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# ECONOMICS

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## TRADITIONAL ECONOMY: INNOVATIONS, EFFICIENCY AND GLOBALIZATION

**ABSTRACT.** North Caucasus is a diverse region at the border of Europe and Asia that belongs simultaneously to the modern civilization and historical traditions, and is populated with numerous multi-language, multi-confessional nationalities that speak a variety of languages and follow diverse traditions, carefully guarding their distinctiveness. Our paper sets up a goal of studying the processes and the mechanisms of modernizing regional economy on the case study of this unique region.

The paper confronts the typical view about the similarity and differences of traditional economies supported by different economic research schools and opens opportunities for scientific (dialectical) analysis of a mechanism, non-customary in the modern society, of modernizing traditional economies inevitably present in the “pore spaces” of the global economy. We substantiate a special methodology for studying traditional economies, characterizing their essence, showing the methodological difficulties of analyzing traditional economies, exposing the specifics of their system-wide organization, studying the non-economic sphere in a traditional economy, and describing the mechanism of modernizing a traditional economy.

### Introduction

When analysing traditional economies with regard to their innovation, efficiency and modernization, the researchers can hardly find more diverse and interesting example than the North Caucasus region (Barrett, 1995; Kolesnikova and Malovichko, 2004; Mamedov, 2004; Gerasimov *et al.*, 2014; or Kolesnikov, 2014). Sandwiched between Europe and Asia, the regions boast both wild and breath-taking sceneries, a blend of modern civilizations and

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historical traditions, as well as traditional versus modernized economy riddled with innovations and investments (Kolossof and Toal, 2007; O'Loughlin, 2011; or Tatuev, 2014).

If raising anthems for the subject of our study in a biblical-style language, it might look as follows: *“and God made a secluded firmament enclosed with mountains and populated it with many nations, and called this Babylon the “North Caucasus”, and gave the created “laboratory for integrating languages, cultures and the economy” to social scientists”*.

The economic analysis algorithm raised in our paper is not too complicated. It is centered on revealing, registering, and proving the main trends typical for a particular historic period. Then, it proceeds to trying to detail how such trends are embodied in local social communities (Höschle *et al.*, 2015). This is where researchers face the most difficulties: like tailors, they attempt to “dress” different nations and economies at different development stages in these trends, and squeeze their customs and traditions, sometimes exotic, in the general social formats. However, as a fashion designer does not see a “standard body”, a sociologist does not see “standard” nations, economies and cultures. Only then a researcher proves to be a true professional: does she or he manages to distinguish the general historic trends in a patchy exotics of the daily life? If so, then the study is within the scientific boundaries. If no – it sinks in tons of ethnographic features.

The scientific novelty of the subject of the paper is determined by the “overlapping” of the research area and the relevancy of the traditional economic enclaves for innovative development of the North Caucasus, all-round beset by the globalizing Russian national market economy. The purpose of our paper is to identify the reasons underlying sustainability of this traditional economy within the surrounding space of the modern economic system in Russia. The objective is to outline the specifics of modernizing the traditional economy along the three aspects of its transformation: innovativeness, efficiency, and globalization. Methodology: comparative analysis, abstract-logical patterning, and ethnical economics. The main constraints of the study are geographic, time-related, and economic. The major characteristics of the source base include the specifics of the North Caucasian social-and-economic works known predominantly in the local professional environment.

This paper is organized as follows: the first section outlines the basic premises. The second section details the changes that take place under the impact of innovations, increasing efficiency and involvement of the North Caucasus economy in the processes of globalization (Mamedov, 2010). The third section brings in an empirical analysis of the innovation and modernization of the North Caucasus traditional economy using the apparatus of the Okun’s law. Finally, the summary conclusions highlight the main results and findings and implicate the pathways which can become the “starting points” for further studies in this field.

## 1. Traditional economy and North Caucasus methodology

This theoretical discussion focuses on the category of “traditional economy”, understanding which determines the ultimate success of the undertaken analysis. Traditional economy means an economy where customs, traditions and beliefs prescribe the principles of economic organization for production of goods and services; in other words, traditional economy is built up around traditions, according to which a particular society lives. The sectors of economic activity include agriculture, hunting, fishing and gathering; primitive barter trade is used instead of money; there is no sustainable excess (surplus) product; the social organization in a traditional economy is represented by local family-tribal communities; while mobility is determined by herd run or soil fertility depletion. The next possible development of a traditional economy is a farmer’s economy centered on stable agrarian production structures (Rosser *et al.*, 1999).

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Other traditional-economy features are no less important: scholars emphasize that decision-making in such economies are based on traditions and a traditional economy is doomed to confine within the bounds of primitive technologies, thus its members live in poverty even if their daily needs are satisfied. As for the modern range of traditional economies, it covers the “third world countries” (countries with emerging markets): Africa, Asia, Latin America and the Middle East, although pockets of traditional economy can be found across the entire world. Since the modern economy historically stems from the traditional one, experience shows that a traditional economy has only three scenarios of its future: the market, command or mixed economies. If competition is present in traditional economy, it is rivalry for scarce natural resources. The need in trade is extremely limited because traditional economies, being identical practically anywhere in terms of technology and sectoral structure, produce roughly the same range of goods. Trade in a traditional economy is a consequence of the initial production specialization (for instance, between tribes of hunters and fishermen). In the modern world traditional economy is being destroyed by its interaction with the market. Still, changes in the environment are more destructive for it. For this reason, traditional economies are forced to limit even the population growth (traditional Economy: definition, examples, pros, and cons).

Methodological difficulties in analyzing traditional economy emerge because with all legitimacy of the above characteristics of traditional economy it is hardly possible to deny their inherent piecemeal approach that registers only particular, albeit important aspects of its functioning. In our opinion, here a scientific approach is reduced to a majoe point: it is impossible to understand “traditional economy” on the basis of it alone. This is a rare case when economists have to go *beyond the* boundaries of the subject of their science, – a heroic deed equal to an outer space walk by a human.

Why do we find a system-wide (interdisciplinary) approach expedient and why do we consider it as a “heroic deed” of economists?

Economy as a socially-organized sphere of creation is a unity of two elements: efficient costs-outcome ratio and equivalent-compensation exchange of the results of social labour with different utility. These are some sort of X and Y axes, in the space of which the “rest of the economy” forms: economic interests, contradictions and institutions. All of them are *intra-economic* elements, intrinsic to the economy.

The name of the system in question – “*traditional*” economy shows that here the economy is controlled through “noneconomic” regulators, which appear and exist *outside* the economy. To reconstruct, recreate this amazing link between the economy as an object and noneconomic phenomena (cultural, moral traditions, traditional values) as the subjects is an exceptionally complex intellectual process that can be actualized only through integration of various fields of social sciences rather than their superficial combination, but it’s the only way to make this process a scientific cognition (Jelínková & Jiřincová, 2015). Thence, there is no surprise that being cut off from “funds” and “indicators” so dear to their hearts, economists feel awkward among the “alien” conserved archaic characters. “Non-economists” (cultural studies scholars, social psychologists, or anthropologists) remain in a similar “subject perplexity”. However, they also attempt to map and to build up their research approaching such a narrow field of social studies as economics and economy.

## 2. The “non-economic” sphere of traditional economy

Economic primitiveness does not mean “relevant” primitiveness of the non-economic sphere regulating the economy. On the contrary, it is quite possible that under a primitive economy the non-economic sphere (first of all, politics and culture) achieves an unthinkable

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complexity and level, as the Ancient Greek society demonstrated. Therefore, attempts to deduce non-economic primitiveness from a primitive economy are counterproductive.

When the non-economic sphere flourishes on the basis of a primitive (traditional) economy, the main task for researchers is to find the major non-economic phenomena that exercise the crucial influence upon a traditional economy.

A common feature of a traditional economy is that its regulators are not generated by the “natural” economic course, but are brought *from outside*, which implies that they originally have a completely different, *noneconomic* character, that does not change even under an impact of “economization” – adapting to the economic imperatives.

Within the scope of the historical approach it can be affirmed: traditional economies prove that societies built on their basis are at early stages of social development since an alternative dependency is established at further stages when the economy regulates the non-economic field.

Proceeding from the above, we can formulate the fundamental “law of traditional economy”: this is the epoch when the non-economic dominates over the economic.

The next conclusion is no less important. When the non-economic field directly, explicitly influences the economic sphere and they are not yet alienated through an “intermediary” layer (distribution and exchange with various parts of the gross social product), such an “interdisciplinary” study object requires a special interdisciplinary approach.

### 3. Traditional economy modernization

How is it possible to measure the movement of a traditional economy (“primitive society”) to the future? How can we evaluate its success in modernizing the foundations of the society? How does it correlate to innovative transformations?

It should be noted that such movements and reinventions can be measured as one desires; however, scientific analysis puts the single requirement: the modernization criteria that bring traditional society closer to its future must be determined by the future! Regarding traditional societies, there is the cognitive charm of a primitive (traditional) economy, its uniqueness as an object of economic learning – the future of it is well known to us since it is the only future that is reliable, because the future of a traditional economy is our present! Any other interpretations of the future nature of a traditional economy would mean not only absence of economic regularities, and, subsequently, the economic science, but also would assert an arbitrary sequence of the stages of economic advance.

Now all that is left for us to do is to identify fundamental, objective, core characteristics of the modern society and look at a traditional economy through the prism of these fundamental regularities (trends), clarifying to what extent and in what form the traditional economy mechanism is gradually subdued to the above trend imperatives. To put it differently, it is necessary to find out how the “institution of traditions” is being forced away and substituted with a genuine economic mechanism.

### 4. Growing efficiency and innovations

Social-and-economic efficiency of a society is determined by an extent, to which the optimal costs/benefits ratio is achieved through market methods and developed institutional forms (Ehrenberger *et al.*, 2015). The integrated nature of social-and-economic efficiency is not so much in satisfying the material needs of a particular society as in augmenting potential for social development of a personality and satisfying the needs in civilized development of a social medium. Under the established international scholarly tradition, social-and-economic

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efficiency combines efficient economic institutions, efficient social relations and efficient public administration. In the economic systems with developed markets it is achieved through robust implementation of genuine market tools, institutions and values in the mechanisms of social development (economic freedom and competition in the economy, equality in social relations, democracy and civil society in politics and the legal sphere). In traditional societies an expanded reproduction of the described-above civilized forms of social-and-economic efficiency is impossible due to their threat to the established socioeconomic paradigms and political regimes. The force of traditions, frequently opposing not only the global direction and trends in public development but simply the basic common sense, counters the goal of achieving general social well-being. The North Caucasus represents a Russian enclave of a traditional economy where social-and-economic efficiency is determined by anti-economic and anti-social methods – preserves a high-level dependency on the preceding paradigms and traditions.

The reality is that socioeconomic development of the North Caucasian region absorbs some elements of market economy while maintaining multiple primitive production traditions (Berezhnaya, 2014). Nevertheless, changes occur in nearly all areas where new modern values and novelties penetrate through information technologies, education, pluralism of opinions, ideologies as well as technological and competence innovations.

Still, on the one hand, the established traditions restrain expanded use of new technologies and dissemination of modern groundbreaking information, and on the other the omnipotent market relations have already infiltrated nearly every regional economy.

The North Caucasian regional economy is an example that substantiates the concept of multi-paradigm production. Multiple paradigms are not an issue as such if lower-level technological paradigms interconnect with the higher-level ones and are gradually substituted with them (Bourov, 2006; Mamedov, 2014). A problem arises when obsolete techno-economic paradigms are supported artificially and their reproduction decreases economic efficiency and even hampers economic development. Economic science describes a multi-level economy as interconnection between three elements:

- *Quantitative*, that changes the scale of productive forces;
- *Structural*, that changes the structure and composition of the elements of public production;
- *Qualitative* characteristics of particular elements of productive forces. Structural improvement of productive forces is accompanied by spreading innovations across products, technologies and production sectors.

Economic research carried out in the North Caucasus showed that the local Republics are characterized by actively developing clusters with positive economic dynamics, implementation of new and state-of-the-art technologies, emerging new marketplaces (Kaluzhsky, 2003; Kalinichenko, 2011). These include, first of all, high-quality large-scale agricultural production by regional communities and cooperatives employing innovative technologies. It should be pointed out that the production and sales functions are specialized like production of consumer goods with some ethnic flavor, for instance, footwear, knitted garments, etc. Producers of such goods use modern equipment; actively novelize their products; take part in national and international fairs and exhibitions. Their products are supplied not only locally but also throughout the entire Russia, sometime under someone else's brand names. Distribution networks for supplying livestock products from the North Caucasian districts to markets in large cities are expanding, which encourages upturn of that sector in the region. Therefore, we believe, that currently the leading trend in the regional development is transition from a traditional to an innovative economy.

This transition is shaped by the factors that are, firstly, conducive to conditions for a transition to innovative development, and, secondly, related to emerging and creating

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incentives for economic actors in the region to develop and implement innovations (Mamedov *et al.*, 2014).

The first group leads to establishing a new (innovative) sphere as a self-sufficient sector of the economy while the second starts to conform directly to development of innovative production.

Here lies a problem: rather than producing high-quality stand-alone product specimen, a traditional economy is required to attain the high level of quality.

Slowly but steadily a traditional economy does begin to react to changing the model of economic development – from the one based on raw materials to the model based on innovations.

Nevertheless, the business practice in the North Caucasian economy proves that certain issues remains: the poorly developed institution of intellectual property, which reduces innovative activity of economic players; lack of effective competition that curtails producers' incentives to modernize and their perceptiveness to innovations; practically absent markets of innovations that are unable to commercialize novelties and spread them out at all levels and spheres of public production.

Thus, innovative activity of economic participants is a condition for economic development as the process of structural changes born within a traditional economy and should be considered only provided the old goods and technologies compete with the new ones that ultimately succeed them. Therefore, production activity will be path-breaking by definition and in view of this will be a continuous source of competitive restructuring of a regional economy, economic growth and development (Waligóra, 2015).

Talking about the innovative potential of a region, it comprises the regional resource potential, which determines and directs opportunities for innovative activities. The matter is that resources as a concept already embeds a possibility of being used in a particular socioeconomic form, including traditional economies.

This way in the market economy innovative products created by regional actors become an object of market relations.

Most innovative products embody the public basis, an ability to be a subject for others. They are produced amidst a rapidly changing product mix and, subsequently, serve the purpose of economic growth of the regional economy and its participants.

Obviously, regional advantages not necessarily generate an effect if the national environment is not favorable for novelties. It can be due to the following reasons: difficulties of finding capital; bureaucracy, high taxes; missing competitive ability as a result of the trend towards dominance by large private and state-run or state subsidized companies.

Contrariwise, some accumulated experience in production of other innovations leads to capturing new markets upon production of "new" goods (services) that generate high profit. Rapid changing of one product with another requires considerable financial investments, so mastering the manufacture of new goods is typically done by small and medium companies that operate in sufficient numbers in the North Caucasian region. Those actors endeavor to capture their market shares by commercializing new products.

Thus, innovative activity, crafts, products create the potential to gain a sustainable advantage over competitors and entrench the leading position in the relevant sector.

Accordingly, one can assume that to enhance competitive ability an innovative element in a region must: first, aim at investments in developing production resources; second, lead to a high-level employment of the developed production resources; and, third, endeavor to transform potential demand for the goods in this sector into the actual demand to expand market access. It will require additional investments in sales, distribution and services, as well as advertising and promotions to inform and make potential buyers aware of the originality of the goods.

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If an economic actor produced traditional goods unsung technological novelties that enhance the product quality and reduce the costs, the innovative strategy will originally target the low-profit markets. At the next stages, entering high-profit markets is possible. However, due to the advantages in the product qualities gained by the producer employing technological novelties (Rosser *et al.*, 1999).

Therefore, changing the current economic conditions rather than taking them as constraints for their operations, innovative entities in the North Caucasus region become dominant on the market through transforming the structure of industry costs, actively shaping demand for their products and achieving a higher output rate than they would be able to sell at lower prices in comparison with other producers in the industry.

It is important to note that the modern global world is developing in accord with the “made in the world” model which implies integration in all spheres of socioeconomic development. Although this phenomenon has been known long before, nevertheless, new trends emerge: information technologies show in practice how the share of import in export is increasing, which is indicative of the national economies integrated in the global production chains. It means further deepening of labor division in the world economy, particularly, fragmentation of production process based on which an economic player decides: what production elements should be located in what country. If there are competitive advantages (highly skilled but relatively cheap labor force, know-how, etc.) the regional economy is, therefore, being integrated in the global economic relations.

## 5. Globalization in traditional economy

Globalization is one of the mechanisms enabling integration of a separate territorial subdivision into the system of world economic relations. Globalization is a multidimensional process, thus, it is expedient to analyze it along the four aspects: economic, social, political and cultural. The economic essence of globalization is actualized in spreading out the most efficient forms of social production, which in technological terms is demonstrated in the speed, cost-cutting and reliability of production processes. It means that globalization is not contained in changing only a particular field of social life but is rather a system of comprehensive paradigm transformation. The economic impact of globalized transformations initiates socio-cultural and political restructuring, reflecting all-inclusive integrative changes.

The concept of endogenous territorial development presumes expanding value-added production, when the surplus formed in the local economy is realized in the national economy and, to the extent that there is relevant demand, at the international level. Globalization is an exogenous factor influencing territorial development since external-economic impacts stimulate inclusion of a particular territory in the world economic relations based on the liberal forms of market organization and trade.

On the one hand, globalization will bring traditional economies to a new level of their development, supporting social, political and cultural transformations. And on the other, modern regulatory tools will force to abandon the old social relations established in the traditional society, which will lead to developing new elites of the society.

Political globalization infers establishing civil society institutions, developing new political traditions and political culture.

Cultural globalization is displayed, first of all, in the polilyngual trend, peoples' involvement in various cultural events through information-and-communications technologies, ethno-cultural proximity between nations.

Social aspects of globalization are extensive and have diverse evidence, from unifying the standards of living to cognitive awareness by human beings of the integrity of the world system that shapes new priorities in the values of social development, “supra-ethnic

communities are formed at the state level and then ethnosocial supersystems emerge through institutionalization” (Kaluzhsky, 2003).

Enclave territories are the regions where old rigid economic and social structures prevail, traditional oligarchic mechanisms and inefficient methods of industrial organization dominate. Social capital in the form of personal contacts and mutually beneficial relations is the ruling organizational-and-control mechanism in traditional systems. The processes of globalization that bring unifying and standardizing production mechanisms, unhampered access to information, low transaction costs destroy the established stereotypic individual contracts transforming subject relationships.

Initially the globalization effects in the enclaves takes place through strengthening economic relations between adjacent regions that perform the role of a conductor to more robust international economic relations.

The least developed subsidized areas will not be attractive for direct foreign investments unless they possess special resources; so at the macro-economic level the regional policy should be designed to integrate the enclaves of a traditional economy in the general globalization processes.

To evaluate how the main features of the globalized economy begin to appear in spatial-territorial enclave entities, the specifics of their development should be analyzed. In other words, will globalization processes be able to penetrate inertial peripheral regions?

## 6. Empirical model and main results

In this section, we will test the provisions of the Okun’s law for the North Caucasus regional economy. Okun’s law represents a macroeconomic relationship that describes the interdependence between output and unemployment. In other words, it measures the level of activity in the market for goods and services to the level of activity in the labour market in the time frame over the business cycle. Over the last decades, this relationship proved to yield an empirical regularity in various countries around the globe (Silvapulle *et al.*, 2004; Mamedov *et al.*, 2015).

Okun’s law remains popular amongst the labour economists of all genres and schools of economic thought due to its robust empirical regularity as well as due to its importance as a macroeconomic tool that finds its implementation in various fields. It can be shown that when the Okun’s law is combined with Phillips curve, one obtains the aggregate supply curve. Furthermore, Okun’s law has strong implications for macroeconomic policy, in particular with regard to calculating the optimal rate of economic growth. This gains particular importance with regard to the scope of our paper that sets a goal of understanding the processes and the mechanisms of modernizing the “traditional” regional economy.

Further down this section, we will estimate the empirical value of Okun’s coefficient which represents an indicator of the responsiveness of unemployment to output growth which is crucial in understanding and yielding the cost of unemployment in terms of output (Abrahám *et al.*, 2015; Lelek, 2014; Jasinskas *et al.*, 2015).

It can be shown that the empirical estimates of Okun’s coefficient are sensitive to the selection and the specifications of the model (either a static or a dynamic model). Model specification might also include the first-difference model or the gap model. If the first-difference model is chosen, the output and unemployment variables are then yielded as the growth rate. However, if the gap model is selected, the variables are expressed as the cyclical components or deviations from long-term trends (Ball *et al.*, 2015).

Our empirical model can be formulated as follows:

$$\Delta u_{i,t} = a_i + b g_{i,t} + v_{i,t} \quad (1)$$

And

$$v_{i,t} = \lambda \sum \omega_{j,t} v_{j,t} + \varepsilon_{i,t} \quad (2)$$

where  $u$  represents the rate of unemployment,  $g$  – is the regional product,  $b$  – is the Okun's coefficient and  $a$ ,  $\lambda$ , and  $\rho$  represents the coefficients.

The model specified in (1) and (2) can be further modified and transformed into the model with both endogenous interaction effects and interaction effects among the error terms (SAC):

$$\Delta u_{i,t} = a_i + \rho \sum \omega_{j,t} \Delta u_{j,t} + b g_{i,t} + v_{i,t} \quad (3)$$

Table 1 that follows reports the results from the models specified in (1)-(3) using the regional data on the North-Caucasus regions obtained from the Federal Statistical Service (2015). The results are presented in the table using four main specifications of the model including SAC.

Table 1. Log-likelihood weighted matrix of regional growth dynamics

	Specifications			
	FE	SAR	SEM	SAC
$b$	-0.102*** (0.008)	-0.016*** (0.004)	-0.015*** (0.007)	-0.015*** (0.002)
<i>Direct effect</i>	-0.102*** (0.008)	-0.020*** (0.004)	-0.015** (0.007)	-0.016 (0.004)
<i>Indirect effect</i>		-0.055*** (0.014)		-0.077*** (0.025)
<i>Common effect</i>	-0.102*** (0.008)	-0.078*** (0.015)	-0.015** (0.007)	-0.098*** (0.025)
$\rho$		0.354*** (0.018)		0.435*** (0.015)
$\lambda$			0.354*** (0.015)	-0.302 (0.080)
$R^2$	0.121	0.168	0.101	0.165
<i>Log-likelihood</i>	1775	2345	2148	2335

Note: \*\*\* – significant at 1% level, \*\* – significant at 5% level.

Source: Own results.

Our results show that the economic development of the region is mainly determined by regional competitive advantages including such factors as the allocation of natural resources, geographical location, agglomeration effects, and human capital. When it comes to the competitive advantages, it becomes apparent that less independent and influential regions might be the losers in this economic gain and modernization and innovations are not likely to contribute to their development and economic growth.

Moreover, there appears to be no asymmetric adjustment to the increase of regional growth rates dependent on the spatial interactions in the model (a regional buffer effect). Due to the regional disparities there are regions with high unemployment slow dynamics of economic growth. Our empirical analysis shows that these regions are dealing with the crisis and economic turmoil due to the presence of spatial interactions.

## Conclusions and policy implications

In general, it seems that the modern society complies with and pursues three fundamental trends: sustainable economic development, innovative behavior mechanisms, and globalization of national economies. All other trends can be classified and pushed into these three basic trends described and classified above.

The most amazing analysis that economic history can offer its researches is to consider how a traditional economy makes steps towards its future (“innovative-industrial”, “effectively liberalized”, and “globally supranational”) economic arrangements. Our paper does it in the context and using the example of the North Caucasus, a region that is seemingly “custom made”. Our results prove the objective trajectory for economic development of all countries and to demonstrate the intellectual and forecasting power of economic science.

Traditional economy is the first and the last epoch when traditions have an overriding priority in everything. Therefore, development of traditional economies is reduced to developing traditions, and is represented in such development. Knowledge of this mechanism of “renewing traditional society” enables to control and manage it, launching and implementing new traditions.

Traditional economy is characterized by the primitive social and administrative organization. This is the situation and the case when the social layer is formed with a “modernized” mentality that becomes instrumental for “modernizing” a traditional economy.

One can conclude by saying that traditional economy poses traditional advantages and shortcomings as well as traditional contradictions. Those include contradictions between society and nature which puts the whole arrangement in contrast with the modern economy. When it comes to modern economy, it becomes apparent that all contradictions that it demonstrates typically become purely social between various groups of economic agents, or participants engaged in production and distribution.

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