

CHAPTER 2

Transition in Russia and China

This section aims to highlight the economic and ideological frame of reference that perpetuated the reform of socialist economies led by Leninist parties that attempted to transform a central planning apparatus that mostly saw an abolishment system of market-based exchanges into a market system. It is hoped that with an understanding of the ideological logic for Russia and China, as well as their on their own economic standing, we can begin to analyze the effectiveness of the intentions of the economic reforms against its achievements.

Ideological Undercurrents

The economies of Russia and China should be considered today to be more or less market oriented especially compared to the pre-reform periods. That the countries have markets, is not an indication that they are like in other countries. In China and Russia the government continues to play a major role in the respective country's economic governance. Of course, whether it is through monetary or fiscal policy or by other means, all states govern their economies to a certain extent. I will show that the socialist legacy is so entrenched into Russia and China's economic governance that the effectiveness of

the government and part of its legitimacy relies on its performance in economic governance.

Thus the Socialist legacy has bequeathed both opportunities and challenges to the economies in terms of economic governance. For instance, in both countries, the transition economy's policies dislocated several parts of the society, granting some economic agents exuberant amounts of money and influence at the cost of others. Namely, the process of instituting market reforms in the socialist economies involved the rebuilding of the state into one that is qualitatively different and suited to markets. This process, which transformed the economy and the vested interests, also created a legacy of continued government intervention. For Shlapentokh strong state can prevent the kind of legal fragmentation that occurs when each region has its own rule.⁷

As Yang points out, "market reforms cannot succeed without the reconfiguration of the socialist state. It is necessary to get the omnipresent state to retreat in some area of the economy, to change its behavior in others, and yet to build and rebuild the institutions and capacity to govern markets and provide various forms of public goods."⁸

In both China and Russia, due to unique political and economic circumstances resulting from the transition (what I'm exploring) the central government in China and the federal government is entrenched in relationships with enterprises through ownership and other connections. The divestiture of the central state's assets through the shock therapy reforms in Russia verses that in China created a significantly different context for the government to influencing its economy through exerting state power on the enterprises. For Russia, much of the power is exerted from Putin against the competing demands of society, including the oligarchs as well as external pressures like the WTO in a way that seems to fracture society.

The reality should be seen as a product of the transition and divestiture of ownership. For China, the divestiture of political and economic power through the gradual transition has allowed the government to continue to take control of its economy

⁷ Dmitry Shlapentokh, "Lessons from China: Russian foreign policy and its implications," *Crime, Law & Social Change* 41: (2004): p. 245.

⁸ Dali L. Yang, *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China* (Palo Alto: Stanford University Press, 2004), 9.

because of the persistence of hierarchical linkages between the state apparatus and various SOES and other economic agents.

Both countries are trying to explore ways to build markets; China and Russia are unique in that their circumstances necessitate their governance over the markets, namely because the infancy of their development can face significant uncertainty, redoubling the importance of maintaining stability, as Simon, who points out using terms of neoclassical economics:

“Neoclassical economics created a unified framework for ‘explaining virtually all human behavior as produced by an Olympian process of utility maximization that recognizes no limits to the knowledge or thinking powers of the human actors. The neoclassical framework assumed a static equilibrium and, as soon as serious attention began to be paid to dynamic phenomena and uncertainty in large, complex social systems, the structure began to deteriorate, and continues to crumble today.”⁹

The author goes on to say that:

“...markets are, indeed remarkable coordinating mechanisms in the parsimony of their requirements for information. But they are far less parsimonious than they appear at first blush, for they require a high degree of economic stability and a low level of externalities in order to operate. ..in important classes of market transactions, much product information must flow in the negotiation of the exchange and the subsequent manufacturing process.”¹⁰

Since power was vested in the government in the first place because of the legacies of central control, the state’s economic governance ability becomes a product of the transition, and its ability to control is affected by domestic and international interests, primarily by on whether the state can promote that interests can be conceived to promote economic growth and stability. This is a unique aspect regarding the transitional countries of China and Russia – a point we will touch on in the following chapters.

In China, After Stalin’s death and in those brief periods in Maoist China when more liberal attitudes prevailed, economists were able to investigate a wide array of ideas, which incorporated many elements of the market economies under the heading the ‘law of value’, an idea that encompassed all those concepts associated with exchange

⁹ Herbert B. Simon, “Public Administration in Today’s World of Organizations and Markets,” *PS: Political Science and Politics* 33, no. 4 (2000): 750.

¹⁰Ibid., 751.

relationships.¹¹ Economists such as Liberman, Nemchimov and Novozhilov in the USSR, or Sun Yefang, Chen Yun, and Dong Fureng in China, opened up new avenues in analyzing the economic problems of the communist countries, using concepts close to those used by economists in capitalist economies.¹² For the Chinese, they opted for a gradual approach to market reform...a point I will get to later.

Meanwhile, in the late 1980s, the consensus in Russia regarding the promise of market reforms grew stronger as the Soviet system entered perestroika, while many considered the gains from Chinese economic reforms to be exhausted. According to Nolan, the perceived failure in Russia of the Chinese reforms led to a consensus being led up about the desirable path for post-communist system reform happened around 1988 and 1991. In these years the communist system was in its death-throes in the USSR. Moreover, China appeared to be in the deepest political economic crisis in 1989 with the Tiananmen massacre while in 1989 communism was overthrown in Eastern Europe.

Search for Economic Models

These events, including the upheavals both in China and Eastern Europe, were major factors leading to a massive consensus built up in Russia among both external and internal critics of the communist system that propounded simultaneous revolutionary change in both the economic and the political and the political sphere, which called on a desirable outcome to the transition from communism. As Nolan notes, “The first was the confidence gained from advice given by the Bretton Woods institutions to the developing countries in the 1970s and 1980s. The policy package proposed for the former Stalinist economies by the most influential foreign advisors was similar to that proposed for stabilization and structural reform packages in poor countries in the 1970s and 1980s.”¹³ Writing in 1991 when the transition was being instituted in Russia, Blanchard et al. seemed very confident about the merits of imported “stabilization packages” for Russia’s economic woes: ‘How much of what we have learned is relevant to Eastern Europe? Clearly the issue is not to repair the damage to an existing market but instead to jump-

¹¹ Nolan, Peter. 1995. *China’s Rise, Russia’s Fall: Politics, Economics and Planning in the Transition from Stalinism*. London: Palgrave Macmillan. 31.

¹² *Ibid.*

¹³ *Ibid.*, 6.

start one. Aren't the initial conditions so different as to require a drastically different approach? We do not think so. Most of the standard stabilization package applies to Eastern Europe as well'.¹⁴

Another major influence in Russia's economic transformation is the way in which the "limited evidence from 'market socialist' experiments was interpreted." Namely, there were very few examples of market socialism. Often discussed was that of Hungary, a case that was at the time convincingly explored by Janos Kornai, whose research seemed to demonstrate that a 'half-way house' solution to the problems of the command economy by combining the plan and the market was doomed to fail: "In Hungary, and also in a number of the other socialist countries, the principle of market socialism' has become a guiding idea of the reform process. According to the author, under this principle, state firms should remain in state ownership, but by creating appropriate conditions, these firms should be made to act as if they were a part of a market. Namely, the author notes in regarding the failure of market socialism, "I wish to use strong words here, without any adornment: the basic idea of market socialism simply fizzled out. Yugoslavia, Hungary, China and the Soviet Union and Poland bear witness to its fiasco."¹⁵

In a similar vein, Prybyla writes pessimistically the following about China's transition experience: "The road to a free economy (New York: Norton). "The sad chronicle of China's post-Mao attempt to introduce a modern economic system contains a useful lesson which others, notably the East Europeans are taking to heart. The lesson is that to address the economic problem in a modern way in the context of a low caliber, inefficient, slothful, wasteful, cronified socialist system, one must go all the way to the market system, do it quickly, and not stop anywhere on the way. To go part of the way slowly, 'crossing the river while groping for the stones' as the Dengist put it, is to end up the creek to nowhere."¹⁶

¹⁴ O.R. Blanchard, P. Krugman, R. Layard and L. Summers, *Reform in Eastern Europe* (Cambridge, Mass.: MIT Press, 1991), 1.

¹⁵ Janos Kornai, *The Road to a Free Economy. Shifting from a Socialist System: The example of Hungary*. (New York: W.W. Norton, 1990), 27.

¹⁶ J. Prybyla, "A Broken System," in *Broken Mirror: China after Tiananmen*, ed. G. Hicks (London: Longman, 1990), 194.

According to Rakhimov Aziz, partly as a result of the pessimism about alternative economic models, different groups of economists prepared possible programs that were openly debated. Russia was taken by surprise by the ‘Chicago School’ program prepared by Yegor Gaidar. On January 2, 1992, Gaidar launched the shock therapy program to inject laissez-faire capitalism immediately into the Russian economy.¹⁷

In China, rather than following the advice of international organizations of shock-therapy reform, China promoted a gradual style of transition. According to Yang, Deng Xiao-peng stated that the criterion for judging reforms should go beyond “capitalism and socialism.” The author points out that issues like foreign investment or the market in general were dependent on whether these and other institutions or organizations are promote to the enhancement of national strength, the development of productive forces, and the improvement of people’s living standards. For Deng, socialism, like capitalism, can have both plan and market.”¹⁸ The gradualist notions were then called forth into significant factors related to the formulations of policies undertaken in Jiang’s leadership. This aspect is a significant from Russia’s strategy and according to Yang, the “gradual transition, the effectiveness of any individual institutional arrangement cannot be ascertained *a priori* because the function of an individual institutional arrangement depends on the function of other institutional arrangements in the institutional structure.”¹⁹

Without such a blueprint for reform, the state would continue to play an important role in the economy, market competition would provide the incentives for firms to improve their performance, and a well-functioning market mechanism would be indispensable to the development of the socialist economy. It is Jiang who declared in 1987 that “it is baseless and incorrect for some people to worry that a larger role for the market would mean going capitalist.” The thirteenth Party Congress, held in 1987, had called for China to build a “socialist planned commodity economy (shehui zhuyi jihua shangpin jingji)”Jiang now proposed the term “socialist market economy (shehui zhuyi

¹⁷ Rakhimov Aziz, “The Comparison of Russian and Chinese Economic Reforms in Transition to the Market Economy,” *International Christian University JDS Working Paper Series* No. 3, November 15, 2006): 2.

¹⁸ Yang, Dali L. 2004. *Remaking the Chinese Leviathan: Market Transition and the Politics of Governace in China*. Palo Alto, CA: Stanford University Press. 7.

¹⁹ Lin, Justin Yifu. 2004. “Lessons of China’s Transition from a Planned Economy to a Market Economy,” Leon Kozminski Academy of Entrepreneurship and Management and Tiger Distinguished Lectures Series 16 (Warsaw, 17, 2004.): 6.

hichang) at the Party Congress in October 1992. Yang notes that the detailed economic reform package Jiang outlined in 1992 “marked China’s move away from Haykian experimentalism to Polanyian programmic reform.”²⁰ The state was to be used as a vehicle to ‘vigorously nurture’ trade in products as well as stocks, bonds, technology, labor, infrastructure, including both hardware (telecommunications, computer networks, banks, transportation) and software (accounting, auditing, statistics, taxation), in order to ensure economic order. Rather than continuing to serve as administrative appendages of the government bureaucracy, state enterprises would become market oriented.”²¹

The orientation should be seen but as a legacy of its transition. Namely, as Lin et al point out China adopted a heavy-industry oriented development strategy “which is inconsistent with China’s comparative advantages at the time.”²² To implement this strategy and support the development of nonviable ‘strategic industries’, the government had to create a macro-policy environment that distorted the prices of products and production factors. Resources were allocated through a highly-centralized planning system. To get the control over the surplus generated during the economic development process, so that this surplus could be used to further the development of heavy industry, state owned industrial economy and agricultural collectivization were introduced. This constituted the micro-operational system in the traditional economic system. Although the three elements were coordinated, the defects of the traditional economic system were more evidently manifested in the micro-management system, especially in the lack of incentives and efficiency.

However, the later reforms attempted to improve the incentive mechanism to improve economic efficiency by decentralizing power and to give up part of the profits to microeconomic agent. Lin et al. have pointed out how this led to economic ‘vigour.’²³ That is, the creation of power for decision making at the micro-management level, along with the increase in retained profit and self-disposable product, required concomitant

²⁰ Yang, 7-8.

²¹ Ibid, 8.

²² Justin Lin Yifu, Fang Cai and Zhou Li, *The China Miracle: Development Strategy and Economic Reform*. (Hong Kong: Chinese University Press, 2003), 238.

²³ Lin et al, 238.

changes in the resource allocation system and the macro-policy environment. Though on the issue, Lin has cautioned that “the reform has not been thorough enough.”²⁴

In the next section, we will look at Russia’s divergent path in instituting market reforms. While bringing about results associated with the functioning of a market like privatization, the shock-therapy reforms created a massive re-alignment of business-state relations and significantly recast the vested interests on society. Through an analysis of the aftermath of shock-therapy, I will illuminate some of the causal factors involved in shock-therapy reform that created the landscape of competing interests based on a business-state realignment.

Russia’s Shock-Therapy

In the next section, I will look at Russia’s divergent path in instituting market reforms. While bringing about results associated with the functioning of a market like privatization, the shock-therapy reforms created a massive re-alignment of business-state relations and significantly recast the vested interests on society. Through an analysis of the aftermath of shock-therapy, I will illuminate some of the causal factors involved in shock-therapy reform that created the landscape of competing interests based on business-state realignment.

While the initial results of Russia’s shock therapy were debilitating economically, overall, Russia’s government has accumulatively privatized more than 140,000 enterprises since 1992. Although the Russian government is still a shareholder with at least 25 percent stake in about 25,400 joint-stock companies and approximately 14,000 unitary state enterprises (in which the government is the sole shareholder) also remain, there is little doubt that since the formation of the Russian Federation in the early 1990s, private businesses have become increasingly important in the Russian economy. Indeed, official statistics indicate that the private sector accounts for at least 70 percent of Russia’s gross domestic product.²⁵

²⁴ Ibid, 238.

²⁵ Harry G. Broadman, “Global Economic Integration: Prospects for WTO Accession and Continued Russian Reforms,” *The Washington Quarterly* 27 (2004): 84.

Under the Mass Privatization Program (MPP) in the early 1990s, 70 percent of the 76,000 enterprises privatized transferred majority ownership to existing managers, employees, and other insiders. Even the MPP's framers among other, have acknowledged that, despite nascent institutional reforms – for example, in the areas of corporate governance, competition policy, accounting, and capital markets – the program's implementation was quick. Supporters of this strategy thought that rapid and large-scale privatization was necessary in the face of small prospective political window of opportunity to facilitate and lock in Russia's transition.²⁶

While the transition processes have made significant headway especially in terms of privatization, which were an attempt to delink the state's influence on the firms, the persistence of subsidies remain a key feature of its economy. Broadman points out that subsidies had bad effects on competition, which can be seen initially through national regional budgets, then from the incapacity to collect of taxes and other revenue, and at present through charging below market prices to firms for energy and other infrastructure services. Moreover, invisible barriers provide protection at the regional level and support for local champions. Thus, "local business often 'capture' regional governments and are major violators of antimonopoly laws."²⁷

In Broadman's analysis he points out that through its economic governance encountered throughout its reform and transition process, the government confronts several vested interests – and in Russia, these interests are deeply held within particular industries. The author notes, "a web of informal relations have strong vested interests still govern Russia, and the boundaries between the affairs of state and those of business are now sharply drawn nor fully obeyed." According to the author, government-state relationships are governed by 'line agencies' and powerful business groups, which include the automobile, agriculture, aluminum, banking, insurance, telecom and civil aircraft sectors. Because of these circumstances the author argues that "it us thus an exceptionally difficult challenge for Russia precisely because there is no single person or body representing the interests of the country's business as a whole."²⁸

²⁶ Ibid., 83.

²⁷ Ibid., 86.

²⁸ Ibid., 92.

I argue that because of the transition process, the vested interests are being recalibrated, which creates new rules to the game and new opportunities for the government to promote key relationships with the vested interests. When doing so, that is, taking an active role in its economic governance, the states are also confronted with the economic pressures from global economic integration while pursuing its strategic objectives and the management of domestic issues. It could be said that Russia's international outlook is based on its past ill experiences begotten because of isolation. According to Nolan, although originally propounded by radical reformers, Russia's focus outward came suddenly. "The need rapidly to liberalize international economic relations and achieve close integration with the world economy was accepted by the 'radical' reformers within the reforming countries. The Russian Stalin economy suffered from isolation from the world economy straight to the proposition that free trade was the best way to the world economy:"²⁹ Writing in 1992, Yavlinsky expresses the true sense of urgency of many Russians to become integrated into the world economy: "Attempts to build a system screened from the outside world have resulted in the degradation and stagnation of most of our industries. Opening up the domestic market will force our entrepreneurs to compete with the cheap imported goods. This will make our economy dynamic and flexible in catering to the market and through the market to the consumer."³⁰

In addition, the exuberance for a sudden transition was augmented by the belief that gradualism would not work. Writing in 1990 Lipton and Sachs express the sense of pessimism saying that "it was politically most feasible to introduce a comprehensive package of changes, lest opposition build up in response to unpleasant piecemeal changes, and cause a reversal for the reform process". For the anti-gradualist school, they believed that governments like Russia, which was facing economic collapse, carrying out strong measures at the beginning of their tenure would be more effective: "If you are going to chop off a cat's tail, do it in one stroke, not bit by bit."³¹

²⁹ Nolan, 77.

³⁰ G., B. Yavlinsky, Fedoro, S. Shatalin, N. Petrakov, and S. Alekashenko. *500 Days of Transition to Market* (New York: St. Martin's Press, 1991), 219.

³¹ D. Lipton and J. Sachs, "Creating a Market Economy in Eastern Europe: The Case of Poland," in *Brookings Papers on Economic Activity Vol. 1*, ed. Kennett and Liebermann, reprinted from *The Road to Capitalism* (Orlando, Florida: Dryden Press, 1992): 350.

Hence, considerations like privatization, becoming a member of the world economy and the perceived societal problems that may arise if the transition process was drawn out, Russia took a “shock-therapy” route to reform, a process which we will show had significant repercussions on not only its economy but also its style and capabilities in economic governance. As we will show, the Russian state’s unique positioning in light of these circumstances creates a dynamic relationship between the federal government, vested interests, and new challenges from globalizing forces like the WTO. According to Aziz, In the course of the privatization of monopolies in Russia,

“... proved to be very complex to avoid corruption and appearance of other problems. The enormous rent incomes, which appear with the privatization, contribute so that the owners prefer to obtain control over the privatized enterprises, but not to invest in creation of its own firms. On the contrary, the policy of assistance to competition frequently decreases the rent incomes and strengths stimuli for the creation of wealth. Important significance has also the priority of conducting privatization and measures for regulation. The privatization of monopoly can create the strong root interests, which will weaken possibilities of regulation or competition in the future.”³²

Aziz seems optimistic in the government capacity to influence rent incomes, the author sees potential negative effects of privatization is not administered in a manner that enhances competition, especially in light of Russia’s monopolies. This research would like to shed light on the extent that Russia’s government can govern the economy – whether the policy choice is toward privatization or federal control – in a way that allows it to capture economic growth. This process may significantly alter the relationship between enterprises and state and ownership in Russia. The main question, then, is how can Russia do to promote growth and stability in the long run?

Russia’s transition from central planning was bound to be more difficult and longer than that of the Central and East European states. The communist system was much more entrenched in the Soviet Union than it was in the rest of the Soviet Bloc. Furthermore, Russia does not have a legacy of a market economy to draw on as is the case with some of the Central and East European countries. Russia has had to deal with the legacy of a Soviet economy that was administered to meet the needs of the military

³² Aziz, 21.

while civilian production and investment were given low priority.”³³ However, Russia’s failures included loose monetary and fiscal policies early in the transition period. They have also included structural problems such as poorly developed and executed privatization programs that have left many potentially productive assets in the control of enterprise managers from the Soviet period or in the hands of a few politically-connected individuals (‘oligarchs’) who extracted value from many of these assets rather than making them commercial viable for the long run. In addition, an inefficient banking system, the lack of private land ownership protection, the absence of adequate commercial laws, and an inefficient and corrupt government bureaucracy have inhibited economic growth and development.³⁴ According to Biryukov and Sergeyev, “The spectacular change in the conditions and span of vertical social mobility characteristic of a revolution paved the way to positions of power for people with the mentality of marginal outsiders, politicians who not only lacked a definite and stable social basis but demonstrated a tendency to break away from whatever links that connected them to their society.”³⁵ According to Cooper’s estimate, the level of Russian GDP in 2000 was still 21% below its level of 1992.³⁶

Transitioning toward the WTO

This section provides a historical account of Russia’s transition into the WTO. On taking office in 1985 Mikhail Gorbachev faced one problem more daunting than all others combined. The Soviet economy had been in a period of stagnation for two decades and was in desperate need of reform. Gorbachev chose to adjust the old system with a period of perestroika or restructuring in the hope of making it more efficient. Namely, by the time that the Gorbachev period ended, the USSR had applied to join the GATT and Russia “had greatly softened its formerly hostile attitude toward the IMF and the World Bank”³⁷ Russia’s relationship with the main international institutions had changed to the degree that the IMF, the World Bank, the OECD were able to jointly ‘undertake a

³³ William H. Cooper, “Russia’s Accession to the WTO,” *CRS Report for Congress* (April 20 2006): 7.

³⁴ *Ibid.*, 7.

³⁵ Nikolai Biryukov and Victor Sergeyev, *Russian Politics in Transition: Institutional Conflict in a Nascent Democracy* (Brookfield, VT: Dartmouth Publishers, 1997), 53.

³⁶ Cooper, 5.

³⁷ *Ibid.*, 2.

detailed study of the Soviet economy, make recommendations for its reform, and establish the criteria under which Western economic assistance could effectively support such reforms.’³⁸ Cooper also points out that there was an understanding among policy makers in the United States, the EU and other trading partners that Russia’s WTO accession would increase stability of Russia’s foreign trade and investment regime.³⁹

As a result of Gorbachev’s shock therapy reforms the state monopoly on foreign trade was eliminated and the ban on foreign investment in the Russian economy was removed. These reforms constituted two of the most important pillars of the Soviet economy. The financial reforms quickly escalated further when in October of 1992, multiple exchange rates were eliminated and the Russian ruble was made convertible into foreign currencies. Moreover, the government instituted a dual exchange rate, which was introduced in January 1999 as a result of the August 1998 financial crisis but was eliminated in June 1999. Previously, in the early to mid-1990s, the Central Bank pegged exchange rates in an attempt to control ruble depreciation. Since the August 1998 crisis, the ruble has been allowed to float but the Central Bank of Russia intervenes by buying or selling rubles. The ruble has remained relatively stable since 1999.⁴⁰

The reforms left Russia with many financial challenges espousing from its liberalization and concomitant economic integration. These forces further propelled the impetus to join the WTO, leading to WTO working party, append. In Putin’s 2002 address to Duma, the Russian president emphasized the need for the Russian government to establish the conditions to improve the economic well-being of the Russian people and linked that effort with joining the WTO:

“Tight competition is a norm in the international community and in the modern world, competition for markets, investments, economic and political influence. Russia must be strong and competitive in this fight. The world market is already here and our market has become part of the system... The WTO is an instrument. He who knows how to use it grows stronger; he who prefers to sit behind the fence of protectionist quotas, and duties – he is doomed, absolutely doomed strategically.

³⁸ IMF, World Bank, OECD and EBRD. *The Economy of the USSR: Summary and Recommendations*. (Washington, DC: World Bank, 1990), 1.

³⁹ Cooper, 2-3.

⁴⁰ Ibid, 8-9.

Our country is still excluded from the process of making world trade rules. We are already in the world trade but we have no say in shaping the rules of trade. This trend to stunt the Russian economy and make it less competitive.”⁴¹

With the creation of the WTO working party In determining the terms and conditions for Russia’s accession to the WTO, the members of the party members put Russia’s trade and investment regimes policies under a microscope to find out the extent that Russia would be able to follow the WTO rules and the areas where Russia needs to change. The negotiations, points that will be elaborated on later, were filled with contentious issues as Russia and other foreign countries on the working group tried to hammer out bilateral agreements and conditions for Russia to abide by if it were to join the WTO. According to Chowhury:

“Russia has also initiated a series of bilateral negotiations with all the interested members of the WP on the terms and conditions of Russia’s membership WTO. The negotiations are in the areas of agriculture, the customs regulations (and customs union and other trade arrangements with CIS States), excise taxation and national treatment, import licensing, industrial subsidies, national treatment, Agreement on Technical Barriers to Trade (TBT), Trade Related Intellectual Property Rights (TRIPS) and services...the most controversial issues sill lie ahead, e.g. agricultural subsidies.”⁴²

Judging by the comprehensiveness of the reforms and the bilateral relationship Russia had within the foreign countries of the working party, a lot of pressure was put on Russia to not only reform quickly but also on countless levels by foreign countries and also the domestic pro-Gorbechev reformers. Veruciel has highlighted this rush to hasty policy making by saying that “After the initial opening up of Russia’s economy, a complex, incoherent, and inefficient customs system was set up, undermined by corruption.”⁴³ At the same time, economic institutions are making real differences, as the next section will highlight.

⁴¹ Vladimir Putin, “Annual Address by Presieent of the Russian Federation Vladimir Putin to the Federal Assembly of the Russian Federation Moscow,” (April 18 2002.): [<http://www.Russiaeurope.mid.ru>].

⁴² A.R. Chowhury, “WTO Accession: What’s in it for Russia?” *Bofit Online* (2003): 3.

⁴³ Julien Veruciel, “Russia and the WTO: On the Finishing Stretch,” *Russie Nei Vision* 10 (February 2007): 12.

Gradualism in China

Harnessing the Levers of Control

Whereas compared to Russia, where the shock therapy transition shook up the vested interests in the country, China did not reject socialism. Namely, its gradual strategy allowed it to maintain control while introducing market reforms. In contrast to shock therapy, China's gradualist approach provided the government to harness the levers of control, which was adapted to the present context of the radical changes that were the result of the reform. Shlapentokh notes that "China wisely did not discard Maoism completely, but merely reinvented it. Official policy says that of course Mao made 'mistakes,' but he was a great leader with a generally sound policy."⁴⁴ The author sees China's economic success is "owing to its strong and, if needed, brutal state." This constituted an authoritarian government that had the capability of having control or being "brutal". Shlapentokh notes, "it is clear that China's economic success is not in spite of a strong state, but because of it."⁴⁵

China's pre-reform economic system had three integrating components: (1) a distorted macro-policy environment which featured artificially depressed interest rates, over-valued exchange rates, low minimal wage rates as well as low price levels of living necessities and raw materials; (2) a planned wage allocation for credit, foreign exchange, and other materials; and (3) a traditional micro-management system of State-owned enterprises and collective agriculture."⁴⁶

It is within this environment that the Chinese government began to institute economic reforms. According to Lin et al, the economic reforms that have taken place in China since 1979 have been extremely successful. China's national economy has grown rapidly as a result of the reforms, and its people's living standards have improved steadily. As the world's most populous country, the main cause of China's slow development in the pre-reform days was the result of the government's adoption of a development strategy that emphasized heavy industry – a strategy that was inconsistent with China's comparative advantages. The reform, however, reformed the traditional economic system – namely, the macro-policy environment with distorted factors and product prices, a

⁴⁴ Shlapentokh, 248.

⁴⁵ Ibid., 250.

⁴⁶ Lin, 7.

highly centralized planned resource-allocation system, and a micro-management mechanism without decision-making power in enterprises. From a comparative perspective, these developments allowed China to avoid many of the pitfalls that were experienced in South American countries and Asian countries such as India and Philippines, which suffered because of their inefficient economic system on the market mechanism to exploit comparative advantages, while those that relied on the market mechanism to exploit their comparative advantages created efficient economic systems and achieved rapid economic growth.⁴⁷

Some scholars and economists attribute success of the Chinese economy to their unique initial conditions, namely, a large agricultural labor force, low subsidies to population, a rather decentralized economic system, and, a large amount of riche overseas Chinese. However, other scholars and economists have suggested that China's success poses a true challenge to the suggestions of the Washington Consensus -- considers stabilization, market liberalization, and privatization as necessary components to a successful transition, and the Chinese experience demonstrates the superiority of evolutionary, experimental, and bottom-up reforms over the comprehensive top-down big bang approach.⁴⁸

In implementation, China adopted an alternative gradual, evolutionary approach to the transition since the reform started at the end of 1978. This approach has often been said to be "piecemeal, partial, incremental, often experiment, and especially without large-scale privatization."⁴⁹ The gradual approach has given the government to take measures increases the granting of partial managerial autonomy and profit sharing, as well promote micro incentives. These mechanisms allow the economy to move close to the production frontier. The means by which it does so is through its activity in economic governance – a point to be touched on later.

Moreover, China has been able to attract a lot of foreign direct investment. A vital cause of this success is the successful implementation of gradual reforms and a successful strategy of economic governance vis-à-vis a divestiture in the central state's economic and political role (but not completely) and the creation of useful linkages between

⁴⁷ Lin et al, 342.

⁴⁸ Lin, 6.

⁴⁹ Ibid, 5.

enterprises and the state, allowing the state to promote a comparative advantage defying strategy as individual firms are made more competitive, while the state vis-à-vis the state apparatus retains the sinews of control.

Although the Chinese government has worked hard to counteract many of the displaced members of society that are created because of the reforms, they will nonetheless occur. For instance, one study, for example, predicts that the opening in agriculture alone will result in the loss of jobs of about 8 million wheat farmers, about 30 percent of the number engaged in wheat production. Substantial reductions in employment and output are also forecast for a number of other products, including rapeseed oil, natural rubber, plastics, and rolled steel.⁵⁰ Lardy, notes however, that many projections “Certainly overstate the challenges that China faced when it finally entered the WTO. Namely the author notes the following:

The reason is simple. The projections are based on conditions that existed in the mid-1990s and thus do not take into account the huge economic restructuring that occurred in China in the years immediately before its entry into the World Trade Organization. On the external side China began significant tariff reductions in the early 1990s. By the eve of its entry into the WTO the average statutory import duty rate was only 15 percent, two-thirds less than the peak level of the peak level of the mid 1980s. More important, by the second half of the 1990s actual import duties were only a small fraction of the average statutory rate.”⁵¹

One should not forget, however, because of economic restructuring saw significant segments parts of the society affected by the policies. For example, the spinning and weaving industry, employing 7.6 million workers in 1991, saw its 1996 employment shrink to 6.34 million and this losses growing to RMB 9.6 billion, and in response to the radical changes instituted by Zhu Rongji, more than 600 state-owned textile factors one-fifth of the 1.4 million workers total, eliminated 9.4 million cotton spindles, and laid off an additional 1.4 million workers by the end of 2000.⁵²

Moreover, as pointed out by Wolf, Jiang’s articulation of the ‘Three Represents’ concept in 2001 – which made capitalist entrepreneurs eligible for party membership –

⁵⁰ Shuguang Zhang, Zhang Yansheng, and Wan Zhongxin, *Measuring the Cost of Protection in China*. Washington (Washington D.C.: Institute for International Economics, 1998), 29.

⁵¹ Nicholas Lardy, *Integrating China into the Global Economy* (Harrisonburg, Virginia: Brookings Institution), 22.

⁵² “State Textiles out of Doldrums,” Xinghua, March 6, 2006.

engendered the legitimation of new entrepreneurial competing interests. As a result, “the new debate currently underway in party circles concerning the building of a ‘harmonious society’ is partly intended to bring liberals and conservatives together by focusing on a moderate reform agenda.”⁵³ Moderate or not, China continues to be enmeshed in new and emerging competing interests and as it attempts to satisfy the needs of promoting stability and as a member of the WTO, redoubling the importance of economic governance.

Comparative Advantage Defying Strategy

Justin Lin Yifu reports the following: “that the economic institutions of the plan economy are endogenously shaped by the adoption of a comparative advantage-defying heavy-industry-oriented development strategy in a capital scare economy (hereafter CAD strategy). This strategy makes enterprises in the priority sectors of CAD strategy nonviable in an open, competitive market. Many institutional distortions in the plan economy are required for protecting and subsidizing the nonviable enterprises in CAD strategy...The gradual approach in China achieves dynamic growth because this approach continues to provide protections and subsidies to the nonviable enterprises meanwhile allowing enterprises to enter into the previously suppressed sectors, which are consistent with China’s comparative advantages.”⁵⁴

Whether Russia can undertake strategies such as CAD, where the state plays a central role in promoting priority sectors so that comparative advantage can be defied, is one of the central themes of this research in that I hope to illuminate ways in which the state can harness the changes occurring as a result of market reforms and globalization. For Russia, the immediate conclusion, as I will show, will be accession into the WTO. But before I describe the changes in the landscape of new relationships between the state and the economy – constituting economic governance – I try to describe China and Russia’s complexion of economic governance following the transition process. No doubt, for both countries, the quest to become a member of the WTO has significantly altered this complexion.

⁵³ Charles Wolf Jr., “Paradoxes: Liberals...Conservative...Go Figure,” *Rand Corporation*. (2007).

⁵⁴ Lin, 7.

Conclusion

In both China and Russia, due to unique political and economic circumstances resulting from the transition (what I'm exploring) the central government in China and federal government in Russia is entrenched in relationships with enterprises through ownership and other connections. The divestiture of the state's assets through the shock therapy reforms in Russia verses that in China created a significantly different context for the government to influencing its economy through exerting state power on the enterprises. For Russia, much of the power is exerted from Putin against the competing demands of the society, including the oligarchs as well as external pressures like the WTO in a way that seems to fracture society, in is a reality that Russia must deal with. The reality should be seen as a product of the transition and divestiture of ownership. For China, the divestiture of political and economic power through the gradual transition has allowed the government to still take control of its economy because of the persistence of hierarchical linkages between the state apparatus and various SOES and other entities.

Since power is vested in the government in the first place because of the Soviet legacies of central control, the state's economic governance ability becomes a product of the transition, and its ability to control or influence enterprises and other economic actors is affected by domestic and international interests. These interests hinge on whether the state can promote economic growth and stability. This is a unique aspect regarding the transitional countries of China and Russia. But uniqueness of the countries' transition processes are put into sharp contrast when we consider how in a gradual transition, the impact of any individual institutional arrangement cannot be ascertained *a priori* because the function of an individual institutional arrangement depends on the function of other institutional arrangements in the institutional structure. This adaptive feature unique to China's strategy creates a major challenge for us to apply the China model on Russia and dramatically changes not only the institutional landscape of economic actors and business state relations but also the rules of the game. The gradual approach has given the government to take measures increases the granting of partial managerial autonomy and profit sharing, as well promote micro incentives. Moreover, the CAD strategy helps protect nonviable in an open, competitive market. Many institutional distortions in the plan economy are required for protecting and subsidizing the nonviable enterprises in

CAD strategy...The gradual approach in China achieves dynamic growth because this approach continues to provide protections and subsidies to the nonviable enterprises meanwhile allowing enterprises to enter into the previously

These mechanisms allow the economy to move close to the production frontier. Although Russia and China diverge significantly, their distinctive development does not preclude the possibility that the latter might be able to learn much from the former. Taking an active role in its economic governance allows China, for better or for worse, to also take an active role in dealing with internal and external economic pressures from global economic integration, while pursuing its strategic objectives and the management of domestic issues. If such were the case what is how capable is Russia to mimic China's strategy in the context of Russia's current economic capabilities and institutional capacities bequeathed by its shock therapy reforms? This is a central question of this research.