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## The Strategy of Modernization of Russia (II)

*M. E. Sharpe*

## **Problems of Economic Transition**

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### **The Strategy of Modernization of Russia (II)**

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O. SUKHAREV

## Priorities of Modernization Policy

*The author suggests that breaking away from the raw materials mode will entail a reduction of profitability in the financial and banking and raw materials sectors, a rise in the profitability of and the lagging machine building and instrument making sectors, research and development, innovations, and high-tech activities.*

Throughout the period since the reforms, the Russian economy has functioned and continues to function based on the infrastructure created in the Soviet era. But the former margin of safety and stability has been exhausted. In many production sectors capacities are critically worn out and obsolete and have become uncompetitive in productivity, energy efficiency, and quality. A raw materials model of economic growth cannot be established because that would make our country dependent on foreign capital. Therefore, the goal of system modernization that has now been adopted is strategically correct. Its implementation requires a certain economic policy—in short, a modernization policy. In connection with this, we express a number of fundamental considerations.

What has to be modernized, and how? As we know, in 1990–2008 the structure of industrial production changed in the direction of an increase in the share of the energy and raw materials sectors, with a decline in the share of processing sectors, in particular, machine building and metalworking by 50 percent, light industry by more than 90 percent, and so

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Translated by James E. Walker.

Table 1

**Russia's Industrial Production Structure** (% of total)

	1990	1995	2000	2005	2008
Volume of industrial production, total	100.0	100.0	100.0	100.0	100.0
Electric power	3.6	11.0	7.9	7.1	6.4
Fuel industry	6.8	14.6	17.5	19.7	19.5
Ferrous metallurgy	4.9	8.1	7.1		
Nonferrous metallurgy	5.4	5.8	8.7	13.9	13.9
Chemical and petrochemical industry	6.9	7.1	6.2	6.4	7.0
Machine building and metalworking	28.0	16.0	16.4	13.0	14.2
Forest, woodworking, cellulose and paper industry	5.2	4.6	4.0	3.4	3.2
Building materials industry	3.4	4.3	2.4	3.1	4.4
Light industry	11.0	2.2	1.4	0.8	0.7
Food processing	12.1	10.6	11.1	10.9	11.2

Table 2

**Dynamics of Industrial and Agricultural Production, Investments in Fixed Capital, and Real (disposable) Household Incomes** (% of 1990)

	1993	1995	1998	2000	2005	2006
Industrial production	64.9	49.7	46.2	54.2	71.2	82.1
Agricultural production	82.7	67.0	56.0	62.8	73.1	86.7
Investments in fixed capital	44.9	30.7	21.0	25.9	41.5	65.3
Real (disposable) household incomes	51.1	40.0	32.8*	36.7	63.3	82.9

\*1999.

on. In 2008 industrial production was 82.1 percent of the 1990 level, and agricultural production 86.7 percent. The crisis of 2008–9 once again set the economy farther back: investments in fixed assets at the beginning of 2008 were just 65 percent of the 1990 level, and real disposable household incomes were 82.9 percent (Tables 1 and 2).

Table 3 shows changes in the product mix of Russia's exports and

Table 3

**Product Mix of Russian Federation's Exports and Imports (% of total)**

	Exports					Imports				
	1990	1995	2000	2005	2008	1990	1995	2000	2005	2008
Machinery, equipment, and vehicles	18.3	10.2	8.8	5.6	4.9	44.8	33.6	31.4	44.0	52.7
Mineral products	40.5	42.5	53.8	64.8	69.6	2.6	6.4	6.3	3.1	3.1
Metals, gems, and products made from them	11.3	26.7	21.7	16.8	13.3	5.1	8.5	8.3	7.7	7.3
Products of the chemical industry and raw rubber	4.6	10.0	7.2	6.0	6.5	4.1	10.9	18.0	16.5	13.1
Products of the forest, wood-working, and cellulose and paper industry	3.7	5.6	4.3	3.4	2.5	10.0	2.4	2.8	3.3	2.4
Textiles, textile products, and footwear	1.2	1.5	0.8	0.4	0.2	1.1	5.7	5.9	3.7	4.4
Raw leather, fur, and products made from them	—	0.4	0.3	0.1	0.1	—	0.3	0.4	0.3	0.4
Food products and agricultural raw material (other than textile material)	2.0	1.8	1.6	1.9	2.0	15.8	28.1	21.8	17.7	13.2
Other	—	1.3	1.5	1.0	1.2	—	4.1	4.1	3.7	3.4

imports in the period since the reforms. As we can see, in eighteen years, raw materials exports have almost doubled, while exports of machinery and equipment have dropped by more than two-thirds. A so-called raw materials structure of the economy has been established, as a result of which the country's raw materials complex makes the predominant contribution to its gross product (as much as 65 percent). At the same time, the efficiency of raw materials production was not high, and its capital-output ratio has declined. Because of this, even the raw materials economy is on a shaky foundation.

So the first thing that must be done is to develop production processes that create products with high value added, based on modern technologies. With this approach, accomplishing the objective of modernization will require not so much individual innovations as the re-creation of advanced production types and economic sectors, and a new infrastructure for the economy as a whole.

For example, developing nanotechnologies, state-of-the-art photoelectronics, and renewable energy production requires organizing the high-tech production of microelectronics, special technological equipment, and the necessary components. Meanwhile, in 1990–2008 the domestic electronics industry was considerably degraded and in its current condition is incapable of supporting the rapid establishment of a nanotechnology orientation. Production capacities for microcomponents and the latest microprocessors and microprocessor devices must be purposefully expanded. And this means creating individual sectors and types of activity almost from scratch, or reestablishing individual types of production to the extent possible.

What resources can be used to create new production processes? The answer depends on the choice of a modernization policy. One alternative is to divert resources from the raw materials complex and use them to accomplish these objectives, but then it would be necessary to compensate losses in the form of a gain in value added produced by the newly created innovative products, and as it accumulates, part of this gain will have to be spent on replacing assets in raw materials sectors when they break down. It is theoretically conceivable that production in raw materials sectors could be built up so that the additional earnings could go (through the banking system) to developing innovative production processes, but to what extent is this possible, with the considerable deterioration of assets in these sectors, and is it advisable, given the need to get away from the raw materials model?

In our opinion, the best option is to emphasize the development of manufacturing by organizing its expanded reproduction, with an increase in the amount of internal accumulation that it generates. The current condition of domestic production and engineering systems favors this option. Consequently, it is necessary to revive the classical chains for the production of machinery and equipment, with proper product quality. Otherwise, there will not be an adequate base for extensive innovations, and they cannot be widely diffused. Therefore, we distinguish a third option, in which the whole economic system is aimed at restoring machine building, manufacturing, and innovation. The effect of this option is heightened by diverting resources from raw materials sectors and using them to accomplish the objective of expanding innovative production processes.

Modernization of the economy and society is, without a doubt, system modernization. Any statement of the content of or plan for modernization that is outside the system or unspecific must be eliminated. Otherwise, uncertainty will remain regarding the achievement of the necessary results and even the correct understanding of modernization itself.

For example, should modernization return the basic macroeconomic parameters to the 1990 level, and how soon? What period will modernization encompass? Depending on the answer to this question, the periods or stages of modernization will have to be defined as well as the basic proportions of the socioeconomic system that are desirable in terms of efficiency and long-term development prospects. All other tools and measures should be of subordinate significance to these aims and proportions.

The statement of the objective of system modernization should take into account the aspect not only of time and stages but also of the requisite proportions, their planning, and the choice of methods and tools that could have an effect on changing relationships and the qualitative condition of the socioeconomic system as a whole. Modernization should introduce a special requirement to the system for governing the country, so as to ensure efficiency and overcome negative conditions, including deindustrialization, raw materials growth, "growth without development," and so on.

Based on all of this, I would like to stress the unacceptability of reducing modernization policy to monetarist policy. This pursuit is increasingly showing its negative nature. By itself, a quantitative increase in



government spending does not mean that real goals and efficiency will be achieved. Therefore, changes must be made in the use of budget and monetary policy tools. Government policy measures must be of high quality, with structural macroeconomic policy and its planning being the main elements of efficient social development.

The experience of many developed powers, including China, indicates the advantage of the planned and regulated type of social development. For our country, taking into account its history, the distinctive features of China's economic policy are known and similar. They have been clearly manifested during the global crisis. China's anticrisis program has included economic planning methods that have an effect primarily on domestic demand and domestic infrastructure, and not just the banking and financial systems. China correctly selected the path of supporting domestic demand, relying on methods of planned regulation, without growth of foreign debt and the debt load, as in the United States. The planned maneuver made it possible to maintain a high growth rate, in spite of a decline in exports.

When creating a modernization plan for the Russian economy, it is useful to consider the sociopolitical aspect as well. China began its transformations with the solution of economic problems in a stable political system, preserving the leading role of the state sector, planning and manageability, and flexible rotation of personnel, combating corruption. China's leaders persistently support a broad social base of modernization, adhering to the principle that wealth is not in possession or money-grubbing, but in the socially necessary use of aggregate industrial capital, relying on the broad masses of the people. The Chinese economic system quite tightly limits opportunities for enrichment through speculation or corruption. It encourages creativity, initiative, and innovative approaches; however, it puts public interests above private ones.

Back at the end of the 1970s, China correctly emphasized the resolution of the food problem, development of rural areas, a flexible price policy, and boosting the domestic market, the capacity of which is very large, by stimulating demand and developing domestic production. A policy of "activating" the agricultural resource was conducted in parallel with the policy for industrializing the country. A successful compromise and a strategy relying on its own capabilities were found here. In the 1990s, developing high-tech production processes and computer technology and raising the population's level of education became priorities.

Meeting the needs of broad strata of society, providing jobs and adequate compensation for labor, and improving the standard of living by progressively stepping up initiatives of the people themselves, is a model that can be called an “economy for the people.” A significant advantage of China’s economy is its use of methods of strategic and short-term planning, which makes it possible to purposefully ensure progressive structural and technological shifts in the national economy.

Rapid growth has been seen in the Chinese economy since the 1990s, based on the development of modern production processes, expansion of domestic investments, attraction of foreign technological investments, and creation of corporations that are capable of mastering new technologies quickly. In the conditions of the 2008–9 crisis, China’s program to overcome it, which has been the most successful, in our opinion, proved to be the exact opposite of monetarist logic: 13 percent of gross domestic product was allocated to constructing housing for the poor, developing transportation infrastructure, generating power, and to agriculture and high technologies. The interest rate was lowered, available resources were mobilized, the yuan was kept stable, tax breaks were provided for innovations, and so on.

In addition, China provides an optimal relationship between autonomy of its economic system and openness, because full-scale liberalization, like privatization, is detrimental to a country’s development. Its strategy of increasing international reserves is also correct and has allowed China to feel confident in conditions of the global financial crisis. It is sound practice to put resources into the large-scale construction of roads and electric power infrastructure, which makes it possible, during financial crisis and with the contraction of international demand, including demand for China’s products, to employ the population and achieve the objective of developing the country for the future, without lowering consumption standards. China’s successful development is based on its own way of thinking, a management approach to problem solving, balance and cautious copying of foreign experience, the principle of systematic, incremental building on results, stability of the political system, and actions in the interests of broad strata of society, using its intellect, traditions, capabilities, and labor energy.

The principles of socioeconomic development used by China are not new to us. For example, China took the principle of planned regulation, with its own specific features, of course, from the Soviet Union. The same

is true of many others, such as the principle of the commanding heights, and the principle of proportional development of the national economy across all sectors and regions. These are proven principles. Developed Western powers should also follow them.

Along with those enumerated, the principle of creating a social base for modernization is very important for Russia, in our opinion. This is the top-priority principle for a successful policy of progressive transformations. Without the social support of the masses, any undertakings, even the most progressive, will fail. And to ensure broad social support it is necessary to devise a policy that takes into account the interests of the social majority. If the level of income inequality in the country is so high that no variation in income any longer has an effect on labor motivation or productivity, then large-scale system and structural transformations are needed in order to change the nature of the intersectoral distribution of resources and, by doing so, to influence the dynamics of development of production and people's economic activity.

It is perfectly obvious that the objectives of modernization are not within the capabilities of disconnected private owners. Therefore, it is very important to provide for social consolidation.

In regard to modernization policy, a unified vector of development is needed, to which the resolution of all private questions and problems should be subordinated. Innovations should be developed with respect to three elements of national wealth: natural, physical, and human potential, and the first two components of the innovation process should be subordinate to the third, to the standard of consumption, and the standard of human life. Reproduction of domestic demand is ensured by the level of reproduction of domestic income, and therefore this is a synchronous process.

At present, the disintegrated structure of the economy and its sectors counteracts the multiplier effect of demand. Unless interrelations between sectors are provided, there will be no increase in demand and income through productive activity, only redistribution of the income received from sales of raw materials and energy.

The time has come for fundamental changes in the system in order to break away from the raw materials mode. The main outcome should be a reduction of profitability in the financial and banking sphere and raw materials sectors, and on the other hand, a rise in the profitability of machine building and instrument making, the research and

development sector, innovations, and high-tech activities. Then we will have the prerequisites for lowering the refinancing rate, stepping up the mechanism of government procurement in strategic directions and sectors, stimulating lending in specific sectors, particularly agriculture and machine building, and also government procurement in education and basic science.

The whole modernization policy should be subordinate to accomplishing the fundamental objectives on which the prospect of Russia's socioeconomic development depends.

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