of the financial regulator.

Despite the presence of geopolitical difficulties, sanctions, and various constraints, we must not forget to *attract foreign investment*. Underestimating this form of investment would mean that we accept the logic of isolation imposed upon us. This does not mean that we must create special conditions for foreign investments. Russia should adhere to the principle of the equal treatment of domestic and foreign investments, as both are important for us.

Of course, bringing in foreign investment should also resolve a specific task, i.e., securing technology transfer. We are not among the world's technological

leaders in many vital areas. The high-tech share of our total exports is only 1.5%. This is why foreign investments must not only be estimated based on funds that have actually been raised (we raised a lot of money, but what did we use it for?). Technology and know-how are even more important.

*Import substitution* constitutes another key area of government activity. It is important not to turn it into a “motto of the day.” It should be noted that throughout the XX century, some Latin American countries have used this motto to pursue policies that have involved closing off markets to foreign competition and then intensively subsidizing domestic industries through the allocation of considerable loans, which have ultimately led to financial crashes. Considering this experience, we must realize that import substitution does not involve the replacement of imports with more expensive domestically produced goods of lower quality.

Certainly, there are specific areas and very particular types of products where imports will need to be substituted regardless of the costs involved. However, applying this practice to the entire economy would be dangerous (in fact, impossible). The best form of import substitution involves the domestic production of goods that are competitive both domestically and globally. Export capabilities refer to capacities to compete (including with imports). This form of import substitution may find government support.

To a certain extent, import substitution is a consequence of sanctioning and devaluation, which are giving a certain head start to domestic producers. However, this head start is only temporary. Today’s situation differs substantially from that which characterized the late 1990s. At that time, as a result of a 40% economic recession, the country possessed significant reserves of production capacity and labor that could easily have been used to substitute imports, which had abruptly increased in price. However, such production factors are limited or are even non-existent today. Moreover, over the past fifteen years, Russia’s economic structure has become more complex, and production requires the use of intermediate products in many cases, which also requires the use of resources. To take advantage of current market situations that are favorable to the domestic producer, we need financial resources and a favorable investment climate.

Popular mottos get distorted more often than others. Principles of import substitution do not contradict openness and are not synonymous with autarchy and self-isolation. They do not oppose exports and cannot, i.e., should not, generate export restrictions on non-commodity products due to fears that “they are going to cart away everything.”

As in the past, Russia sees its economy as *open*, following the path of global integration. Of course, this is a complicated process that is far from straightforward. However, we are very interested in promoting integration and free trade zones. For Russia to develop sustainably, we must expand markets. Integration processes in the post-Soviet area, the foundations of the EEU, and WTO membership constitute important steps along this path. Another equally important measure will involve strengthening ties with our eastern partners and with BRICS countries, which should be regarded not only as fast-growing markets and investment and equipment import sources but also as promising areas of cooperation in the development of advanced technologies. These countries are actively developing, mastering, and replicating advanced technologies and possess the necessary market scale.

Through mutual trade with new partners, opportunities to use national currencies where necessary arise. Our monetary policy is directed at the ruble's gradually improving status as a regional reserve currency. This is possible given Russia's geo-economic and geopolitical position. Current global turbulence is creating conditions for the emergence of new currency configurations. Accordingly, *while we are not abandoning our plan to create an international financial center in Russia*, this plan will take much longer to realize now.

Finally, Russia will continue to move towards membership in the OECD, although some members of the club are not enthusiastic about this right now. Certainly, our goal is not only formal membership but also the experience and implementation of advanced institutional standards and practices.

*The promotion of competition* constitutes another problem that is deserving special attention. Under conditions of weak competition, a market economy loses most of its potential, if not its purpose altogether. This issue is especially relevant to the current situation, as the recent devaluation trend serves as an objective restriction on imports in the Russian market. Sanctions and import substitutions are producing the same effect. All of these processes can weaken competition in our economy, which is already excessively monopolized. Another barrier relates to the persistent and even growing participation of states in segments of the economy where it is not necessary. The underdevelopment of small and mid-sized business is generating its own negative "contribution" to the situation.

Of course, the promotion of competition cannot be boiled down to antitrust regulations. Unlike the latter, rather than protecting the consumer from abuse, it constitutes an attempt to provide the consumer with options through the emergence of new producers. In this context, the encouragement of competition is similar to attracting investment and to improving the investment climate. However, certain features are involved here. Investment attraction is often related to sales guarantees, tax benefits, etc. However, many of our business owners believe that they should be protected from the market itself (at the government's expense, of course). We can hardly expect high levels of competitiveness in this case: investors should be protected from abuse and from the unpredictable actions of people, organizations and authorities, but not from the economy itself.

Competition will be encouraged through the re-building of supervisory agencies. Their official and unofficial "tick" or "quota-type" systems of evaluation encourage actions that contradict common sense. Such actions not only discredit government control but also show that, in practice, its real goals have been forgotten long ago or have been simply ignored. Recently proposed steps to limiting inspections of small businesses and to regulating businesses through antitrust laws show that approaches to supervision are gradually changing.

Finally, an essential prerequisite of real competition is a system for the adaptation and retraining of released labor, new employment schemes, increased labor market flexibility, and small business assistance. Creating and maintaining an all-Russian vacancy database (including information on social and other conditions of the proposed workplace), the adoption of regional programs of labor mobility (involving the employment of people from other regions), and other measures constitute only some necessary steps. They are few thus far, and our experiences in this area have been limited and occasionally negative. Traditions that involve relocating the workforce on a centralized (often coercive) basis do

not meet the needs of the present-day market either. The necessary infrastructure (and most importantly social infrastructure) remains underdeveloped.

The absence or scarcity of such conditions constitutes a serious socio-political obstacle to the development of a competitive economy and the incentive to the maintenance of redundant employment and inefficient production facilities. Put simply, the choice between competition (with its unavoidable difficulties and costs) and social stability (even with the growing inefficiency of companies) is always easier to make in favor of stability as long as the state possesses the funds needed to support such companies or until efforts are made to develop a modern labor market.

### *3.3. Preserving and developing human capital*

Principles of the social state, established more than a century ago, are not keeping pace with modern reality. The growth of wealth and new demographic trends require profound changes to previous methods. Countries that have achieved breakthrough development levels over the past decades have invested heavily in human capital. It is human capital, rather than a certain industry, that is becoming a government policy and investment priority.

The role of the social sector in society is changing as well. It no longer employs “welfare state” models, financed by whatever funds remain. Its role is not limited to the social sphere or to social stability. Sectors of human capital are melting pots for socio-political complications, investment difficulties, and fiscal problems in developed countries. At the same time, no effective social state models (of redistribution or accumulation or of mixed strategies) have been created. A country that succeeds in creating them would gain an enormous competitive advantage.

At the same time, competition for human capital is increasing, while the latter itself is becoming increasingly mobile. It is no longer rare for people to live in one country while working, learning, and receiving medical services in others. We cannot ignore this form of competition. Moreover, increasingly more often people prefer to choose between different resources in their own country, expanding the role of the private sector. We must eliminate barriers that prevent private entities from participating in the provision of such services financed by the state and that prevent the development of public-private partnerships in the social sphere. On the whole, we need a structural modernization of respective industries.

*In education*, we must overcome increasingly obvious structural problems while improving capacities to respond to modern challenges. First, we are facing a surplus (to use a financial term) of specialists with higher education and a deficit of those with vocational education. Second, higher education has become almost universal today, which has certainly affected its quality. We must improve the quality of education without compromising its affordability.

The continuity of education is becoming one of the most important requirements. The famous motto “learn, learn, and learn” will accompany a person throughout his or her life from now on. The problem of education is arising for adults and seniors in realms involving mastering computers to learning a new specialty. Appealing to high school graduates while helping investors invest in

education will prove critical to the efficiency of modern universities. Higher education institutions and other schools that ignore the new reality in their curricula or that respond to it only perfunctorily will not be able to compete successfully. Competition is becoming more pronounced in the education system. Our universities, at least the leading ones, are competing at the national and global levels. This constitutes a serious problem for education and for the healthcare system: if demand for high-quality services is concentrated outside of the country, it will decrease domestically, lowering the quality of such services.

We must complete numerous tasks to meet these requirements (e.g., create preferences for companies participating in the development of facilities for educational institutions, including endowment funds). We must support modernization projects of distance learning while creating a national portal of open education. We must restructure and reorganize higher education institutions whose graduates are not in demand in the labor market.

We must tackle equally and even more serious challenges in the realm of *healthcare*. Investments in modern equipment (the largest in Russian history) and increased medical staff wages are necessary but will not fully address these challenges.

We could name a whole host of management and technology-related areas in which Russian healthcare systems will develop. These include the high-priority development of primary medical care, the development of so-called treatment protocols (clinical recommendations for medical care), the development of telemedicine technologies, and the development of unified electronic cards containing patient medical data that are accepted by any doctor or clinic that a patient may apply to.

The availability of options and the promotion of competition between doctors and medical institutions help make the insurance-based model of healthcare attractive. Insurance-based healthcare is not 100% effective in all countries. However, its effect can only be determined when its implementation is not perfunctory. A real transition to the insurance-based model involves an even more complicated process than, for example, the process of pension reform, which is currently being debated so intensely.

Insurance-based methods are quite difficult to introduce in our country, and this is related to the role of insurance companies and to their effects on prices and the quality of service. However, we have made our choice and are not going to change our minds. As an aside, contrary to some stereotypes, the global experience shows that within insurance-based systems, citizens typically pay less for medical services than citizens occupying budget-funded systems. However, the actual insurance-based model can only be applied when state guarantees of free medical services are clearly defined for the people.

The *pension system* and prospects for its development constitute fundamental social and economic issues, notably for developed countries with longer life expectancies. This issue is highly topical for Russia as well. It is not limited to a discussion of the retirement age or of budget expenses that cover the Pension Fund deficit. A bigger problem lies in the principle of “special treatment for every age.”

As Russia’s working-age population begins decline, assistance for those who are willing to continue working will become pivotal. Extending the active labor activities of the elderly now constitutes an economic and social challenge.

Very few cases of modern economic growth in countries have involved declining working populations. This presents yet another serious challenge.

A separate issue is related to support for elderly persons who are retired. These individuals often require assistance that their relatives—if any—cannot provide. This aid is not always associated with money payments. It is mainly a matter of time and effort. These individuals receive aid from volunteers and public organizations, but existing related state services are in need of improvement.

The specifics of pension systems reveal that such systems are highly inertial—not unlike demographic processes. In the future, the retirement-age and working populations may become equal in size. This may lead to a sharp increase in tax burdens and in other most unpleasant consequences. To avoid this, our economic, financial, and social spheres and the pension system itself must respond in advance.

### 3.4. *Non-economic factors of modernization*

Some may argue that we are living under conditions involving the “falling productivity” of economic institutions. In other words, the effects of purely economic decisions will be relatively lower than those of non-economic decisions and will be much lower than those of the first years market economy transition. During such a period, the transition to market pricing, the overcoming of product deficits, the introduction of a convertible ruble, and the shaping of a modern banking and credit system play a decisive role.

To ensure our successful development, we must radically improve the quality of public services and of public administration.

First of all, this involves *ensuring personal and property security*. The most sustainable form of economic development is produced from the institution of strong policies that protect property and that restrain abuse. We need a sophisticated system of brakes and balances that is aimed at protecting businesses from unreasonable administrative and law enforcement pressures.

Surveys of businessmen in all countries (including those in Russia) show that key institutions that foster business development are still those that influence levels of crime and corruption, customs regulation, and infrastructure access.

Of utmost importance is the building of a competitive jurisdiction in Russia, and this requires an efficient *judicial system*. This is a complex issue, as it involves institutional decisions, changes to the education system, and, most importantly, tradition and practice.

An efficient jurisdiction is as difficult to achieve as an efficient economy. However, they are closely related, as the former is a prerequisite of the latter.

However difficult, this task is not impossible to complete. Moreover, Russian history offers a precedent for the creation of an efficient judicial system over a historically short period. The 1864 reform created a new judicial system in a practically empty space by replacing a corrupt system with one of Europe’s best, and this occurred over a single generation. The reform profoundly changed principles and procedures of the judicial system: courts were opened through a competitive process. Nearly all judges were replaced with professionals with a university education. This change introduced better-qualified judges while also eliminating corruption.

The creation of an integrated court system constitutes a critical step to the modernization of the judicial system. However, this is only the beginning, and organizational changes per se will not produce the necessary results. Ensuring an inflow of new, highly educated professionals is vital to the transformation of the judicial system, as was the case during the second half of the 19th century. It is equally necessary to engage the entire stock of modern information technologies, which can help increase the transparency of the judicial system and decisions made within it.

The issue of *improving the quality of public administration* has been actively discussed as of late. This is also a complex issue that involves optimizing the public administration system, building a decision making mechanism (including strategic planning), implementing modern management technologies, and, finally, training public servants.

We must create a system that holds public authorities accountable for their decisions. Of course, they must be granted access to respective legal and financial resources. Program funding and planning and the attestation and promotion of government officials must be linked to the achievement of clearly defined goals (targets).

A key objective of the public administration system today involves the encouragement of investment activity. This largely depends on willingness and capacities to improve the business climate and to persuade businessmen to invest in respective sectors and regions. This condition should be treated as a basic criterion when evaluating the work of authorities at various levels.

A government decision making system that fails to become integral and consistent can hardly be considered truly “systematic.” A law on strategic planning is needed to create the foundations of a target setting system. However, the goal is not to re-create bureaucratic plans of the Soviet era in any form, but rather to ensure self-control, if you will, so that strategic goals are not boiled down to mottos with current tactical decisions contradicting long-term targets.

Very much depends here on the quality of public services and on systems of public servant training. The following can be named among measures to improve the efficiency of staff policies: ensuring performance-based work with talent pools; optimizing the number of public servants; improving the efficiency of competitive hiring for public services; creating a modern system of work with young staff (including mentorship); and the active implementation of attestation procedures and technologies in public service.

Some governments that have faced a need for comprehensive modernization have even created special departments for such reforms, which have come to be called *performance management delivery units*. These units are mandated to develop programs to improve particular quality indicators; to introduce rigorous procedures for monitoring program implementation; and to define and monitor performance indicators for specific agencies. Ultimately, the goal is to continue achieving strategic goals while avoiding endless approvals between agencies.

This has been an interesting experience, and we should take it into consideration. The main issue, of course, relates not to the presence of a dedicated agency (even with an appealing name (we know how to create agencies)) or to endowing such an agency with extraordinary powers (this we can perform equally well), but to the availability of a well-elaborated action plan that can be clearly understood by the society. If we have no such action plan or a will to implement one, we will

have nothing to “deliver” to the society, and the new agency will become nothing more than a PR unit.

#### 4. Conclusion

In sum, certain principal conclusions can be drawn regarding ongoing changes in Russia and around the world and with regards to challenges we face today.

*First*, a *new reality* is emerging in the world as a result of the global crisis, which has affected the economy as well as all significant facets of life in modern society. The world’s leading countries are entering a new growth trajectory that involves growth rates, growth factors, and growth quality levels. Many criteria used to evaluate development in the late XX and early XXI centuries will need to be revised.

New technologies and innovations implemented, inter alia, by small companies are quickly and radically transforming entire markets and industries. This requires new market behaviors, including new approaches to the implementation of major long-term projects. Industry-based criteria of “progressivism” and “backwardness” are being abandoned in the modern world, with almost all industries presenting innovative potential.

*Second*, Russia—according to many social and economic parameters—is a developed country, and thus its problems should first be compared with those of other developed economies. At the same time, we enjoy certain advantages as a developing economy, which we can and must use to overcome the current crisis and to respond to long-term challenges.

Of course, this is no reason for pride and wishful thinking, as our place in the world creates additional challenges and problems for us. Russia’s desire to be an organic part of the developed world generates opposition from our competitors. Geopolitical tensions in recent years have largely been associated with these circumstances.

*Third*, we must create a new model of economic growth that is relevant to contemporary realities in Russia and around the world. New long-term “rules of the game” are being created during the current global crisis. The new model should ensure dynamic and sustainable mid-term growth for the Russian economy at rates exceeding the world average, accompanied by qualitative structural changes.

*Fourth*, human capital is becoming the main area of global competition, and it is the most important and, at the same time, the most dynamic facet of modern industry. This form of competition will become severe due to a clear realization that has appeared in the world: leading positions are going to be occupied by countries that are attractive to educated and energetic people.

*Fifth*, the search for an adequate response to challenges of the quickly changing world has formed a key trend towards economic liberalization. This is understood not only by developed countries but also by many developing countries, which are striving to create conditions required for innovation, capital, and technological transfer.

This means that a number of high-priority objectives must be achieved to ensure our country’s sustainable social and economic development.

*First*. We must ensure macroeconomic stability, as well as a well-balanced budget and a consistent reduction of inflation levels to a target value. This will improve the predictability of and confidence in the national economy. Decreasing

inflation should be accompanied with decreasing interest rates, i.e., increased credit affordability for businesses and households. Finally, monetary policies must ensure the ruble's status as a regional reserve currency.

*Second.* We must increase the efficiency of budget expenditures via budget maneuvering and through improved budget procedures. Investments in infrastructure and human capital should be considered a top priority. The budget will need to be balanced in recognition of the fact that the fiscal burden must not increase over the next few years.

*Third.* We must ensure the consistent realization of plans for attracting private investment and for expanding their role in ensuring economic growth. The state is already using and will propose new forms of support for investment activity: they must acquire new momentum in the next year or two. However, government incentives must not be endless, and most importantly, the state must not replace private investors. The efficiency of government agency departments, including those of regional officials, should be evaluated in terms of their capacities to attract private investors.

*Fourth.* Domestic savings must become the most significant source of investments. While achieving this strategic objective will take many years, we must pursue it nonetheless. In this respect, we will evaluate the efficiency of the application of retirement savings. Pension reforms and subsequent insurance reforms constitute main sources of “long-term money” in the economy, and even a developed banking system cannot fully replace it.

*Fifth.* We must work toward the development of small and mid-sized businesses as a condition of sustainable economic growth and to ensure social stability. Dynamics of small and mid-sized businesses constitute some of the most significant indicators of a country's economic and social health.

*Sixth.* The promotion of competition. A major source of weak competition is related to business and regional concerns regarding social stability. Therefore, modern labor market development is an economic and social issue. A perfunctory approach to its solution will hinder the accelerated creation of highly productive workplaces. We cannot increase our competitiveness without increasing the flexibility of this market.

*Seventh.* We should encourage the growth of non-commodity exports (in absolute terms and in terms of the percentage of total exports). Apart from other benefits, this would indicate that import substitution actually works and has begun to yield positive results.

*Eighth.* Qualitative changes must be made to the efficiency of public administration. We must create a system that holds public authorities accountable for their decisions. The attestation of public officials and program funding must be linked to particular results, and basic criteria should include incentives for investment and for business activities. The decision-making system should be integral and consistent to prevent tactical decisions from contradicting declared long-term targets.

Our experience shows that defining the right course is not enough. It is equally important to make it known to all of the society. Of course, the main issue relates to its implementation. This is our primary objective.

Theodore Roosevelt said: “I foresee a huge future for Russia. Of course, it will have to endure certain shocks and, maybe, heavy crises, but they all will pass,

and Russia will rise to become a citadel for the entire Europe, probably the most powerful country in the entire world.” While even those who were not born in Russia view this kind of future as obvious, for us it is simply inevitable.

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