

CHAPTER 1

Introduction

Background and Purpose of Study

This research compares Russia and China's formal and informal economic institutions, against the backdrop of the WTO. It analyzes the interaction of institutional elements and processes that create the framework for economic governance, how these frameworks have transitioned from the socialist era to that of the WTO era. This framework comprises such elements as: policies, legislation, institutions, organizations, government capacity, predictability, accountability, transparency, participation. According to Andrew Stoeckel "transparency, accountability, predictability and participation" are what the World Bank and the ADB describe as the four pillars of "good governance" because they promote "balanced socioeconomic development" and "nation building."¹

This research argues that while Russia and China significantly diverged in strategies in their transitions from a socialist economic system, their linkages to the past as they transition into the WTO create useful comparisons to gain insights into what types of economic governance has worked better, and what the two countries can learn from each other. No doubt, in both countries, the transitioning processes have affected their economic governance in meaningful ways and have positioned them to take on both the challenges and opportunities that the WTO presents them.

We argue that in Russia, Putin's capacity to govern Russia's economic system has no doubt been altered because of shock-therapy, especially when compared to China. In both countries, the institutional background the government has to maneuver, and the

¹ Andrew Stoeckel, "Economic Governance and the Asian Crisis, *Quality Assurance Series* 30(April 30, 2003): 5-8.

arena of policy making affecting economic governance has changed because the respective countries' divergent transition policies. We argue that the events leading up to Putin's administration have created complex relationships espoused by various competing interests resulting from various external and internal factors that are coming to the fore in the impending WTO membership. We envisage Russia as a transitional state, which having witnessed a dramatic political and economic transformation following the break-up of the Soviet Union and the end of the Cold War, its institutions continue to promote a type of governance that has government control imbedded. This characteristic, which we contend is a hallmark quality of countries transitioning from a socialist past, and is hallmark of the Chinese economic governance system. As much as both governments have let go of powers they extended over the economic systems because of the WTO, they are also trying to leverage their economic position. While the World Bank and ADB might find fault with Russia and China for their role in not keeping their institutions in line with "good" governance, to what extent have their activities created benefits to their own country or the world system? In terms of the WTO, to what extent can Russia today learn from China's economic transformation experience? To what extent are their experiences comparable in terms of economic governance, and how do their unique histories position them to contend with the WTO?

Namely, the reason why we are using China as a backdrop in our study of transitioning countries is that we see that China's path of development and its transitional experience into the WTO can be promising for Russia, at a maximum a model, and at minimum a useful frame of reference for comparison. Therefore, our analysis regarding China is not so much about China's strategy, as it is an exposition on the ultimate implementation of its development and transition strategy as well as accession into the WTO. Therefore, because we are, in fact, examining the extent that Russia might be able to accrue some of the both positive effects or negative effects if its economy had looked to China as a model. In other words, in my analysis of China, I am more concerned about the results of its strategy than the government's intentions. However, when we are analyzing Russia, we also aim to look at the results of its economic transition, with an eye toward understanding the government's strategy – and its initial intentions in instituting one policy over another – verses how those intentions really played out. With this

understanding, we believe much light can be shed on the Russia's capability and willingness to use China as a model and the applicability of the China as a model for Russia's economic governance as it pertains to WTO accession.

Hypothesized Propositions and Framework of Study

From our reading, we see Russia as a democratic-authoritarian regime that is still in the midst of transition into a liberal democracy and market economy, devolving itself from its socialist past. It is in this connection that a comparison of the ways in which the WTO will and has shaped the respective economic landscapes of both Russia and China would not only help to illuminate their respective challenges and opportunities that globalization would present to transitioning economies but also contrast the respective governments' divergent abilities, strategies and constraints to carry out economic policies seeking to maximize economic development as a result of the WTO compliance and other spillover effects engendered by the WTO accession process. I will use an analytical framework that will stress three major factors: the changing economic conditions; the importance of leadership and the rhythm of domestic politics; and the role of crises as catalyzing events for politicians to adopt certain reforms. In our inquiry, we must make note that our discussion should be seen in the context of China's rise to prominence as well as the emergence of Russia and China's 'good neighborly' relationship. For instance, Kuo notes,

“Improved relations... have eased border tensions, with the border demilitarization talks that began in November 1989 yielding various military confidence-building measures. In 1994, the Chinese and Russian authorities adopted a 'no first use' nuclear weapons policy. In 1998, they established a direct presidential hot line, the first such line between China and another government.²

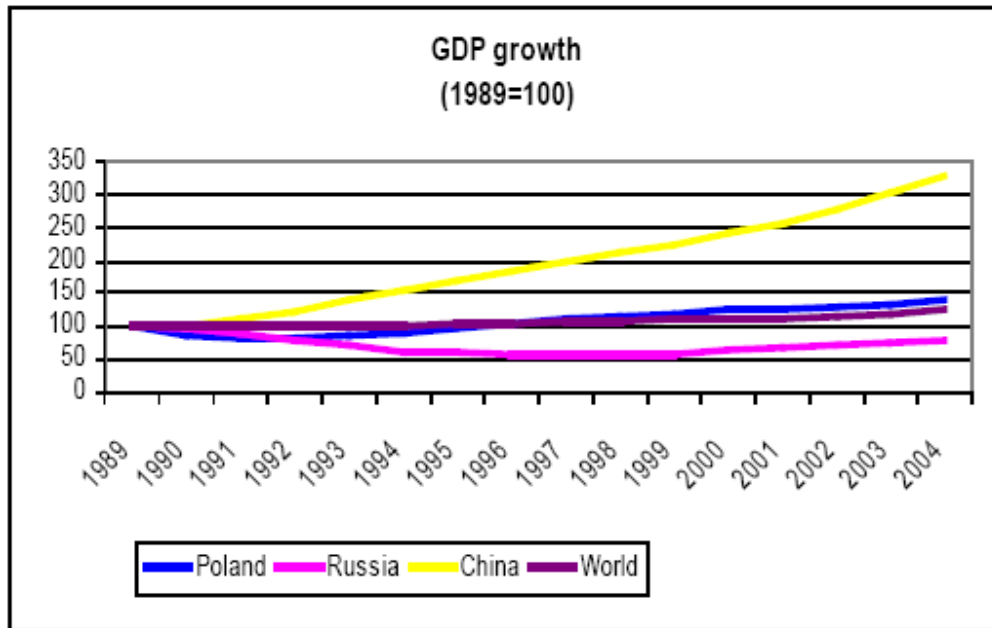
Thus both countries are not only transitioning, but also they are becoming more interconnected to each other and with the world; therefore, comparative inquiries into Russia help to reveal the effects of a countries' unique political and economic circumstances, as indicators for divergent strategies. Analyzing Russia and China

² Sangtu Kuo, “Strategic Partnership in a Unipolar System: The Sino-Russian Relationship,” *Issues & Studies* 42, no. 3 (September 2006): 212.

together also allows us to look at the possible consequences of importing the “China model on Russia” or the “Russia Model on China” (the focus of this study is the former). This research will highlight the constraints, divergent strategies and domestic and international constraints, the governments seek to maximize their interests by seeking to reap as many benefits as possible from joining the WTO while minimizing disadvantages using their economic and political leverages, which were created as a result of the transition process. By highlighting the changing strategic interactions brought about by pressures related to WTO compliance on a international and domestic level and how China and Russia and uniquely position in its relationship to other countries and the WTO; this research attempts to put the prospects of economic governance in Russia after the WTO into high relief.

Like Russia, China remains one of the mere handfuls of countries caught up in the midst of transition, which include countries and regions like Vietnam, the CIS, Eastern Europe – all countries attempting to detach themselves from their legacies of centralization. China’s spectacular economic performance and improvements in social living standards while it has retained political controls and significant economic control highlights, in some ways, seems China’s totalitarian regime can significantly enhance the capabilities in economic governance in China has espoused many benefits for the country and has also helped to buttress its leadership’s legitimacy. For instance, the following chart reveals the spectacular growth of China, which shows that by 2004, China’s GDP growth was approaching 350% of its 1989 levels, whereas Russia’s 2004 GDP was less than its 1989 levels:

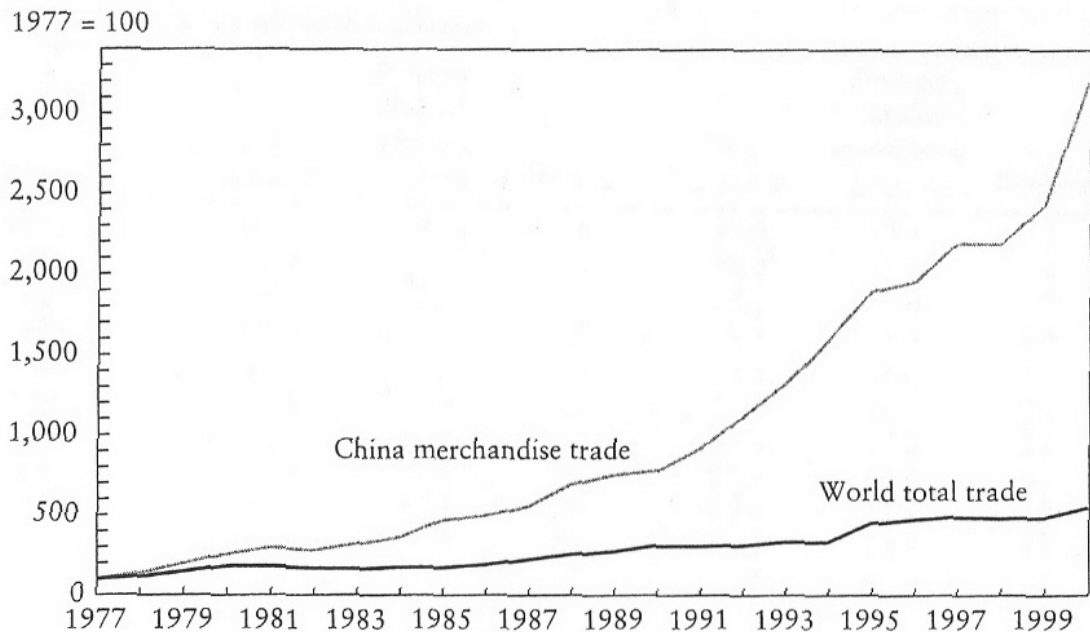
Chart:



Source: The World Bank and national statistics (from Justin Yifu Lin, Lessons of China's Transition from a Planned Economy to a Market Economy, p. 1)

However, while the government has sought to promote economic growth and social stability, new challenges and vested interests arise, which are undeniable aspects of any political and economic change. That Russia and China's are both transitioning countries and that they want to promote economic growth by participating in the world economy give us insights into two countries that, in some ways, share a similar vision. Part of the reason for China's growth is due to its ability to augment merchandise trade, as the following graph shows China's economic performance in that dimension:

Figure: The Growth of China Trade vs. World Trade, 1977-2000



Source: Lardy, Nicholas. 2002. *Integrating China into the Global Economy*/ Harrisonburg, Virginia: Brookings Institution, 5.

For Russia, China’s case may also seem like a good idea for alternative to US or EU-propounded development strategies, which oftentimes neglects Russia’s transitional circumstances and have been seen to be aimed at promoting foreign interests. If there’s anything we’ve learned from Russia’s “shock-therapy” political and economic transformation, is that international pressure, led by states and international organizations, such as the Washington Consensus, the IMF, the World Bank has created significant economic repercussions on Russia, causing among other travesties, economic slowdown, hyper inflation, and corruption. Thus experiences show that prescriptions about reform imposed by foreign actors should always be taken with a sense of skepticism at best. This research proposes an explanation of Russia’s governance after WTO, which are but a product of the issues related to WTO compliance and the inherent qualities about Russia’s political and economic system that either enhances or handicaps its maneuvering capability and state economic control. Hence, the skill in which the incoming Russian leadership executes its political and economic influence onto the vested interests and stakeholders in the Russian economy as a result of WTO accession, could enhance or

deter the positive and negative effects of the Russia's transition into the WTO as well as the state's role legitimacy in economic governance.

What we mean by the importance of the Russian government transitioning into the WTO is that we see Russia's WTO accession process as a part of a larger picture of its transitioning from a Soviet style economy to that of an open one. Coupled with globalization, these changes will not only create a significant challenge to the federal government's capacity to control the economy, but also would fundamentally change the state's relationship with enterprises and society at large, hence creating an underlying tension in the exercise of economic governance in Russia: For instance, Wallander highlights the way Russia might conduct itself in the era globalization, that is, with economic governance that does not conform necessarily to economic liberalism:

Writing in 2007, Wallander notes, "Russia is engaged with the international economy, but on terms antithetical to economic liberalism. Transactions, negotiations, and relationships are channeled primarily through the state; and the state controls major sectors of the Russian economy, particularly in sectors deemed strategic, including energy, metals, and defense. The trend toward privatization, particularly in important sectors such as energy, defense, high technology, and natural resources, has been reversed. Foreign direct investment outside of the consumer goods sector and agriculture is increasingly unwelcome. Foreign investment in strategic sectors must be limited to less than 50 percent and perhaps as little as 30 percent of a firm's value, with close state oversight of foreign investors and their proposed purchases requiring state approval."³

Against this backdrop, officials of the federal government are envisaging high economic performance for the government, a goal that yet again, highlights the importance of effective economic governance in the WTO era because of the federal government's strategy and the state's sinews of economic control. For instance, Sergei Prikhodko, aide to president Putin, reports, 'It is planned to reach a figure of \$60 billion in mutual trade already by 2010.' Prikhodko is convinced that this is a quite realistic goal because 'the turnover of trade grows by 3-35% annually and may reach 20 billion in the next five

³ Celeste A. Wallander, "Russian Transimperialism and Its Implications," *The Washington Quarterly* 30 no. 2 (Spring 2007): 111.

years.’ Chinese experts are more optimistic. They presume that the level of \$20 billion will be surmounted already in 2004.⁴

This also comes as more and more countries, particularly those that are hungry for natural resources, are showing significant interest in trading with Russia. This relationship, coupled with its future WTO obligations, is creating positive steps in cementing economic Russia’s international economic valence. Moreover, its bilateral WTO trade talks with other countries is also solidifying Russia’s ability to cooperate with other countries on not just issues pertaining to trade. For instance, In October of 2004, after China and Russia had concluded bilateral talking on Russia’s WTO, the two countries recognized each other as full market economies. According to a Xinghua report documenting the trade relations after the negotiations,

“[t]he two countries will expand trade of electronic and machinery products, improve the forms and methods for economic and trade cooperation and investment, focus on large cooperation projects and seek substantial progress in energy cooperation...The two sides will also expand cooperation in peaceful use of nuclear energy and enhance scientific technological cooperation in prior fields such as spaceflight, nuclear energy and other kinds of power, new material, chemical industry, biotechnology, communication and information technology, the statement says.”⁵

Moreover, Voosty shows how Russia and China’s negotiations are creating new linkages that facilitate not only their trade but also infrastructure. These developments would help not only help to solidify economic interdependence, but also would likely augment mutual sphere of influence. For instance, Voosty points out that, Russia’s foreign minister Gref noted that China had made plans to invest \$1 billion into the building of the Moscow-St. Petersburg highway were signed. Apart from that, the Chinese companies are planning to invest \$350 million in building big projects in Moscow.⁶

I propose that in looking at China’s experience’s in which the government has retained an ability to control key segments of its economy leadership under WTO vis-à-

⁴Sergei Prikhodko, “Russia Offers Oil To China in Exchange for WTO Membership and Investments,” *The Russian Business Monitor*, October 19, 2004.

⁵*Xinghua*, 2004. “Russia and China Sign protocol on Completing Russia’s WTO admission Talks. (October 15).

⁶*RIA Voosty*, “Russia and China Sign Protocol on Completing Russia’s WTO Admission Talks – Gref”

vis a gradual transition process, Russia's future leadership ability to control its economy gradually and impute political influence may in fact help achieve its national interests as a member of the WTO.

The reverberations on Russia – politically, sociologically and economically – are so high, that Russia must be able to govern its economy. The effectiveness in the ability to govern the economy – i.e.: the state's ability to influence domestic economic agents or monetary levers – will be the touchstone of legitimacy for Russia's leaders. Due to the immaturity of its democratic system and the aftermath of transition on the countries political and economic institutions, if Russia blindly conforms to the WTO agreements without exploring ways in which it could defy comparative advantage, promote economic growth and stability, not only is there the real cost economic cost associated with the inability to be competitive in the WTO context but also significant segments of society would become dissatisfied and disenfranchised, risking political instability – a process that ultimately leads to economic inefficiency. Thus the Russian government has no other choice but to take a significant role in the governance of its economy.

For Russia, like China, a major determining factor in its future economic prosperity is its effectiveness at governing the economy, in light of economic integration and internal economic change.

Despite the concessions and economic integration the WTO could offer Russia, there is no question the federal government will continue to wield significant influence on the economic system. With this power, a remnant of its authoritarianism, the government faces both opportunities and constraints. Russia's own political and economic legacies, Putin's influence, as well as local and global pressures create a myriad of different policy options.

By looking at the successes of China, and to see whether they are applicable or useful to Russia's economic development strategy comes as a critical juncture as changes are occurring ever more quickly, helping to recast the dynamics between the competing interests in Russia. Moreover, Russia can be seen as developing economy that has the potential to become a major player in the world economy like China, and increasingly India and Brazil. Yet Russia also faces several structural problems. Highlighting Russia's political and economic special status, its unique positioning in the global commodity,

against the backdrop of China's unique status provides invaluable insights on "authoritarian", "irregular", "transitioning", trading countries seeking to tackle the 21st century's problems in their unique way.

Literature Review and Methodology of Study

In order for us to tell you the story of Russia and China's transition and WTO membership, we have used a variety of social science literature aiming to provide both theoretical background on areas like politics and economics as well as current literature that situate the reader in the most salient debates of the later half of 2000. As part of our methodology, we chose to formulate an argument first and then create an outline based on our hypothesis. The outline, changed as the research progressed. I have included the final outline above, which is attached under the contents.

We wanted to familiarize the reader with a basic understanding of Russia's and China's economy – how it has performed, what are the most salient issues at stake and some general knowledge about how the markets in those countries work. We analyzed works like that of Lardy and Xu who give good analysis of economic issues in China. We consulted works by Cooper and Tsygankov to further familiarize the reader with some basic background on Russia and China's economy.

The literatures we've chosen to review are of four broad themes. Firstly, we wanted to assess China and Russia's strategy using several levels of analysis, particularly at the state level and sub-state level, including such actors as the central government in China, the federal government in Russia, enterprises and other relevant contending voices and economic agents, which are as we argue, instrumental in shaping policy decisions. In terms of Russia, the works of Stephen White, which illuminates important issues facing the federal government and Putin particularly like terrorism, Chechnya and the demands brought about by the balancing required for the federal government to remain in control. The study also gives shape to the degree of Putin's support in Russia by revealing the results of his survey on public sentiment about the leader in Russia. In order to have an even more nuanced understanding of Putin's role, we also delved into the works of Sapir, in which Putin's goals are put forward. In addition, the analysis on Eurasia that Tenin provides another dimension to Russia's external concerns.

Works like that of Kuo and David Kerr also provide context by highlighting some of the most important issues in China for the central government. For instance Kerr looks at external outlook favoring multipolarity and its implications for not only the central government. Kuo also talks about the role of the central leadership by highlighting its main importance of we call the “institutionalization of encounters”. Moreover, the author provides additional context for the reader on Russia and China’s positioning vis-à-vis the United States.

Secondly, we also used extensively works that sought to compare the transitional experiences of Russia and China – particularly in the respects that Russia used shock-therapy political and economic reforms while China has expressed restraint in curtailing central control with its gradual economic and political reforms. Mostly historic in nature, this group documents relevant political and economic issues and other political or ideological undercurrents. The works we used in our study helps us flesh out ideas that help us develop the dimensions of our study using our analytical framework, namely, the changing economic conditions; the importance of leadership and the rhythm of domestic politics; and the role of crises as catalyzing events for politicians to adopt certain reforms. The work of Nolan offers an excellent comparison on precisely the issue; however the material is somewhat outdated. However, it does help to give us a sense of the main political and economic direction of the reform strategies, and expounds on the respective countries’ reform strategies using a multi-layered analysis, helping to break down and delineating the key focal points where the two countries have diverged. The works of Kornai, also outdated, which we also have included gives us a further nuanced viewpoint by compare Russia’s transition experience to that of several Eastern European countries in the late 1980s.

For both countries, we wanted to single out particular issues that we thought were becoming more salient as they become more entrenched into WTO commitments as well as the unfolding of domestic and international forces. For Russia, we looked at the impact of Russia’s transition on its geographic distribution of FDI by analyzing Iwaskai’s findings. We also looked at what are perceived structural issues that have been bequeathed because of the transition. In particular, Roland looks at the potential for Russia’s economy to experience “Dutch Disease”.

We also heavily quoted from Cooper, critically analyzing his theory that the WTO created the impetus for the dismantlement of the Russian economic system. The author lays out several aspects of Russia's transition aftermath, particularly emphasizing how there are both winners and losers in the transition, and how, going forward with the WTO, the contending shifts in winners and losers because of the accession, will significantly be a centerpiece of the federal government policies, and harnessing it will be a key to its effectiveness. The author analyzes how the processes of divesting control by the government have created significant challenges to Russia.

Two other authors also offer similar critiques of Russia's transition process. Namely, Aslund contends that because of economic integration, opportunities are being created for rent seeking. Broadman also analyzes the deficiencies and deepens our understandings of the divestiture methods, resulting in economic efficiencies caused by the loans for shares program.

As for China, we looked very closely at the work of Lin Yi-fu, who in addition to contending that China's success was partly attributable to its gradualist economic reforms, he also contended that China was able to effectively pursue a comparative advantage defying strategy, namely in that it was possible for the government to administer the economy (economic governance) to have positive shifts to pareto improvements. In Lin's analysis the evidence he used was very helpful in rendering a thoughtful understanding of the Chinese economy and the evolving relationships between state and economic agents as well as pressing issues that have come to the fore as China becomes integrated into the world economy. In addition, Xu's discussion on China's Financial system illuminates some of the most pertinent changes to the economic institutions in China, and the author especially highlights new financial instruments.

Thirdly, the third large category of books we used is those that analyzed the impact of the WTO on both the respective countries. Whereas previously in the second group the aim was to highlight the major divergent strategies of Russia's transition from a Soviet style economic system, this group of works examines the impact of economic change and the structural deficiencies that are coming to the fore as a result of the transition, and in particular with the countries' membership into the WTO.

Broadman's analysis gives us a thoughtful context in which to analyze the implications of Russia's WTO membership by highlighting what he believes are the most salient positive and negative trends coming to the fore, as well as many ways in which compliance to the WTO membership embodies both opportunities and challenges, citing such areas as accounting, corporate governance, and capital markets. The author also illuminates impending challenges such as the lopsided concentration of economic opportunities in Russia as exemplified by both regional and business interests.

Vercueil elaborates on these issues and discusses how the government has taken steps to mitigate many of the inefficiencies that are born from ineffective economic governance. For instance, the author shows that the government has taken action by introducing such measure as simplification of procedures for tax system on customs, a restructuring of state monopolies, and reforms in the fiscal codes. The aim was to balance the demands of securing its grand vision of economic growth while balancing the needs of promoting emergent economic interests. The author shows how in industries like the autos, banking, natural energy – among others – the government is reticent about making bold commitments, as other members of the international community are putting on Russia to make stick to the rules. Yet, the author highlights, through the negotiations, Russia has made many concessions, just not completely.

As for China, in addition to the literature on the Chinese economy as made clear by Lin Yifu and Yang, we also explored Nicholas Lardy's points on the impact of the WTO on China. Lardy analyzes the nature of the commitments and projects what he thinks will be the result. Lardy seems enthusiastically optimistic about the WTO reforms on China, but he does see significant structural factors that could plague China in the further term. For instance, the banking sector, while instituting a restructuring vis-à-vis its economic governance favoring internationalization and the introduction of competitive mechanisms, still suffers from overall structural issues, such as the prevalence of non performing loans. In addition, problems might arise because of growing unemployment, as well as a reliance on inputs. Lardy's rosy picture of China, especially compared to our findings about Russia, is that China's growth has, in fact, been an economic miracle. This is the main conclusion, also, for Lin and Yang.

Fourthly, we studied Yang intensely because we thought his theory on China's successful method of economic governance may hold insights into the reform strategies that Russia could take. It may also bring to light how China and Russia's experiences are unique from each other, and thus incomparable. In terms of economic governance, our goal is to assess the degree to which Russia would first have the capacity to carry out economic governance like that of China, whether Russia's unique the changing economic conditions; its leadership and the rhythm of domestic politics help to catalyze reform measures that would seem to echo China's in terms of strategy and/or end result, or are the different economic and political contexts of China and Russia create a necessity for the countries to follow their own unique path. Such is what those who study path dependency would probably claim.