ECONOMIC TRANSFORMATION IN RUSSIA AND CHINA: A COMPARATIVE STUDY (1985-2000)

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MASTER OF PHILOSOPHY

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DECLARATION

I declare that the dissertation entitled **"Economic Transformation in Russia and China: A Comparative Study (1985-2000)"** submitted by me for the reward of the degree of **Master of Philosophy** of Jawaharlal Nehru University is my own work. The dissertation has not been submitted for any other degree of this University or any other University.

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CERTIFICATE

We recommend that this dissertation be placed before the examiners for evaluation.

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Dedicated to my parents

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PREFACE

Economic reforms carried out in Russia and China provide a unique setting for comparing two paths of transformation of a communist economic system into a market economy. In both cases, the transition followed years of increasingly unsuccessful economic performance. Yet, the transition itself was very different in the two settings. In the case of China, economic growth has from the start exceeded most expectations. In the case of Russia there was a precipitous and unexpected economic decline in the first three to eight years, with notable growth thereafter. While China adopted a gradual approach and appears to have benefited from sensible policies and relative absence of adverse shocks, the Russian policymakers underestimated economic problems associated with a rapid transformation and made a number of questionable choices in the first few years of the transition.

The research schema is as follows. It is divided into five substantive chapters. Chapter one introduces the topic by giving a brief background of the economic transformation carried out by Russia and China, different policies adopted by both the countries and their outcomes. The chapter also deals with the existing literature and the research design. Chapter two begins by tracing the economic reforms followed by Gorbachev and Yeltsin. It analyses the economic reforms in various sectors and critically evaluates their outcome.

Chapter three covers the economic reforms initiated by Deng Xiaoping in China. It deals with the reforms carried out in different sectors of economy and analyses their successful outcome. Chapter four presents a comparison of the economic reforms in Russia and China. It also discusses the initial condition, shock therapy vs gradual reforms, differences in the strategy adopted by both the countries and the sequencing of reforms. The outcomes of the economic reforms in the different economic sectors are also dealt with. It also elaborates on the success and failure of the reforms as well as compares the similarities and differences between the two countries. Chapter five is the concluding one that sums up the whole research and examines to what extent the hypothesis is proved.

ABBREVIATIONS

CDSP	Current Digest of Post-Soviet Press
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
COMECON	Council for Mutual Economic Assistance
CPC	Communist Party of China
CPSU	Communist Party of the Soviet Union
CRS	Contract Responsibility System
EBRD	European Bank for Reconstruction & Development
FDI	Foreign Direct Investment
FIE	Foreign Invested Enterprises
G7	Group of Seven
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GKI	State Property Committee
GKO	Short Government Bonds
HRS	Rural Household Responsibility System
IFI	International Financial Institutions
IMF	International Monetary Fund
NEP	New Economic Policy
OECD	Organization for Economic Cooperation & Development
RF	Russian Federation
RFSR	Russian Soviet Federative Socialist Republic
RMB	Renminbi
RTS	Russian Trading System
SETC	China's State Economic & Trade Commission
SOE	State Owned Enterprises
TVE	Township & Village Enterprises
UN	United Nations
UNDP	United Nation Development Programme
WTO	World Trade Organization

Chapter 1

Introduction

Chapter 1

INTRODUCTION

"Economic transformation of Russia and China is one of the most important experiments in economics ever to have occurred, a massive and relatively sudden change in the rules of the game." (Joseph E. Stiglitz 1999)

Russia and China have undergone economic transition with positive as well as negative outcomes. Both the countries had specific historical, economic and political conditions and the reform leaders in the respective countries used varied policy mechanisms to bring about the market reforms. It is imperative at this stage to demonstrate that there is a great deal to learn from the countries' comparative experiences in both policy and implementation approaches.

The reform of a communist economy involves shifting away from central planning towards a market-based resource allocation. It also entails moving towards private ownership thereby linking material reward to economic performance and reforming management incentives within systems that maintain extensive social ownership. Reform may incorporate political transition to pluralism but not necessarily (Alan Gelb, *et al.* 1993:1).

The transition of countries from socialism to capitalism differs according to when the change begins, which block it begins in, and what reciprocal effects the changes have brought about[1]. Transformation towards capitalism includes providing constitutional safeguards for private property, officially encouraging free enterprise, legalizing advocacy of pro-capitalist ideologies etc. For the firm consolidation and smooth operation of capitalism, it is essential to have a legal infrastructure that protects private property and puts in force private contracts and financial discipline[2] (Janos Kornai 2000:31).

[1] In discussing this change, it is important to distinguish between systemic and non-systemic change. For example, devaluation of the currency is not a systemic change; the introduction of currency convertibility is a systemic change in the amount of market coordination allowed (Janos Kornai 2000).

[2] The spontaneous development of capitalism speeds up significantly if the state is an active assistant (Janos Kornai 2000).

Map-I: Russia, Eurasia and China

Source: http://encarta.msn.com/map_701516125/Russia.html.

Economic Transformation in Russia and China

Russia and China have progressively moved away from a centrally planned economy to a market[3] based one and from a relatively closed system to one that is increasingly integrated into the world economy. Russia followed the 'transition orthodoxy' of revolutionary political change under Gorbachev, followed by "Shock Therapy" dominated by rapid privatization under Yeltsin and his foreign advisers. China's approach to economic reform was gradual and evolutionary, under an authoritarian political system in conditions of stability (Sadrel REZA 2007).

[3] Market economy implies a self-regulating system of markets; in slightly more technical terms, it is an economy directed by market prices. (Karl Polyani 1944).

Russia started with radical approach and went for mass privatization. The so called 'Washington Consensus', which was based on stabilization-cum-adjustment policies and recommended by the Bretton Woods institutions, was the guiding economic thought and action in Russia. Russia's capacity for reforms was limited by the lack of institutions that can design and carry out market oriented policies. Its capitalism was dominated by 'oligarchs' and it underwent sharp declines and high unemployment which aggravated abject poverty (ibid: 287).

China adopted a 'Gradualist' approach to privatization. It developed transitional institutions. China followed a so called Dual-Track strategy where both market forces and planning disciplines could simultaneously operate. It achieved spectacular economic growth accompanied by low inflation and low state budget deficits. It contributed to remarkable GDP growth sometimes referred to as the 'Chinese Puzzle'. On the other hand, GDP growth turned negative in Russia, inflation blew up in the early 1990s and its budget deficit widened (Sadrel REZA 2007).

China's privatization process had also been marked by some setbacks like local corruption and insider deals. Towards the other end, Russia also achieved some degree of progress by the end of 1997, when inflation was brought under control, the currency stabilized, FDI increased and thousands of enterprises were transferred to private ownership (ibid).

One line of reasoning for such varied outcome of reforms runs in terms of the "Initial Objective Conditions". It has been argued that China's economic structure proved felicitous to reform. China was dominated by the rural and agricultural sector at the beginning of its reform process. In contrast, Russia's heavy industrial base was more rigid and ill-adapted to adjust to change. Second, the economic system was much more hierarchical, centralized and command-oriented in Russia. However, in China the devolution of power was qualitatively different and significantly more pervasive in terms of decision-making autonomy, thus encouraging local initiatives. Third, relates to the nature and importance of pre-reform external ties, e.g. CMEA's (Council for Mutual Economic Assistance) decline which seriously affected Russia. Finally, there were differences in the cultural and political realms. Greater homogeneity in China helped maintain social stability but serious divisive forces in Russia caused political turmoil and declining economy (ibid: 281-282).

Another line of reasoning for such diverse outcomes between Russia and China were the major "Differences in the Design and Sequencing of Policy Reforms". The Chinese policy of 'gradualism' is often contrasted with the 'rapid privatization' of Russia. Russia attempted 'Shock Therapy' to introduce wide-ranging reforms within short period. These measures included, besides State Owned Enterprises reforms and privatization, complete price liberalization, unified and convertible foreign exchange, financial stabilization measures and partial liberalization of foreign trade (Sadrel REZA 2007).

Transitional Economies

The process of transition begins when society shifts away from the fundamental characteristics of the socialist system and ends when society reaches the characteristic of the capitalist system. Moreover, the new state of affairs has to strike roots and become irreversible (Janos Kornai, 2000:30).

The significant characteristic of the transition countries is their decision to abandon central planning[4] as the principal mode of organizing their economies and to move to market-oriented economies with significant private ownership of the means of production. The two dimensions of the transition economies are the structural and institutional reforms implemented by the respective governments and the resulting changes in economic behavior and institutions (IMF 2000).

In most of these countries, the "transition" coincided with major political transformations, and some observers include the shift from a one party autocratic system to a multiparty democracy in their definition of "transition"[5]. In China however, the political system has not been modified significantly during the transition process (ibid).

[4] By definition, central planning implied massive direct government involvement in economic decision making. The only countries currently holding on to central planning and the predominant state ownership of means of production are North Korea and Cuba (IMF 2000).

[5] Whether countries can make a full transition to a market economy without a political transition to a representative democracy remains a bone of contention among social scientists (*Transition Report 1999,* Chapter 5, London: EBRD,1999).

According to the International Monetary Fund (IMF)[6] following are the important features of Transition Process:

Liberalization: the process of allowing most prices to be determined in free markets and lowering trade barriers that had shut off contact with the price structure of the world's market economies.

Macroeconomic stabilization: primarily the process through which inflation is brought under control and lowered over time, after the initial burst of high inflation that follows from liberalization and the release of pent-up demand. This process requires discipline over the government budget and the growth of money and credit (that is, discipline in fiscal and monetary policy) and progress toward sustainable balance of payments.

Restructuring and privatization: the processes of creating a viable financial sector and reforming the enterprises in these economies to render them capable of producing goods that could be sold in free markets and of transferring their ownership into private hands.

Legal and institutional reforms: These are needed to redefine the role of the state in these economies, establish the rule of law, and introduce appropriate competition policies.

The key economic objectives of the transition are to raise economic efficiency and promote growth. Despite the similarity of ultimate objectives and basic direction of requisite changes, countries' actual transition experience has differed extremely, with respect to both policies implemented and results achieved so far. The reasons behind the differences include the country's initial conditions, the external environment and the particular policies pursued during the transition (ibid).

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[6] *Transition Economies-An IMF Perspective on Progress and Prospects*, IMF, November 3, 2000.

Theory of Transition

The Theory of the Political Economy of Transition[7] integrates the political process into the analysis of economic problems. Political Economy issues are introduced and analyzed in all the areas of economics like trade, macroeconomic policy, regulation, public finances, financial economics, labour, and others. The tools of game theory[8] allow the research to integrate the analysis of economic and political processes (Gerard Roland 2001:3).

The literature on the Political Economy of Reforms can be divided into two broad categories, that is, normative and positive. The Normative Political Economy of Reforms focuses on the decision-making problem of reformers which are subject to political constraints. In this model the "agenda-setting hypothesis" is broadly used. According to this hypothesis, the executive branch of government has monopoly power over the design and sequencing of reform packages (ibid: 4).

In contrast, the Positive[9] Political Economy of Reforms attempts to analyze the clash of interest groups. The positive political economy of reform seeks to explain differences in the extent of rent-seeking and how special interests may effectively control the regulatory bodies. In the context of Russia, the oligarchs controlled the government decision-making to prevent reforms that would enhance security of property rights. This allowed them to convert corporate and social assets to their private use (ibid: 4; 11).

While discussing the Theory of Political Economy of Reform, the politics of the transition countries is also taken into cognizance. We observe that Russia opted for presidential regime with strong concentration of powers in the hands of the President. During the transition period Russia suffered political instability which interfered with its economic reforms.

[7] The Theory of Political Economy of Transition belongs to a more fundamental trend in economic research in recent years (Gerard Roland 2001).

[8] Game Theory captures the behaviour in strategic situations, where an individual's success in making choices depends on the choice of others. It is also applied in the field of political economy.

[9] In the transition context, the positive analysis of reforms has been somewhat less developed than the normative analysis.

Whereas in the context of China, the economic reforms have been initiated and implemented within the guided auspices of the CPC[10]. Since 1978, the CPC has realized the first transition, that is, from the rule by revolutionary method to the rule by administrative means and from a revolutionary party to a developmental party, a ruling party that makes economic development its main task (Angang Hu 2007).

The geopolitical factor also plays a major role in determining the Theory of Political Economy of Reform. The geopolitical impact of transition for Russia represented the loss of the Soviet empire and also of territories[11]. It also implied uncertainty for the millions of Russians living in the former Soviet republics and who became "immigrants" in former Soviet territories. The loss of superpower status could have been compensated for by the economic gains from transition. Unfortunately, such gains did not materialize for the majority of Russians. It is thus obvious that resistance to transition proved much harder in the former Soviet Union as it had to face greater difficulties (Gerard Roland 2001:15-16).

Political Economy can also be used to highlight the potential policy mistakes that involve sequencing of reforms. For example, a set of sequencing issues arose with regard to implementation of mass privatization in Russia. Mass privatization created a sudden and strong concentration of economic power among insider managers who gained economic control over enterprises. Moreover, there was lack of institution building in Russia before the reforms were executed. This led to corruption within the state, weak tax enforcement, weak law enforcement, and eventually culminated in economic inequality and political instability (ibid: 20).

Apart from the Theory of Political Economic Reform, Russia and China have taken steps and adopted their own unique mixture of theories and phase of change from a planned economy to a market system. Advocates of a "big bang" approach to transition argued for a fast and comprehensive implementation of all major reforms. They argued that governments should adopt reforms as fast as possible (David Lipton and Jeffrey Sachs 1990) and attempt to create irreversibility for these reforms (Maxim

[10] Communist Party of China.
[11] Like the Ukraine or the Baltic states that had belonged to Tsarist Russia.

Boycko, Andrei Shleifer and Robert Vishny 1993). Fast Privatizers argue that more comprehensive and rapid ownership reform is necessary to increase efficiency. Without the power of a substantial capitalist class, the reform process would be undermined and prematurely terminated by the interest groups representing the adversely affected segments of society. Reform must be radical and fast moving so as to deny such groups the opportunity to consolidate (Stanley Fischer and Alan Gleb 1990:23-24). The approaches adopted in countries such as Bulgaria, the Czech Republic, and Russia fit this model of economic reform (Doug Guthrie 2008:11).

On the other side, those who advocated "gradualist strategy" opposed the big bang approach and emphasized the need for a precise sequencing of reforms. An appropriate sequencing of reforms would provide demonstrated successes to build upon, thus creating constituencies for further reforms (John McMillan and Barry Naughton 1992; J.M. Litwack and Y.Qian 1999).

The Gradual school of researchers includes scholars like Barry Naughton, Thomas Rawski, Andrew Walder, and Jean Oi. The architects of the Chinese reforms have embraced the gradualist view, and it has led to a gradual and stable path through the economic reforms (Doug Guthrie 2008:11-12).

At the center of the tension between these two opposite schools of economic reform is the whole debate over the role of the state in the construction and maintenance of new markets and the extent to which economic processes are fundamentally political processes (ibid:12).

The Post-Structuralist view of transition recognizes that social formations are always in some kind of transition. According to this view all societies are in a state of transition and development. Transition or development does not follow any particular pattern, a linear path or is random. Transition is constituted by the interaction of myriad social and environmental processes producing a trajectory of change that is always partially seen and understood in social analysis. To gain that partial insight into transition requires narrowing down the focus to some aspects of the social formation (Satyananda J. Gabriel 2006).

The Neo-Liberal stream of thought also renders an insight into the theory of economic transformation. According to Robert Keohane and Joseph Nye (2000), globalization has produced a more complex system of interdependent states in which transnational rules and organizations have gained influence. Neo-liberals[12] believe that with radical economic globalization, a liberal global regime, which is above all nation-states, has been established. This global regime is based on a set of formal and informal institutions, rules, norms, and shared assumptions (Yongnian Zheng 2004:16).

Rationale and Hypotheses

The interpretation of transition and the criteria for determining it are not trivial issues and there is no consensus in this matter. There is a widely accepted view that regards the transition as unfinished as long as the composition of output and real fixed assets is distorted and has not yet adjusted to demand, or the standard of living has not caught up with that in traditional market economies and so on (Janos Kornai 2000:30-31).

The important question which looms over is: why were there such large differences in policy objectives and in countries' success or failure in translating the objectives into legislation and then implementing this legislation? (IMF 2000) As the reform process is linked to political factors and is economically complicated, and there exists substantial differences among the reforming countries, no single detailed road map can guide the way to the new systems (Stanley Fischer and Alan Gelb 1990:2).

The varied experiences of Russia and China going through the process of transition represents an important set of economic and social experiments ever conducted, and provides a rich opportunity to study and understand the process of reform and to gain insights into the workings of economies. The limited success in so many of the countries means that there remain many opportunities for applying the lessons of such studies. The disparity between the successes and failures between Russia and China is so large that interpretation and explanation is called for (Joseph E. Stiglitz 1999).

[12] For neo-liberals, the liberal international regime, manifested in the General Agreement on Tariffs and Trade (GATT) and now the WTO, becomes extremely important in shaping the role of individual nation-states in both domestic and international arenas (Yongnian Zheng 2004).

While comparing the economies of any two countries which have undergone transformation in their core monetary and fiscal policies, what needs to be seen are the innumerable factors and circumstances. When the economic transformation of Russia and China are compared, these factors and policies need to be perused in minute details. The case study of Russia and China are of utmost significance as they are mammoth economies which underwent metamorphic economic transformation from communist economies to market economies.

In today's fast changing economic scenario (economic downturn) where the formation of a new economic order is taking place at the behest of China, one cannot overlook the economic transformation undertaken by Deng Xiaoping. Russia's economic transformation needs to be studied in detail as it went for drastic monetary and fiscal policy changes right after Soviet Union disintegrated. Soviet Union played a crucial role during the cold war era as being the other prominent challenge to United States in the bi-polar world scenario.

A comparative analysis of the experiences in Russia and China provides a fascinating case study and a kind of natural experimentation for the issues under investigation. An attempt is made to explain the differential economic performance of the two economies with reference to initial conditions and policy dynamics during the 1985-2000 time period. The time frame from 1985 to 2000 spans a ten year period of economic scenario in Russia and China.

Russia and China have made significant progress in their reforms with both positive and negative results. A comparison of the economic transformation of Russia and China produces clear similarities and radical contrasts. The aim of transformation have been similar in both sets of cases: transformation of state- run economy into a market oriented one. The outcomes of the process have been vastly different- an 'economic miracle' on one hand, decline and collapse on the other. The incremental reforms of China have to be compared with the radical reforms adopted by Russia. Shock Therapy in Russia fuelled inflation, devastated the country's industries, led to plundering of national assets and left the population worse off. On the other hand, gradualism in China was accompanied by remarkable economic growth but its poor performance in regard to State Owned Enterprises reforms and privatization has remained a sore point (Sadrel REZA 2007).

While comparing economic transformation of Russia and China scholars have taken two opposite stands. Some have taken the stand of Initial approach and others have taken the Radical vs. Gradual reforms debate. What needs to be understood is that bifurcating one into two opposite camps renders a very biased opinion. Russia under the leadership of Yeltsin went for Shock Therapy reforms. The initial outcome of the radical reforms was dismal. Many scholars have blamed Yeltsin for his fast paced reforms, yet, what needs to be seen is whether he had other alternatives available to him. Moreover, the state regulation of reforms in China would be compared with Russia's 'no role for state' in economic reforms. The study would try to look into the whole picture and come to a balanced opinion.

The aim of this study is to understand the reasons why in Russia shock therapy was unsuccessful as compared to the gradualism theory applied in China. The study also will explain the factors behind the successful transition dynamics. This study will also highlight the role of liberalization, initial conditions, pace and speed of reforms, political factors conducive to private ownership, macroeconomic stabilization, privatization and institutional reform and microeconomic reform to an adequate degree and phase in both the countries.

None of the studies on transformation economies has taken an integrated approach in explaining the transition experience. In particular no systematic attempt has been made so far to look at the interaction of all factors including initial conditions, political change and reforms, in a unified framework comprising Russia and China (Martha de Melo, *et al.* 1997:4). The literature on post-communist economic transformation is huge, comprising thousands of academic articles, journals and books. Most studies focus on one or a few countries. But, systematic comparison of the two country's experience under reform is still limited.

There are several important conclusions which can be drawn from this study. The Russian experience demonstrates that macro-economic imbalances, collapse of trade with Eastern Bloc countries, pressure to service the foreign debt and production plunge in oil and gas in Russia were the major reasons behind its economic collapse. The Chinese experience shows that instead of pushing for the transition in a big-bang, top down, revolutionary fashion, which has come to be known as shock therapy, economic transition in China has proceeded in a step-by-step, evolutionary manner, building on a basis of trial and error pragmatism. The main purpose of this study is to consider two reform cases- Russia and China- both of which experienced successes, difficulties and failures in various degrees for various reasons.

We need to delve into the fact whether major institutional features or lack of them played an important role in privatization process in China and Russia. Private sector growth related to property rights and business related laws, industrial regulatory measures, the growth of capital markets and social safety net schemes need to be analyzed in depth.

The study would gauge into the necessity of standardization of market activities, removal of all barriers and blockades between regions and departments, and opposition of unfair competition, and most importantly the creation of an environment for equal competition in order to form a unified, open, competitive and orderly market. The research would explore whether Russia's failure to follow cross-regional competition generated by foreign firms and domestic non-state firms, led to its unsuccessful economic transformation.

This study would attempt to demonstrate whether an innovative and active use of the SEZ as a policy instrument in achieving an overall transition would have had far-reaching implications for economic liberalization and development of Russia. The study researches the implications of SEZs in the evolution of economic transition in China and attempts to generalize from the Chinese experience to policy lessons for economic transition, liberalization and development (Wei Ge 1999).

Existing Literature

Notwithstanding the plethora of scholarly publications on the subject of the transition period, there are no generally accepted criteria for determining its completion. The literature has proved virtually powerless to provide a theoretically grounded answer to such questions as: how should one make the transition from a planned to a market economy? (Becker and Becker 1997; Stiglitz 1996) There have been theories of transforming capitalist system into socialist system but no clear theory of transformation from socialism to capitalism exists.

The literature on transition emphasizes the importance of different factors in different country groups. Many observers have noted that the inherited economic conditions, natural resources, histories, and institutions of transition countries were very different in Russia and China. Drawing attention to these differences, they point out that the transition path of a given country will depend both on its initial conditions and on the economic policies it chooses to implement (Martha de Melo, *et al.* 1997).

The literature available on the topic is abundant. Most of the work done on transformational economy comprise various research studies in form of books, articles, reports and research papers conducted by various International Organizations like World Bank, IMF etc. The IMF policy paper (2000) highlights the reasons why results have varied widely between the different transition countries. It also reviews the main policy lessons that can be drawn from the experience to date and the policies required to move the transition process forward.

However, the literature falls short while dealing with systematic comparison of the two country's experience under reform. Keeping the afore mentioned broad themes in mind, the work of prominent authors would be surveyed, like Sergie Glazyev, Anders Aslund, Joseph Stiglitz, Jeffrey Sachs, Wing Thye Woo, Peter Nolan, Andrei Sheliefer, Barry Naughton, Gregory C. Chow, Jinglian Wu and others. A survey of literature brings forth various issues, internal and external, responsible for the success and failure of the economic transformation in Russia and China.

Anders Aslund and Jeffrey Sachs are the most influential figures in the 'transition orthodoxy', that is, the necessity of a liberal anti- communist revolution in order to allow real economic reform. They have argued for the 'initial condition' perspective, that is, Russia's pre-conditions for reforms greatly differed from those of China at any time. According to Anders Aslund (2002), post-communist governments have chosen very different economic policies, leading to different outcomes. The countries that have done the best are those who have pursued their reform agendas most consistently. He says that first of all, unlike China the Soviet Union suffered a multiple collapse, offering no room for a gradual approach like the one adopted in China (Janos Kornai 1992).

Jeffrey Sachs and Wing Thye Woo (1994) bring out the point that the main policy differences between China and Russia have been macroeconomic. China was more cautious than Russia in monetary policy. Chinese reforms have been successful because it has been gradualist and Russian reforms failed because it applied shock treatment. They also point out that China's economic structure also mattered in the successful implementation of reforms. The structural differences in the economies were enormous, as Chinese economy was still dominated by agriculture.

Aslund (1989) and Sachs and Woo (1994) argue that the differences in results between the two countries is explained not by differences in reform policies but, rather by the different starting points. It was neither gradualism nor experimentation, but rather China's economic structure that proved so felicitous to reform. China had the advantage of backwardness.

Andrei Shleifer (2005) describes the problems facing Russian reformers from the perspective of destroying old institutions and building new ones. The creation of institutions of democracy and a market economy is a political goal that is inseparable from the need to eliminate the mechanisms of communist control. Partial reforms are fraught with pitfalls. By destroying the traditional coordination mechanisms in the economy, without substituting true markets, partial reform contributed to the collapse of output.

Sergie Glazyev (1999) has objectively evaluated the qualitative characteristics of the social and economic policy carried out in Russia which led to its systematic collapse. The choice of strategy for transition to the market was made in favour of the concept of Shock Therapy imposed by certain circles from the west like IMF. This was a radical version of the extremely liberal approach to the economic policy known as the 'Washington Consensus'. The disregard for the structural specificity of the Russian economy, in hopes that the mechanisms of market self-organization would function automatically, provoked processes of economic disintegration and increase of chaos. Peter Nolan (2004) examines the two systems, that is, Russia and China on the eve of their respective system reforms in order to evaluate their respective possibilities for accelerated growth. He argues that despite the differences, both the systems possessed large possibilities for accelerated growth with the introduction of market forces in an incremental fashion, in a stable political environment with an effective state apparatus. These possibilities stemmed to a considerable degree from common features of the communist system. On the eve of reform, China did not on balance possess greater possibilities for improved system performances than did the USSR. He argues that the main explanation for the differences in outcome must, therefore be sought in the policies chosen, not in system differences. The Soviet disaster primarily stems from the wholehearted embrace of the 'transition orthodoxy', policies of political reform (*perestroika* and *glasnost*) and subsequent economic change (shock therapy) advocated by foreign advisers and commentators.

Joseph Stiglitz (1999) argues that the failures of the reforms in Russia were due to the misunderstanding of the very foundations of a market economy as well as a failure to grasp the fundamentals of reform processes. Policy advisers put forth policy prescriptions in the context of a particular society- a society with a particular history, with a certain level of social capital, with a particular set of political institutions, and with political processes affected by the existence of particular political forces. Washington Consensus doctrines of transition, failed in their understanding of the core elements of a market economy. The Chinese chose the path of incrementalism and non-ideological pragmatism to market economy. Stiglitz upholds the 'reform strategy perspective'. He criticized that Russia's plan for reform has been too centralized and was carried out in a top-down approach.

Gregory C. Chow, Barry Naughton and Jinglian Wu talk of Chinese economic transformation. Gregory C. Chow (2007) has talked about the transformation of China's economy into a market economy by taking into consideration the institutional changes, Chinese government and China's historical and cultural traditions. He has argued that China's historical and cultural tradition is an important determinant of the country's economic reform process and policies. Barry Naughton (1996) argues that

China's superior growth performance partially reflects the advantages China enjoyed from having started the reform process a full ten years earlier than the Russian reforms. Reforms have been gradual and evolutionary. Jinglian Wu (2005) shows that Chinese economic reforms started by laying emphasis on concrete results instead of arguments of theory and ideology. According to Jinglian Wu, in studying the economic reform in China, Kornai's[13] framework can be used, with some modifications to suit the country's specific situation.

The advocates of the Shock Therapy school like, Lipton and Sachs (1990), Balcerowicz (1995), Boycko, Shleifer and Vishny (1993) talk about the necessity of carrying out fast-paced reforms in Russia. The advocates of the Gradual Reform are Dewatripont and Roland (1992, 1995), Wei Ge (1997), McMillan and Naughton (1992), Litwack and Qian (1999) who talk about the incremental reforms being carried out in China and its advantages.

Despite the growing body of literature on the Chinese SEZs in recent years, many of these analyses have been confined to empirical case studies or have approached SEZs related issues from the viewpoints of political economics, economics geography, or urban economics. There is a dearth of systematic examination of the SEZs in the context of China's overall economic transition. The implication of the concept of SEZs for successful economic transition has not been made clear. (Wei Ge 1999)

The academic literature written in the West on Chinese economic transformation consists of a group of economists claiming that China's high growth is the result of successful economic experimentation. It is claimed that this experimentation has fostered the emergence of new, non-capitalist institutions that have promoted growth; and that other countries would do well if they incorporate these "lessons from China." This school of thought is called by Wing Thye Woo[14] as the "Experimentalist School[15]" (the E-school). Prominent members of the E-school include Gary Jefferson,

[13] Kornai talked of market socialism where the state firms should remain in state ownership, but by creating appropriate conditions, these firms should be made to act as if they were part of a market.

[14] See Wing Thye Woo "*The Real Reasons for China's Growth*"; Vol. 41, January 1999, pp 115-137.

[15] The E-school proposes two basic economic propositions concerning China's reforms: (a) Gradualism-key to China's rapid growth in market reforms is transferable to other economies in transition from central planning; (b) China's experiments in non-capitalist institutions are proving to be

Thomas Rawski, Barry Naughton, and Peter Nolan.

Disputing the claims of the E-school is a group of economists who give emphasis to comparative analysis of reform experiences. This second school is called by Wing Thye Woo as the "Convergence School[16]" (the C-school) because it sees China's good economic performance since 1978 to be caused by the same factors behind the fast-growth of the East and Southeast Asia economies, that is, the increasing liberalization, internationalization, and privatization of economic activities. Members of the C-school include Michael Bruno, Gang Fan, Geng Xiao, Jeffrey Sachs and Wing Woo.

Research Methodology

While making a distinction between Russian and Chinese economic transformation the historical approach could be incorporated. Like all other social systems, the existence and operation of capitalism depends on certain historical conditions (Minqi Li 2008). In 1985 both the countries had a hugely different economic scenario. Taking the economic, political and social past of both the countries we come to the conclusion that most of the differences in their outcomes could indeed be attributed to their varied historical backgrounds. China had adopted Maoist communism which gave emphasis to the agricultural economy. Till 1980s China had not undergone industrial revolution. On the other hand Soviet Union under Lenin and Stalin had carried out massive industrialization in consonance with the ideology of communism which highlighted proletarian revolution.

The political economy aspect of the transition process is applied to explain inter-country differences in reform efforts and results. Political economy arguments, along with being used in the context of the pace, speed and sequencing of reforms, have also been used to explain and justify many aspects of the transition process and the

successful in (i) agriculture, (ii) township and village enterprises (TVEs) in the rural areas, (iii) state owned enterprises (SOEs); and China is evolving towards a unique set of economic institutions, as a result of experimentalism in policy design (Wing Thye Woo 1999).

[16] The Convergence school, on the other hand, rejects Naughton's and Rawski's ideas. The C-school holds that China's successes are the consequences of its institutions being allowed to converge with those of non-socialist market economies, and that China's economic structure at the start of reforms is a major explanation for the rapid growth.

differences in the privatization approach (Gerard Roland 2001:2-3).

Political economy arguments have also been used to explain the striking difference in economic performance across transition countries. While all transition economies experienced a fall in output at the start of the process, most countries in central and Eastern Europe recovered growth after a few years, Russia and most former Soviet Union countries saw little or no recovery of growth through most of the 1990s. One political economy argument often made is that the extent of state capture and rent-seeking was much more important in former Soviet Union countries than in other transition countries and that this difference goes a long way in explaining differences in output performance (EBRD 2000; Gerard Roland 2001:3).

Primarily a comparative case study where the cases of two countries, that is, Russia and China would be analyzed; the study will use surveys, empirical facts available on the subject in the form of various reports and researches undertaken by various Russian and Chinese organizations, official documents, International organizations etc. like the Russian ministry of Economic development and Trade, UN Special agencies, World Bank, IMF and so on as the primary source. Secondary sources would include various books and articles written on the subject.

The study is organized by reviewing the primary and the secondary research material critically based on data and statistical modelling. It is also based on informed views of prominent economists, political scientists and policy makers of the respective countries in this field. This process enables the critical discussion and logical analysis of the findings of the literature to synthesize and form an informed and unbiased objective conclusion on the economic transition of Russia and China.

The nature of the proposed study would be both descriptive as well as analytical, using both quantitative and qualitative methods. Since the ultimate objective is to analyze the reform process in Russia and China and identify the distinctive and similar aspects, the analytical approach would be used. To facilitate the evaluation and monitoring of progress in transition over time, and to allow a comparison of progress between Russia and China, quantitative indicators of structural change is used on the basis of expert judgment.

The political, legal and social aspects involved in the matter will be scrutinized using the appropriate qualitative tools. The transformation of both Russia and China would be subjected to an objective evaluation.

In order to investigate the arguments of differences in reform policies and initial conditions keeping the above mentioned hypotheses and research questions in mind, the study will take Russia and Chinese economic transformation as dependent variable and the various factors behind their economic transformation as independent variable.

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Chapter 2

Economic Reforms in Russia under Gorbachev and Yeltsin

Chapter 2

ECONOMIC REFORMS UNDER GORBACHEV AND YELTSIN

"Russia is making the transition from one historical era to another at a speed commensurate with the life of a single generation. Fast-paced transformations frequently come at a price. Replacing the old technology of power, based on ideological and political coercion, with up-to-date methods and approaches is a difficult process." (B. N. Yeltsin[17] 1995)

In Russia as in other countries, the post-communist transformation was inextricably linked to the country's passing through a profound economic crisis. The attempts at reforming the Soviet system that were undertaken after Mikhail Gorbachev ascended to power, in 1985, fueled the onset of economic collapse in the USSR. By the middle of the 1980s, there was a clear understanding in the USSR that certain reforms had to be made. Economic reforms were openly discussed, and the measures that might be needed to bring about reform were addressed in party documents at various levels (Vladimir Mau 2003:31-33).

Economic Reforms under Gorbachev

Mikhail Gorbachev succeeded Konstantin Chernenko as General Secretary of the Communist Party of the Soviet Union in 1985. In 1985, when Mikhail Gorbachev came to power, the economic situation was only superficially stable. In reality, the possibilities for maintaining the existing level of production and consumption depended on external factors such as world oil and gas prices and the prospects to issue low-interest debt. However, the economic condition became grave due to a fall in world oil prices and the decline in export earnings from $91.4 billion in 1983 to $86.7 billion in 1985 (Yegor Gaidar 2003).

The new economic strategy of development proclaimed by M. Gorbachev in April 1985 at the plenary meeting of the CPSU can be summed up in the concepts of

[17] Extracts from Yeltsin's February 16, 1995 Speech to the Federal Assembly (*Rossiiskaya gazeta* February 16 1995).

"Uskorenie" (acceleration), *"Perestroika*[18]*"* (restructuring), and *"Glasnost"* (openness). At the root of this new economic strategy lay the concept of *"Uskorenie"*, that is, the acceleration of social and economic development (Abel Aganbegyan 1998).

Gorbachev envisaged reform within the socialist framework, in order to make the system more workable. The initial attempt by Gorbachev's team and the government led by Nikolai Ryzkov was to address the specific problems of the Soviet economy. Gorbachev used his mentor Andropov's framework to rejuvenate the economy and used the notion of "acceleration" (*Uskorenie*) with the intention of speeding up the growth. Gorbachev worked out the basis for reform in his first year and formalized it in the 27th party Congress in 1986 (Anuradha M. Chenoy 2001:19).

In Marshall Pomer's words (2001:146-47):

> "Uskorenie symbolized boldness of purpose in breaking out of the economic stagnation that characterized the Breznev years. It entailed commitment to a high rate of economic growth, which had once been the basis for claiming the superiority of Soviet socialism and was recognized as the foundation for improving the lagging of standard of living. The goal was to accelerate growth at once and eventually achieve growth rates 'two to three times faster than those in Western countries'[19]."

Mikhail Gorbachev's motives for declaring an economic programme to renew the existing system resulted from a number of factors like his motives to consolidate his political position; the impending economic crisis which was visible in the plunging growth rates of the Soviet economy; and the budget constraints due to the slump in oil prices (Vladimir Mau 2003).

At first Gorbachev attempted to rejuvenate the Soviet economy by adopting the "mobilization approach". Its chief features were (a) to bring about industrialization with emphasis on machine building (b) a new method of political leadership, and an anti-alcohol campaign. Gorbachev then moved on to "market socialism", that is,

[18] However, in June 1987, *Uskoreniye* was phased out and a series of economic reforms that came to be known as *perestroika* (restructuring) were initiated in which "democratic market system", that is, the promotion of private economic activity was sought to be created.

[19] Abel Aganbegyan (1988:40).

cautious market reforms. Its fundamental elements were (1) increasing the autonomy of socialist enterprises by converting them to fully self-financing and self-managing entities; (2) developing individual and cooperative forms of ownership; and (3) attracting foreign capital through joint ventures (ibid).

Gorbachev tried to revive the 'incentive system' of Alexie Kosygin which was implemented unsuccessfully in 1965. The incentive system relied on success indicators, that is, sales revenue, profit, and measures of product quality that complemented the mandated output targets. An investment campaign was launched in which emphasis was laid on machine-building industry, which supplied most of the capital investment for the economy. The five-year plan for 1986-1990 under Gorbachev called for doubling investment in the industrial sector (Marshall Pomer 2001:148-49).

Investment was increased and housing construction and social spending rose. Producing and importing more capital goods and military equipment reduced the supply of consumer goods, causing shortages. Enterprises merely expanded their facilities instead of investing in new technology as they were faced with higher output quotas. A new quality-control programme resulted in high rejection rate that reduced supplies, including the availability of new capital equipment. Thus, despite higher investment, neither productivity nor product quality showed improvement (Marshall Pomer 2001).

After the initial experiments of improving the economy, he shifted to the holistic approach of addressing several political, economic and social issues simultaneously under the slogan of *"perestroika"*. In order to protect his flanks and involve mass support he incorporated *"glasnost"* or openness to this formula. He also formulated a critique of the Soviet system under the framework of democratization ("demokratizatsiya") (Anuradha M. Chenoy 2001:19).

The first six years of *perestroika* were marked by unexpected changes in the course of economic policy: from an acceleration in investment to an acceleration in consumer goods production; from a campaign to reduce the consumption of alcohol to efforts to sell more alcohol for increased tax revenue; from intensified legal restrictions on private economic activity to legal equality between private and state businesses (Marshall Pomer 2001:151).

In late 1986 and early 1987, steps were taken to increase the scope for privately owned businesses. The Law on Individual Labor Activity formalized the right of the self-employed. It made legal for foreigners to become private partners in joint ventures with Soviet enterprises (ibid).

The Decree on Cooperatives legalized any enterprise as long as it had at least three owners. This led to a surge in retail trade, small scale construction, and services. The Law on Cooperatives was one of the key elements of *perestroika* to transform the Soviet economy. Lenin's concept of socialism as a system of civilized cooperatives was considered as the manifestation of the gradual rebuilding of society's economic life. Within the framework of the law on cooperatives, the management of numerous collective farms and consumer cooperatives were to be revamped. Many cooperatives especially in the service sector sprang up. The Law on Cooperatives also made way to the creation of agricultural cooperatives. Yet, the taxation system proved to be an impediment in the way of individual farming (Arun Mohanty 2003:41-42).

However, the law led the bureaucrats to set up cooperatives illegally for reaping in huge profits. These cooperatives led to hoarding of goods thereby creating artificial scarcity, which enabled rise in the prices of goods arbitrarily. This led to the creation of black money and parallel economy (ibid).

The Law on Individual Labor Activity which took effect in May, 1987 greatly enhanced legal private economic opportunities, permitting individuals to work alone or to unite into cooperatives (Marshall Pomer 2001:151). The Law on State Enterprises, implemented in 1988-89 disempowered the ministries, and the Soviet system moved towards market socialism. It called for "self financing," managerial autonomy, and lifted the lid on wages, while the state eased its exactions from enterprise profits (ibid; Robert V. Daniels 1993).

By destroying the traditional coordination mechanisms in the economy, without substituting true markets, partial reforms contributed to the collapse of output. Stateinducted inflexible prices led to endemic shortages and the domestic consumer demand in 1990-91, fell short of 70 billion rubles. 28% of the population lived below the poverty line of 100 rubles a month. Meanwhile, tax yields remained flat or worse, initially due to the anti-vodka campaign and subsequently when the government cut consumer goods imports to balance the drop in the price of its oil exports; and when the enterprise taxes fell off (Andrei Shleifer 2005:27; Robert V. Daniels 1993).

Gorbachev's partial economic reforms in 1980s obstructed the implementation of a responsible macroeconomic policy. Enterprise directors were freed from the control of the state bureaucracy but were not subject to the controls of the market. While, real private enterprises were allowed to exist in the form of cooperatives, they were not accompanied by the creation of adequate legal tools to check the criminal complicity between cooperatives and state enterprises that had become self financing. It led to a profound crisis, particularly in 1988, evident by the rapid drop in the value of the ruble, yawning gap between incomes and production, deterioration in the trade balance, and deterioration in the external debt situation (Vladimir Mau 2003).

The socioeconomic situation in the USSR in late 1980s and the beginning of 1990s were characterized by deepening of economic malaise, restructuring of the socioeconomic sphere through the formation of diverse interest groups, increasing competition between different political institutions for control over decision making (ibid).

Ownership Debate

The 19th Party Conference of the CPSU in 1988 heralded a free and frank debate on the ownership issue. The Law on Ownership was adopted by the Supreme Soviet on March 6, 1990. Essentially, this law was based on the principles enunciated by Abalkin and Ryzhkov. It did not explicitly condone private ownership, although it accepted citizen's ownership of "individual and other economic activity." Property rights were to be safeguarded by the law, but the equality of various forms of property was not announced (Anders Aslund 1991).

Academician Stanislav Shatalin, who became a member of the new Presidential Council in March, and Gorbachev's advisor Nikolai Petrakov were greatly disappointed and demanded an open acknowledgment of private ownership, whereas Abalkin claimed that the issue was not important as long as joint stock companies were accepted (ibid).

Eventually, private property was recognized in the Congress declaration, in the words: "in the system of forms of ownership, labour private property, which can work to improve the people's life, must have its place." Still, the party failed to put forward any operative program to show how the public sector was to be reduced. Although Gorbachev did accept private ownership in theory, he specified that it would be very limited (ibid).

The law sought to transform the state property into lease, cooperative, collective and joint stock property but not into blanket private property. The new law was laden with contradictions leading to controversy as it ruled out alienation of man from means of production as well as the exploitation of man from man. However, the new law was a giant step as it laid down the principle of pluralism by allowing varied forms of property and the government ensured the basis of their equality and their protection. The law laid the foundation for rapid implementation of economic reforms. The law, due to be enforced from 1st July, 1990 was expected to provide significant boost to the country's economic and political development in subsequent years (Arun Mohanty 2003).

Debate over the Economic Reform

By 1989, as the economic crisis deepened and *glasnost* spread, wide debate commenced about the necessity of quick and radical reform in the direction of a market economy. Radical reformers of the free-market school—Stanislav Shatalin, Grigory Yavlinsky, and others, along with their Western advisors—were working both with Gorbachev's government and with Yeltsin in the Russian Republic to formulate a total transformation of the economic system. A new "State Commission of the USSR Council of Minister of Economic Reform[20] " was established by decree on July 5, 1989. It was headed by a reformist and academic economist, Leonid

[20] It possessed an independent apparatus, had extensive powers and was entitled to issue commands to other permanent bodies of the Council of Ministers.

Abalkin[21] with the rank of deputy prime minister. Yavlinsky, serving as Abalkin's deputy, worked this initiative into the "400 Days Plan" of free market reform and privatization on the Polish model (Robert V. Daniels 1993:47; Anders Aslund 1991:22).

Meanwhile Yeltsin, newly elected as chairman of the Russian Supreme Soviet, embraced the 400 Days Plan (subsequently 500 Days) and made Yavlinsky his deputy prime minister for economic reform. Gorbachev turned to Yeltsin to seek an accord on the economy, and the two commissioned a working group of economists under Presidential Council member Shatalin to refine Yavlinsky's plan into a concrete reform programme. The "Shatalin 500 Days Plan," hurriedly worked out in August 1990, envisaged quick implementation of market-oriented reforms (Robert V. Daniels 1993:48).

Abalkin Programme Vs Shatalin Programme

As early as October 1989, the Abalkin commission presented a comprehensive programme for economic reform. The "Abalkin programme" condemned central planning and explicitly embraced the market. Every form of ownership apart from strictly individual ownership of enterprises with hired labour was allowed. A distinct feature of the Abalkin programme was its advocacy of a quick transition to a market economy, starting by 1991, although allowing for a transitional period of five years (Anders Aslund 1991:22-23).

According to L.I. Abalkin[22] (1990):

> "....what we will have next year is a market that is not yet fully developed ...It will be only a changeover to a market, and the very first stage at that. The formation of the basic structures of a market will take from two to five years, estimates by leading experts show. ... If we are talking about 1991, there are three key, interconnected problems here: filling the market with goods and services, or what is called goods supply; the regulation of income, or demand; and, finally, prices as a necessary element of any market structure."

[21] L.I. Abalkin was the Vice Chairman of the USSR Council of Ministers.
[22] Excerpts from the report by L.I. Abalkin (Izvestia, November 28 1990).

Regarding the prices and the price-formation reform, the plan upheld that markets required a different system of prices from the one that developed under the command distribution system. The change to a new system was supposed to be not carried out instantaneously but in the form of a number of successive and well coordinated stages. The plan further had decided on the question of wholesale and purchase prices which were in consonance with the actual state of the market. It had also worked out to introduce a whole system of anti-inflationary measures and progress towards demonopolization and destatization of the economy (CDSP January 2 1990).

The "Shatalin programme", on the other hand was substantial and extremely radical. It aimed at the transition to a full-fledged market economy within a short span of 500 days. Four central points were: a far reaching delegation of power to the republics; massive privatization through sales of state property of all kinds; a strict stabilization policy with the elimination of the budget deficit from the beginning of 1991; and a gradual liberalization of all prices with the exception of 150 basic commodities (Anders Aslund, 1991:29).

It included the freeing of controlled prices, rationing and income supplements to protect the poor, further autonomy for enterprises, enhanced opportunities for foreign investment and joint ventures, encouragement of private trade and farming, and acknowledgment of the economic powers of the Union republics, all to accomplish shock therapy and place the Soviet economy into recovery (Robert V. Daniels 1993:48).

The essence of this programme consisted in accelerated development of market relations. The main idea of the programme presupposed energetic and urgent measures to put finances and monetary circulation on a sound footing, which were to have been followed by a liberalization of prices. Destatatization, the development of entrepreneurship and a market infrastructure, and the demonopolization of the economy were to be carried out in 500 days (CDSP December 12 1990).

The implementation of the programme envisaged a number of general political conditions: unified, swift and decisive actions; coordination of all economic and political decisions by bodies of power, and subordination of those decisions to the aims of conducting the reform; and the restructuring of Union bodies of administration, bringing in a new personnel in order to restore trust in these bodies on the part of the republics and the population (ibid).

This programme suffered from numerous faults. There was little logic in the sequencing within the 500 days. For instance, the budget deficit was supposed to be eliminated before a great many prices were released. There was a fair amount of unrealistic populism, since the standard of living was not supposed to decline during the transition and minimum wages were supposed to be set at a high level. The privatization process was poorly conceived and clearly unrealistic. Still, this was the first comprehensive programme for a real change in the economic system, and it was impressive that such a substantial programme could have been produced in such a short space of time (Anders Aslund 1991:29).

There were two primary differences which existed between the two programmes. First, the Abalkin programme preferred creating the stabilization period in the economy, especially in the area of finance and credit system before carrying on the transition to the market economy. Whereas, the Shatalin plan argued that there was paucity of time to carry out the gradual transition to market economy. Second, Abalkin programme sought to privatize the economy over a period of several years. The Shatalin programme insisted on the completion of privatization in a matter of less than two years (Arun Mohanty 2003:57-58).

However, the Shatalin plan was challenged by Ryzhkov and even by Abalkin who were not prepared to accept liberal demands for a swift shift to free pricing and a speedy privatization. They preferred to keep a strong centrally planned sector and balked at the private property implications of individual farms and enterprises. However, the Shatalin plan remained on the shelf and the Soviet president and the Soviet economy together went into terminal decline (Robert V. Daniels 1993:48).

Outcome of Gorbachev's Economic Reforms

There was no institutional development to support change in the governance and financing of enterprises. Due to inflexible price system, the economy moved towards an unstable and incompatible mix of centrally controlled enterprises, private enterprises, and market socialism. The sudden removal of outside scrutiny and growth of black market widened opportunities for organized and casual criminal activities (Marshall Pomer 2001: 152).

In the final years of Gorbachev period, economic contraction accelerated amidst suppressed inflation which meant acute, widespread shortages. The Anti-Alcohol campaign had lowered tax receipts from sales of domestic wine and vodka and had cut gains from government resale of imported liquor. External shocks like a steep fall in the world price of oil, the Chernobyl disaster, the earthquake in Armenia, and the continuing war in Afghanistan depleted the government's resources. The deficit rose to about 10% of GDP in 1988, and it exceeded 20% in 1991. The deficit was inflationary as it was covered not by financing but due to the printing of money. Moreover, the Law on State Enterprises and the growth of the private sector led the stable wage rates to climb. Government decree held some prices rigid, but market determined prices skyrocketed. Some goods were available at less than 1% of prices outside of Russia (ibid: 153).

Table: 1.1 Economic Development of Russia, 1986-1991 (in % to the preceding year)

Indicator	1986	1987	1988	1989	1990	1991
GDP	102,4	100,7	104,2	101,9	96,3	97,4
Industry	104,5	103,5	103,8	101,4	99,9	92,8
Agriculture	106,7	98,8	103,2	101,7	96,4	95,5
Investment	109,2	105,9	107,7	104,1	100,0	84,5

Source: *Narodnoye Khozyaistvo Rossiskoi Federatsii, M.* 1992, p-14

During Gorbachev's period, the economy retained positive growth till 1989 (Table 1.1). However, the crisis took a dramatic turn to worse in 1990 and 1991 due to the grave policy mistakes committed by the leadership in the economic sphere. The ruble was devalued as a medium of exchange and store of value. The use of barter and supply interruptions was aggravated by criminal interference in various sectors. Amidst worsening economic conditions in 1990, all Soviet republics formally claimed the primacy of their own laws over Soviet laws. By late 1991, reserves of foreign exchange were depleted and the authority of the Soviet state to implement economic policy had disappeared. After the failed putsch of August 1991, Russian President Yeltsin in effect seized power from Soviet President Gorbachev (Marshall Pomer 2001: 154).

The economic reforms initiated under *perestroika* were not well-conceived or effective enough to offset the effects of deteriorating labour discipline, regional rivalry, and state-sponsored inflation. Reforms in agriculture and the service sector in 1987, set up individual peasant leaseholds and cooperatives. These reforms were successfully implemented in Moscow and Leningrad but were slow to take effect in the provinces. Moreover, "market socialism" was supposed to govern *perestroika*, yet its operation was restricted by the continuing practice of obligatory state orders that controlled major portion of the output of factory and farm at administratively set prices (Robert V. Daniels 1993:47).

Critical Appraisal of Gorbachev's Reforms

Theories of the Soviet economic downturn under Gorbachev are numerous. Economic transformation was poorly conceived, hastily executed, and corruptly managed. The Soviet conservatives attributed the crisis to the chaotic and ungoverned slide towards a market. On the opposite wing, radical reformers insisted that the trouble stemmed from delay in the introduction of market oriented reforms and saw the cure in "shock therapy" (Robert V. Daniels 2003).

Other factors of the crisis which are more definite are the fiscal practices of the Soviet government. Anders Aslund (2002), the Swedish economist observes, *"The initial problem of the Gorbachev regime seems to have been that the previously firm fiscal conservatism was replaced by extraordinary laxity in 1985"*.

The reforms initiated by Gorbachev were slow and incremental: the economy, including most prices, remained centrally planned and entrepreneurship severely limited. Moreover, Gorbachev inherited a political system where the weakness of the Soviet system overshadowed its strengths. Gorbachev envisaged reform within the socialist framework, in order to make the system more workable. Gorbachev insisted on the Soviet Union remaining a communist state, and refused to bargain the reforms to surrender the Communist Party's and the state's monopoly on power. Gorbachev paid little attention to the potential role of the market (Marshall Pomer 2001).

Gorbachev shifted from one economic strategy to another, abandoning the Abalkin Plan for the Shatalin Plan thereby giving emphasis to the speed of the reforms. However, the problem lay in not the speed but the method and approach necessary for change. None of these strategies yielded results and the economy was characterized to be in a dismal state. The Soviet economy was termed as the "command and control economy" after 1987 (Anuradha M. Chenoy 2001:23). Many have blamed Gorbachev for not having been sufficiently reformist during his early years, but he had little choice because of political resistance posed by the communist elite. Gorbachev succeeded in breaking down the CPSU and the state economic administration, but that left economic power vested in state enterprise managers, who were not accountable to anybody. Gorbachev's attempt to give autonomy to enterprises led to the creation of a system where the *nomenklatura* started extracting profits from industry (Anders Ausland 2007:17).

Gorbachev has often been blamed, who, unlike the Chinese leadership, started with political liberalization, not economic reform. However, given the interconnectedness of the economic and the political spheres, it is much more appropriate to ask whether Gorbachev had any viable alternative (Yegor Gaidar 2003). Gorbachev moved towards the NEP model of market socialism. In June 1987, under Abel Aganbegian[23], Gorbachev's principal economic adviser, the central controls over prices, wages, allocation of supplies, and enterprise administration were relaxed but the new laws were vague and inadequate (Robert V. Daniels 1993).

According to some critics the arbitrary price system, was the reason behind the failure of *perestroika*. Gorbachev's half-measures accelerated budget deficit, the market

[23] A. Aganbegian was the director of the Institute of Mathematical Economics.

disequilibrium, and stagflation. Economic performance in general and finances in particular were further undermined by the weakening of central authority over the union republics, as well as by the collapse of Communist and economic cooperation within East European block (CMEA). Gorbachev's government responded to the changes in Eastern Europe by suspending its barter trade arrangements with the bloc and insisting that Soviet exports especially petroleum be paid for in hard currency. These measures disrupted the interdependent connections between the parties, shutting off both supplies and markets both ways and the Council of Mutual Economic Assistance[24] quickly withered away (ibid: 46).

Economic Reforms under Boris Yeltsin

Amidst worsening economic conditions in 1990, all Soviet republics formally claimed the primacy of their own laws over Soviet laws. The rivalry between Gorbachev and Yeltsin who was elected president of the Russian republic in June 1991 finally led to the formal dissolution of the Soviet Union. By late 1991, reserves of foreign exchange were depleted and the authority of the Soviet state to implement economic policy had disappeared. After the failed putsch of August 1991, Russian President Yeltsin effectively seized power from Soviet President Gorbachev (Marshall Pomer 2001:155).

The economic reforms and plans for privatization begun by Gorbachev in 1988 have been largely continued and in many ways extended by Boris Yeltsin. Gorbachev's economic reforms failed and Yeltsin came into office facing an economic crisis. The previous two years had seen declines in output and worsening shortages. By the end of 1991, Russia's GDP had dropped 13%, industrial production had fallen 15%, retail prices had risen 90%, inflation had reached a monthly rate of 13%, and budget deficit exceeded 30% of GDP. The collapse of trade with the Eastern countries, the pressure to service the foreign debt, and the production plunge in oil and gas only compounded Russia's economic troubles (Andrei Schleifer 1995:4).

[24] Comecon—the Communist answer to the European Community.

B. N. Yeltsin spoke on October 28, 1991 at the Congress of Russian SFSR People's Deputies:

> "The most important, most decisive actions will have to be taken in the sphere of the economy. The first area is economic stabilization. It will be based on a tough monetary, financial and credit policy, a tax reform and the strengthening of the ruble. But the most painful measure will be a one-time unfreezing of prices in the current year. The second area is privatization and the creation of a healthy mixed economy with a powerful private sector. Giving greater dynamics to land reform and creating a fundamentally new situation in the agrarian sector by the spring of 1992 are of special significance for Russia." (Izvestia October 28 1991)

Yeltsin broadened his powers in the legislative regulation of the economic reform and also banned all elections in the republic for one year. Yeltsin immediately appointed a reformist government headed by Yegor Gaidar[25]. Over the following three years, the government pursued a radical economic transformation. Yeltsin's economic programme called for simultaneous attacks on various fronts, that is, macro-economic stabilization, price liberalization, privatization, strengthening the social safety net, and attacking the monopolies. The stabilization measures envisaged centered on: (1) slashing subsidies to unprofitable enterprises; (2) reducing outlays for defense and administration; and (3) discontinuing republic contributions to the union stabilization fund and union grants and credits to foreign governments (James H. Noren 1992:4).

Prices were to be decontrolled before the end of 1991. The initial targets were: (1) within three months about 10,000 or up to 50% of small and medium sized enterprises in Russia were to be privatized. (2) In November 1991, state property was to be divided among several levels of government in Russia. (3) Within two to three weeks, the basic privatizing housing was to be formulated (ibid: 5).

Yeltsin signed the decrees which granted enterprises and individuals the right to engage in foreign trade and foreign currency operations while requiring enterprises to sell part of their hard currency to the Russian Central Bank. There was also the decree which abolished state regulation of wages and increases in enterprise incentive funds (ibid: 6).

[25] Y. Gaidar was also made the Deputy Chairman of the Russian government for economic policy issues.

The first steps in reform implementation provoked dissent and active opposition within the Russian government as well in parliament. Yet Yeltsin carried on with the economic reforms. In his words:

> "The implementation of the economic reform has begun, after repeated attempts to block transformations. We have finally begun to move forward. I categorically disagree with the assertion: 'This is just another experiment.' On the contrary, for the first time we have put an end to this discreditable practice and have embarked on the path that the civilized world has taken..." (B. N. Yeltsin[26] 1992)

Shock Therapy

By 1991 the radical approach[27] embodying Western suggestions was put forward by Yeltsin. To take up the responsibility of the transition programme, a new government, composed largely of radical liberals, was formed in Russia in November 1991, and headed by Yeltsin. Yeltsin delegated the implementation of Shock Therapy to his deputy prime ministers, Yegor Gaidar, Gennady Burbulis and Alexandr Shokhin, while Anatolii Chubais became the chairman of the State Committee on Managing State Property (GKI) (Pinar Bedirhanoglu 2004:23).

The Russian Federation government had chosen the "shock therapy" model that was applied in Yugoslavia in 1986 and in Poland in until 1990. The radical approach was to involve a speedy drive toward rapid market transformation. It was to embody a "shock therapy" that left prices free to find market-clearing levels, freed the private sector from bureaucratic restrictions, set in motion the processes of privatization, and maintained macro-stability by restructuring credits and balancing the budgets. This

[26] Yeltsin spoke to the fourth session of the Russian Federation Supreme Soviet on January 16 1992 (Rossiiskaya gazeta January 17 1992).
[27] The radical program for market economic reforms was supported by three powerful groups. The first group consisted of primarily American macroeconomists such as Jeffrey Sachs, Stanley Fischer, Lawrence Summers, and David Lipton. Harvard University, the Massachusetts Institute of Technology, and the London School of Economics were focal points of radical reform thinking. The second group comprised of the economists in the East, notably Leszek Balcerowicz in Poland, V´aclav Klaus in Czechoslovakia, and Yegor Gaidar in Russia and politicians with economic insights, such as Mart Laar in Estonia and Einars Repˇse in Latvia. The third group consisted of the international financial institutions, primarily the International Monetary Fund (IMF) and the World Bank, and the major Western governments. This programme had been named the "Washington Consensus" by John Williamson (1990). It can be summarized as "prudent macroeconomic policies, outward orientation, and free-market capitalism," and it drew on neoclassical mainstream economic theory (Anders Aslund 2007).

policy, adopted by Yeltsin in December 1991, was launched in January 1992. The "shock therapy" involved immediate price liberalization, attempts to bring down the rapidly rising inflation, conflicting fiscal policies, the continuance of state subsidies mainly to non competitive industries, failure to reduce the growing unemployment, absence of coordination with regard to capital markets and privatization involving the auctioning of state property with large concessions to the *nomenklatura* of managers and to the worker collectives (Pinar Bedirhanoglu 2004:23).

The primary difficulty in the implementation of the radical programme was contradiction between the freeing up of prices and the continuing high level of monopolization in the economy. The other obstacles were the creation of a truly competitive environment and the state to ensure the legal protection and support for all those who wished to engage in entrepreneurial activity (R. Yevstigneyev[28] 1991). As Sachs said, such a reform was *"a seamless web, piecemeal changes cannot work."*

Rather than propel the economy forward, sudden liberalization precipitated severe contraction. For the year 1992, per-capita personal income fell in half while hyperinflation of 2500% decimated the savings of millions of Russians. By 1994, industrial production fell to about 1990 level, and investment declined by two-thirds (Marshall Pomer 2001).

The "shock therapy" could not be successfully initiated in Russia as it had very unfavorable conditions for conducting it: the enormous scale of the economy, and the societal readiness for radical reforms was on the whole less than that it was in the East European countries (R. Yevstigneyev 1991).

Yeltsin led Shock therapy helped the former *nomenklatura* to transform itself into Russia's new capitalist class. The economic policies implemented by the government were conducted in close association with the IMF's advisory and financial assistance. The IMF agreed to provide Russia with a $4 billion stand-by credit after its prospective full membership as part of the $24 billion aid package promised by the Western governments in the G7 Summit in April 1992 (Pinar Bedirhanoglu 2004:22).

[28] Prof. R. Yevstigneyev was the Director of the Center for Comparative Economic Research.

Despite the setbacks, in 1992, Yeltsin said, *"The reform has not yet become irreversible, and what it needs right now is effective support, mutual trust and interaction. Only in that way will we able to overcome the difficulties and extricate Russia from its crisis..."* (CDSP February 12 1992).

Stages of Economic Transformation

The four pillars of the Russian economic reform:

- Price liberalization.
- Privatization.
- Elimination of state monopoly over trade.
- Macroeconomic stability.

Price Liberalization

The decree, "On Measures for the Freeing up of Prices", dated December 3, 1991 issued by Yeltsin led to the shift to market prices for goods and services. The decree stated that:

> "Starting January 2, 1992, a changeover is to be carried out, in the main, to the use of free (market) prices rates, formed under the influence of supply and demand, for production-and-technical output, consumer goods, operations and services[29]."

The RSFSR[30] Ministry of Economics and Finance was to work out a statute on procedures for the use of free prices for production and technical output, consumer goods, operations and services and, taking antimonopoly legislation into account, procedures for applying economic sanctions for the violation of state price discipline, and transmit these documents to the organizations and enterprises concerned (Rossiiskaya gazeta December 25 1991). As a result of the freeing of prices that took place on January 1992, approximately 90% of consumer goods and 80% of producer goods prices became free from direct administrative regulation (CDSP April 1 1992).

The liberalization of prices led to hyperinflationary conditions and a drop in the prevailing standard of living, the fall in production, economic disorganization, miscalculations of the budget deficit, and the collapse of the ruble. It led to charges of monopolism and of failure to provide an adequate safety net. Consumer prices had gone up by 250 % in January, 1992, with food prices rising by 296 %, non-food prices

[29] Excerpts from the Decree signed by Yeltsin on December 3, 1991.
[30] The Russian Soviet Federative Socialist Republic (RSFSR).

by 150 %, and charges for services by 130 %[31]. The unmanageable rise of prices led to the de-monetization of the Russian market. In the first three years following the initiation of shock therapy, real GDP fell 33%, industrial production 44%, and investment 60%. The share of wages and social payments in the population's income fell from 74% in 1990 to 43.4% at the end of 1996 (Pinar Bedirhanoglu 2004:24; James H. Noren 1992:8; Nicolas Spulber 2003).

As said by B. N. Yeltsin at the Congress of Russian People's Deputies, *"For approximately six months things will be worse for everyone, but then prices will fall, the consumer market will be filled with goods, and by the autumn of 1992 there will be economic stabilization and a gradual improvement in people's lives."* (CDSP January 29 1991) Population reaction to the price increases was at first sharp, even violent in some instances, but did not turn into the pervasive mass demonstrations and riots that many had predicted (James H. Noren 1992:8).

Liberalization of prices had produced a logical chain reaction of problems besetting Russian economy. In a few months after January 1992, the "crisis of payments" had developed in the economy. People had run short of cash and low quality products of Russian factories found a few customers. Enterprises short of cash had ceased in most cases to pay their counterparts, especially in cases of newly independent CIS countries, for deliveries or services. Payments of wages had to be discontinued in many regions of the country (Zafar Imam and N.V Romanovsky 2002).

Russia's reformers set new objectives for the remainder of 1992 in a policy memorandum adopted by the government. The memorandum declared that about 90% of consumer goods prices and 80% of producer goods prices were already free but recognized that the lack of competition was leading to unduly large price increases in some areas. Thus, a January 29, 1992 government decree gave everyone the "right to trade anywhere in whatever they wish" unless a given activity is specifically forbidden. With regard to Russian budget, it counted on price decontrol to help reduce subsidies to less than 1.5% of GDP by fourth quarter of 1992 (James H. Noren 1992:17).

[31]This data is provided by the head of the Russian State Committee for Statistics- Goskomstat.

The Russian Central Bank also sought agreement on the withdrawal of rubles with the central banks of any republics planning to establish their own currencies. While putting a lid on social security benefits and restraining earnings, the government planned to shift toward greater reliance on cash payments in forming safety-net while redirecting these payments to the low income segments of the Russian population (ibid: 19).

The Russian Privatization Programme

The cornerstone of Russian privatization process is RF (Russian Federation) Act No. 1531-1 of July 3, 1991, on the Privatization of State and Municipal Enterprises in the RF or the "Privatization Act", adopted in the pursuance of the USSR Act of July 1, 1991, on the Principles of De-Statization and Privatization of Enterprises (Alexander Letenko and Dmitry Lvov 2000).

There were mainly three stages of Russian privatization:

- Mass or Voucher Privatization.
- Monetary Privatization.
- Loans for shares.

Privatization of Small Scale and Large Scale Enterprises

In 1992 Yeltsin signed his Edict No. 341 on December 29, 1991, confirming the Basic Provisions of the Programme of Privatization of State and Municipal Enterprises for 1992. This was followed by the issue of Edict No. 66 (January 29, 1992) on Acceleration of Privatization of State and Municipal Enterprises which was fundamental because it confirmed the provisions regulating the practical mechanism of privatization (ibid).

Privatization of each enterprise started with a development of a privatization plan which determined the procedures for the sale of shares as well as the proportions offered to various groups of potential investors, especially the employees and managers, within the limits allowed in the privatization regulations. The plan was to be approved by the State Committee for the Management of State Property (GKI) – the main Russian privatization agency – or its regional offices. The next step involved corporatization, which transformed state enterprises into open joint-stock companies wholly owned by the state. Shares of newly created companies were transferred to the Federal Property Fund (FPF) and its regional branches, which acted as the sellers of enterprises (Paul Hare and and Alexander Muravyev 2002).

The document assigned state and municipal enterprises one of the four groups in terms of whether and when they would be privatized. Priority was given to 'consumer-oriented enterprises'[32] which were to be privatized in the first quarter of the 1992. One fourth of the nominal value of the enterprise was to be distributed as non-voting shares of preferred stock to the workers of the company, 10% of the value was to be sold as shares to the workers if they want them, 5% of the shares to be sold at face value to the management of the enterprise and shares representing the remaining value of the enterprise to be auctioned off (James H. Noren 1992).

As a first step the programme divided firms that would be sold primarily for cash by the local governments and those that would go into the mass privatization programme. Thus, most small shops and small enterprises were immediately allocated to the local governments (Maxim Boycko, *et al.* 2005:37).

As a second step, the programme divided larger firms into those subjects to mandatory privatization, those subject to privatization with the permission of the privatization ministry (GKI), those requiring government approvals for privatization, and those whose privatization was prohibited. Mandatory privatization included firms in light industries, such as textiles, food processing, and furniture. Firms requiring GKI approval tended to be the larger firms, yet not operating in any of the strategic industries. Major firms in most strategic industries, such as natural resources and defence, could be privatized only with the agreement of the government. Finally, some firms involved in space exploration, health and education could not be privatized at all (Maxim Boycko, *et al.* 2005:37).

[32] Consumer oriented enterprise comprises of the wholesale and retail trade, public catering and agricultural- related enterprises.

As a third step, all large and medium sized industries were to be corporatized. They were to re-register as joint stock companies with equity owned by the government. Once a firm was corporatized, its managers and workers got to pick among three privatization options:

Option 1: Workers and managers were to receive 25% of equity in the form of preference (non- voting) shares for free, plus the right to purchase a further 10% of ordinary (voting) shares using cash or vouchers (at 30% discount on the January 1992 book value). In addition, senior managers of enterprises could purchase an additional 5% of the stock in the form of ordinary shares.

Option 2: Workers and managers could buy - for cash or vouchers - 51% of voting shares at 1.7 times the book value of the enterprise on January1992.

Option 3: A managing group (that could include existing management and workers, or any other physical or legal person) that took responsibility for the execution of the privatization plan and the prevention of enterprise bankruptcy could buy 30% of the voting shares; a further 20% could be purchased by management and workers (regardless of whether they were part of the managing group) at a 30% discount (Maxim Boycko, *et al.* 2005:37; Paul Hare and Alexander Muravyev 2002).

Option 1 was first proposed as the main approach, but it met with strong resistance from managers who, through regional leaders and representatives in the parliament, were able to put sufficient pressure on the government to have Option 2 included in the programme. Option 3 was also included due to pressure from the managerial lobby, but in practice the government banned its use at large enterprises and by imposing a "no bankruptcy" condition finally made it rather unattractive for the managers. Over 70% of the firms offered for privatization chose Option 2, just over 21 % chose Option 1 for their privatization, giving insiders - managers and workers taken together - an overwhelming degree of control at most enterprises (Anders Aslund 1995; Paul Hare and and Alexander Muravyev 2002).

Within two years the programme transferred the majority of state-owned firms to private ownership, representing an unprecedented privatization effort in the world. As a result, by September 1994 there were already 100,000 privatized firms in Russia accounting for over 80 % of the industrial workforce. Most small enterprises had been privatized, and of the 24,000 or so medium and large enterprises, most had been corporatized and over 15,000 privatized by the end of 1994 (Appendix I). The main goal of separating the business sector from the state to limit the scope for state interference into enterprise activity was formally achieved (OECD 2005; Paul Hare and Alexander Muravyev 2002).

Mass or Voucher Privatization Programme (1992-1994)

In August 1992, the President issued Edict No. 914, "On the Introduction of a System of Privatization Vouchers in the RF", ushering in so-called voucher privatization, which, according to the intention of its architects, was to have paved the way for access by everyone to state property (Alexander Letenko and Dmitry Lvov 2000).

Through this programme, shares in most firms were transferred from the government to their managers, workers, and the public. This programme[33] was to be based on the following fundamental principles: There would be widespread dissemination of free privatization coupons with the aim of creating broad support for the privatization programme; employees would be given a share in the ownership of their enterprise, but not a controlling block of shares; a sharp reduction in restrictions on the privatization of certain enterprises and sectors; and restrictions on participation by foreign investors was to be eliminated (Pinar Bedirhanoglu 2004; CDSP April 1 1992).

The principal way in which the sale of shares took place in Russia was through auctions of shares for "vouchers". The voucher had a denomination of 10,000 rubles, was supposed to expire at the end of 1993, and was freely tradable. Voucher auctions were run locally, which gave local government some limited opportunity to exclude undesirable outsiders. By the end of the programme, roughly two-thirds of Russia's manufacturing employment came from privatized firms (Maxim Boycko, *et al.* 2005).

[33] Excerpts from the Russian government Memorandum on Economic Policy (February 1992).

The privatization checks or vouchers were issued to ensure to every citizen of Russia the right to his or her proper share of former state property and enable virtually everyone to take part in the reform. In Yeltsin's words, *"The privatization check is a unique ticket for each of us to a free economy."* (Izvestia August 20 1992)

The holders of vouchers[34] had several possible ways in which they could use them. One could buy shares in or property of one's own enterprise; take part in an auction at which other firms and companies are sold; or put the privatization check into any investment fund, which could invest the checks in some business that will bring a profit to the holders. A voucher may be sold, transferred as a gift, or conveyed as an inheritance (Rossiiskaya gazeta August 27, 1992).

During the first privatization drive, most of the privatized enterprises in trade and consumer service were purchased locally by members of the workers' collectives[35]. For the large enterprises included in the programme, corporatization- that is the transformation into joint stock companies- had been mandatory. The majority of these were either medium sized or large firms. The privatization of joint stock companies through voucher auction involved a total of 13,500 enterprises.

During the second privatization drive, through the initiative of the largest financial groupings and with active government support, the largest Russian companies became the major targets (Appendix II). Foreign participation in privatization and in share transaction had been limited, particularly in "strategic enterprises" in the energy and the financial sectors (Nicolas Spulber 2003:310).

The auction of vouchers was marked by irregularities. Under the auction design, if fewer vouchers were bid for a company's shares, more shares would be distributed per voucher. This gave insiders an incentive to discourage others from bidding. The largest enterprises were held out of voucher privatization, with the government distributing at most a minority stake. In several important industries, the government created "pyramid structures", bundling controlling stakes in a number of operating companies into a few holding companies, and later sold controlling stakes in the

[34] Text of the Statute on Privatization Checks (1992).
[35] As per the Information released by the IMF and the OECD.

holding companies. The government created seven oil holding companies: LUKOil, Sidanko, Sibneft, Rosneft, Tyumen Oil, Yukos, and VNK (Bernard Black, *et al.* 2000:1730).

During the period from 1993-1994 the Russian population experienced devaluation of its savings and loss of property in "Financial Pyramids". The financial pyramids wiped out 20 trillion rubles of the savings of 40 million people. They allowed the concentration of property in the hands of organized crime. When the financial pyramids collapsed, the Government restored them with their own financial pyramid of short government bonds (GKO), issued at high rates of return for purpose of financing the budget deficit. In 1998 the GKO financial pyramid collapsed, accompanied by the Central Bank's decision to freeze currency exchange operations of a capital nature and devalue the ruble, marked the effective financial bankruptcy of the State, which was the lawful result of the macroeconomic and financial policies (Sergie Glazyev 1999:48).

The large scale privatization of state property led to the redistribution of national property. Under conditions of decline in incomes, people were forced to "dump" their privatization vouchers into the hands of middlemen. Thus, many Russian enterprises ended up in the hands of foreign competitors (Nicolas Spulber 2003).

The process tuned out to be an effective device to transform the political authority of the former *nomenklatura* into economic power. Implementation of the programme under hyperinflationary conditions led the small entrepreneurs out of the market. The "insider model" which became the dominant mode of privatization in Russia, proposed the sale of 51% of each enterprise's shares to its employees at nominal prices, with the aim of workforce and management ownership of enterprises. Although, mass privatization enabled the workers and managers to become major stakeholders in 70% of the privatized enterprises, the managers became the de-facto owners of the enterprises without any formal responsibility (Pinar Bedirhanoglu 2004).

A report by the Prosecutor General's Scientific Research Institute for Problems of Strengthening Law and Order concluded that,

> "...the process of mass privatization of state owned and municipal enterprises and housing....occurred in a highly unorganized and hasty fashion, without due state supervision. Everywhere it was accompanied by numerous serious infractions of the law, such as: illegal acquisition of federal property; transfer of huge quantity of national capital into the hands of a select small circle of people; loss of the controlling block of shares in many companies in important sectors of industry; depression of the value of the privatized entities; unlawful mortgaging of state property; unlawful sale of facilities belonging to the social services sphere; privatization of housing to the detriment of minor's rights under the law, and so on."(Sergie Glazyev 1999:46)

Monetary Privatization

In March 1993, for the first time, a monetary[36] programme was adopted that was formulated in a joint declaration of the government and the central bank. The programme outlined a number of stabilization measures, such as a clearly stated ceiling on the budget deficit, targets for money supply growth, restrictions on the growth of domestic borrowing, and limits on centralized credits to the economy and government. Based on this programme, it was predicted that average monthly inflation would be reduced to 5% by the end of 1993. This expansionary fiscal policy led to a stable although high average monthly inflation rate of around 20% for almost all of 1993 (Sergei Sinelnikov-Murylev and Georgy Trofimov 2003:131).

In accordance with the joint statement of the government and the central bank on economic policy for 1994, the central bank established control over the money supply. The fall in inflation in the second and third quarters of 1994 was followed by significant lowering of interest rates which attracted large volumes of household savings into the banking sector, and thus mitigated the severity of the liquidity problems caused by the reduction in refinancing credits. The volume of money in circulation tripled over 1994, reaching 97.8 trillion rubles on 1 January 1995. In 1997, monetary privatisation was launched which among other things included trade sale of enterprises (ibid: 155-156).

[36] The term "monetization" refers to substituting planning and "state orders" with the use of money in the production sector of the Soviet economy. The process of monetization is a necessary but not a sufficient condition for the full marketization of the sector. Nevertheless, the term "marketization" is also used from time to time (Gur Ofer 1990:313).

In order to control the growth of the money supply, the IMF set limits on net domestic assets, and also set guidelines concerning the size of official foreign currency reserves. The preliminary results of the monetary and credit policies provided grounds for optimism. In the middle of April 1995, economic agents undertook a mass conversion of dollar assets into rubles, and as a consequence the nominal ruble exchange rate rose (Vladimir Mau, *et al.* 2003:173).

The year 1997 saw the continuation of the tight monetary policy that had begun in 1995. The main causes of a significantly lower rate of inflation in 1996–1997 were control over growth in the money supply within the limits agreed to with the IMF and some reduction in the budget deficit as a result of cuts in government spending (Sergei Arkhipov et al. 2003:235).

Russia was hit hard by the financial crisis of 1998 due to the failure of all the successive cabinets in Russia to adopt and execute a realistic budget. The positive trends in 1996 and 1997, such as falling inflation rates, stabilization of the ruble exchange rate, declining interest rates, and an incipient economic rise, were maintained solely by a tight monetary policy pursued against the background of highly unbalanced government finances. The considerable government finance shortages, which pushed up government debt and debt servicing while simultaneously depressing national savings and reducing the current balance of payments surplus, were a major destabilizing factor in the nation's socioeconomic development[37].

During the 1998 financial crisis, the banking sector remained underdeveloped and consisted of over 1000 banks, most of which were small and undercapitalized. Moreover, the crisis resulted in a loss of confidence in the banking sector on the part of depositors and a virtual monopoly of the state controlled Sberbank or Savings bank. Overall, the Russian banking sector functioned extremely poorly for much of the past decade, and contributed to the endemic "soft budget constraint" culture (RET 2002; OECD 2000).

[37] *"The Crisis of the Russian Financial System: Key Factors, Economic Policies, and Initial Results"* (Art.) by Sergei Arkhipov, *et al.* (2003)

Similar to the banking sector, the Russian stock market did not play an important role in providing enterprises with financial resources. The number of listed equities was about 200 of which only a few dozen were regularly traded. For example, while the market capitalization of several individual companies amounted to billions of dollars; the average daily turnover in the Russian Trading System (RTS) – the largest over-the-counter market in Russia – did not exceed USD 100 millions (Paul Hare and Alexander Muravyev 2002).

Loans for Shares

A new phase of privatization took place between 1995 and 1997. It involved the largest Russian companies and brought to the fore for the appropriate transactions a variety of procedures, including loans for share auctions, sales of debtor debts, purchases of promissory notes etc. (Nicolas Spulber 2003).

Two reasons are typically put forward to explain the use of the loans-for-shares scheme. On the one hand, the Russian government was desperate in 1995 to increase its revenues from privatization. But it was facing severe difficulties in achieving its budget targets for privatization revenues, given the increasing uncertainty due to approaching parliamentary elections, as well as a direct ban on privatizing enterprises in the oil industry, which had been imposed by the parliament. In 1995, Yeltsin tried to broaden his support ahead of the 1996 presidential election. As part of his political campaign, and in an attempt to balance the budget, Yeltsin agreed to a "Loans for Shares" programme. Yeltsin won a second presidential term.On the other hand, the banks wanted to gain control over some of the largest Russian companies as cheaply as possible (Paul Hare and and Alexander Muravyev 2002; Andrei Shleifer 2005).

Loans-for-shares was a scheme to acquire Russia's biggest companies for a small fraction of their value. It began in 1995 with a proposal by Vladimir Potanin[38], backed by most of the major new Russian banks. The Russian Government wanted to raise revenue but found it politically hard to sell its stakes in these enterprises, which had been excluded from voucher privatization. The banks proposed to loan funds to the

[38] Owner of Oneksimbank.

government for several years, with repayment secured by the government's controlling stakes in these enterprises. The Government would not repay the loans, and would instead forfeit its shares to the banks that made the loans (Bernard Black, *et al.* 2000:1731).

Under loans-for-shares, the Government auctioned its shares in a number of major oil, metals, and telephone companies, giving the shares to whomever would loan it the most money. The right to manage the auctions was parcelled out among the major banks, who contrived to win the auctions that they managed at low prices. The auction manager participated in two separate consorts, each of whom bid the government's reservation price or trivially above that. No one else bid at all. Foreigners were excluded formally to bid. For example, Oneksimbank managed the Norilski Nickel auction, with a reservation price of $170 million (ibid).

Beginning in 1994[39], the government often required bidders in privatization auctions to promise specified future investments in the enterprise. Once the winning bidder acquired the shares, the promised investments were often quietly shelved, or the shares were transferred to supposedly good faith purchasers, who were not bound by the investment promise. Another privatization rule gave a firm's managers the right to acquire 30% of its shares cheaply if they first secured an agreement with the employees that would prevent the enterprise from going bankrupt for one year. Since proof that the enterprise would go bankrupt without the agreement, or would not go bankrupt for a year with it, was in the eye of the beholder, this was an open gift of a controlling stake to the managers, in return for a phony agreement with the employees (ibid).

A small number of individuals, who mostly achieved initial wealth through favourable deals with or outright theft from the government, ended up controlling most of Russia's major firms and, to a certain extent, the government itself. The reform accelerated the consolidation of a few large groups in the Russian economy, led by the so called oligarchs, who enjoyed great political and economic influence. Roman

[39] Basic Provisions of the State Programme of Privatization of State-Owned and Municipal Enterprises in the Russian Federation after July 1, 1994 approved by Decree of the President of the Russian Federation No. 1535 of July 22, 1994 (LEXIS, Intlaw Library, RFlaw File).

Abramovich (Berezovski's apparent partner; Chairman of Sibneft); Vladimir Bogdanov (Surgut- neftegaz); the Cheroy brothers (aluminium companies); and Anatoli Chubais (former Prime Minister; head of the UES electric power company were the famous oligarchs in Russia (ibid: 1747; Andrei Shleifer 2005).

Legal Basis of Privatization

In the early 1990s, Russia wholly lacked the institutional infrastructure to control self-dealing by managers of private firms. Basic commercial and capital markets laws did not exist when voucher privatization was completed in 1994 (Bernard Black, *et al.* 2000:1752-1753).

Some initial tentative steps in establishing legal structures were: new Civil Code adopted in 1995-96; law on securities adopted in 1995; law on joint stock companies in 1996; decent laws on bankruptcy and limited liability companies in 1998 (ibid: 1753).

The legal and institutional framework could not take roots in Russia when market reforms were being carried out. Because of their belief in the power of the invisible hand, Gaidar's team did not envision a role for the state in creating market-supporting institutions. Rather, these institutions were to form spontaneously. The oligarchs were able to co-opt the Central Bank and the Finance Ministry into opposing a strong securities law or Securities Commission. They opposed efforts to strengthen or enforce the capital markets laws. The government's own behaviour reinforced disrespect for rules. Managers had to cheat on their taxes, bribe tax and customs inspectors, and avoid cash transactions to survive. The government did not pay its own bills to companies that provided it with goods and services, thus hardly providing an incentive for those companies to pay their tax bills (ibid: 1754; Michael Mc Faul 1995:236).

Elimination of State Monopoly over Trade

The law On Restricting Monopolistic Activity in the USSR was passed in 1991. This law defined the legal and organizational principles of preventing and restricting monopolistic activity by economic actors. The abolition of the state monopoly over the foreign trade had some immediate consequences. First of all, it allowed for free flow of goods, capital funds and technology over the state boundaries. Secondly, these new circumstances allowed for a different set of actors in foreign economic deals to emerge: some old foreign trade players disappeared while the new ones arrived (Izvestia July 25 1991; Vyacheslav Amirov 2001).

Joint ventures were first allowed in 1989, and in 1991 fully-owned foreign companies were allowed to function in Russia. In theory, with exception of strategic industries, foreigners and foreign companies had the same rights in privatization as Russians and Russian companies. In practice, however, the rights of foreign investors were often abused by Russian enterprise owners and managers. Due to this Russia lagged behind in FDI inflows (Ksenia Yudaeva 2002).

In 1993, confronted with massive output decline, the government started to reinstall trade barriers. This process was reverted by the stabilization agreement with the IMF in the mid-1990s, which stipulated decline in both import and export tariffs (ibid).

As a result of these positive developments Russia had managed to repair some of the major distortions that characterised its foreign economic relations during the Soviet period. But at the same time the country could not avoid some of the negative developments, particularly those that came as a result of the combination of the unexpected economic and political freedom and a rather chaotic development of foreign trade during the first post-Soviet years. Many Russian producers found themselves operating in the conditions of an extremely low domestic demand and widespread barter trade, and at the same time had many opportunities to earn large profits on substantial margins that existed between internal and export prices. The newly found freedom to trade directly with foreign countries had also resulted in a rush to establish Special Economic Zones in many Russian regions (Vyacheslav Amirov 2001).

Macroeconomic Stability

In 1992 Russia's gross national product and industrial production fell about 20%. Retail prices rose twenty fold, with inflation reaching 30% in January 1993 alone. Looking at the table (1.2), it becomes clear that Russia's macroeconomic condition was not sound. The ruble collapsed from the pre-reform market rate of 60 rubles to the dollar to nearly 600 at last reckoning. The key objective of macroeconomic stabilization in Russia was to reduce inflation to less than 40% per annum in order to encourage direct investments. This objective was attained only in 1997. However, as the financial crisis of 1998 showed, it was not attained securely, and it took considerably longer to achieve (Pinar Bedirhanoglu 2004; Vladimir Mau 2003:89).

Table: 1.2 Indicators of Russia's Macroeconomic Performance, 1991-2000

Item/Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
GDP Growth (%)	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.9	-4.9	5.4	9.0	5.0
Inflation (% Dec to Dec)	160.4	2509	839.9	215.1	131.3	21.8	11.0	84.4	36.5	20.2	18.6
Governm-ent Balance (consolida-ted budget, % of GDP)	n.a	n.a	-4.7	-9.4	-5.7	-8.9	-8.8	-4.5	-1.0	-2.8	2.9
Unemplo-yment (% of labour force)	n.a	5.2	5.9	8.1	9.5	10.4	11.8	13.2	12.6	9.8	8.9

Source: *Goskomstat* (various issues).

In December 1992 Yeltsin appointed Victor Chernomyrdin as the Prime Minister in place of Yegor Gaidar. Chernomyrdin declared tougher credit and monetary policies to stabilize the exchange rate of the ruble. At the end of 1994, Yeltsin faced a choice of paths and mechanisms for consolidating power and stabilizing socioeconomic processes in the country. The inflationary policy of spring and summer 1994 led to a sharp deterioration in basic macroeconomic indicators which led to a sudden drop in living standards (Vladimir Mau, *et al.* 2003:159-160; Pinar Bedirhanoglu 2004).

The Russian government increased real interest rates and made credits scarce for the loss making enterprises and introduced a ruble corridor in 1995. The promotion of short term state securities (GKO) with positive real interest rates to Russian financial capital after 1994 were ensured to prevent banking sector's engagement in inflationary practices. These policies finally drove inflation down to 0-5% from mid 1995 to mid 1997 (Pinar Bedirhanoglu 2004).

Macroeconomic stabilization was achieved mainly by the contraction of aggregate demand for commodities, which led to a reduction of production and of state budget revenues accompanied by a rapid decline in the income of majority of population. In 1995 the Government pursued an anti-inflationary policy of reducing aggregate demand by means of contraction of the money supply and reduction of state spending. Inflation was reduced by means of putting the economy into an unstable equilibrium state, characterized by its dollarization, drawing of the money supply into the state debt pyramid, substitution of imported goods for most of the market, bankruptcy of half of the goods-producing enterprises, and the shutdown of production in most sectors of manufacturing (Sergie Glazyev 1999:49).

Late in 1995, market of labor force, land estate, as well as competition among producers had begun despite slow pace of respective legislating, and political bickering. Russian currency had become more stable, and production downfall ceased. Export earnings of Russia exceeded the value of imports. Modest improvement in living standards had been reached in 1996 (Andrei Shleifer 2005).

In 1997, an illusion of macroeconomic stability had appeared. Inflation was substantially reduced, there were slight improvements in the real sector, the exchange rate was stable, and small gains were made in real incomes and consumption. The collapse of this "bubble economy" in 1998 was inevitable as the economic stabilization was narrowly conceived and superficially implemented. Instead of structural reforms and fiscal adjustment, the government chose foreign borrowing and propped up exchange rate (Yevgeny Gavrilenkov 2001).

Russia's GNP had fallen in the first quarter of 1998 by 0.5%. As oil prices collapsed in 1997-98, the federal budget and the financial turmoil that started in East Asia spread to Russia. The ruble lost over 70 % of its value, and banks defaulted on their debts and forward currency contracts. The third largest at that time "Incombank", once held to be a leader of Russian banking system to emerge outside former state structures of the USSR, had gone bankrupt in 1998. Up to 20% of food had to be imported in 1998 (Zafar Imam and N.V Romanovsky 2002).

Due to the turbulent economic condition, Yeltsin replaced Viktor Chernomyrdin as the Prime Minister. There was a government led by Primakov from September 1998 to May 1999. The central government resorted to massive debt finance of its deficits. The crisis led to a debt default and a sharp depreciation of the ruble[40]. However, it also led to a rapid economic recovery. Yeltsin found a successor in Vladimir Putin whom he appointed as the Prime Minister in 1999.

Economic Reform in various Sectors

Agricultural Policy

The privatization of agriculture was carried out in a sui-generis fashion. Three state committees were involved in this field: The State Land Committee became responsible for all land privatization; the Ministry of Agriculture was in charge of the privatization of all non-land assets; and finally, the State Management of State Property was responsible for preparing legal documents as well as for privatizing the upstream and downstream industries connected with agriculture (Nicolas Spulber 2003:317).

The presidential decree "On the Regulation of Land Relations and the Development of Agrarian Reform in Russia", guaranteed the inviolability and protection of the private ownership of land, as well as the protection of landowner's rights during land transactions. Yet this decree did not contain any radical new measures in the field of land reform. Furthermore, it preserved and strengthened the collective farm and the state farm system of agricultural production (CDSP October 20 1993).

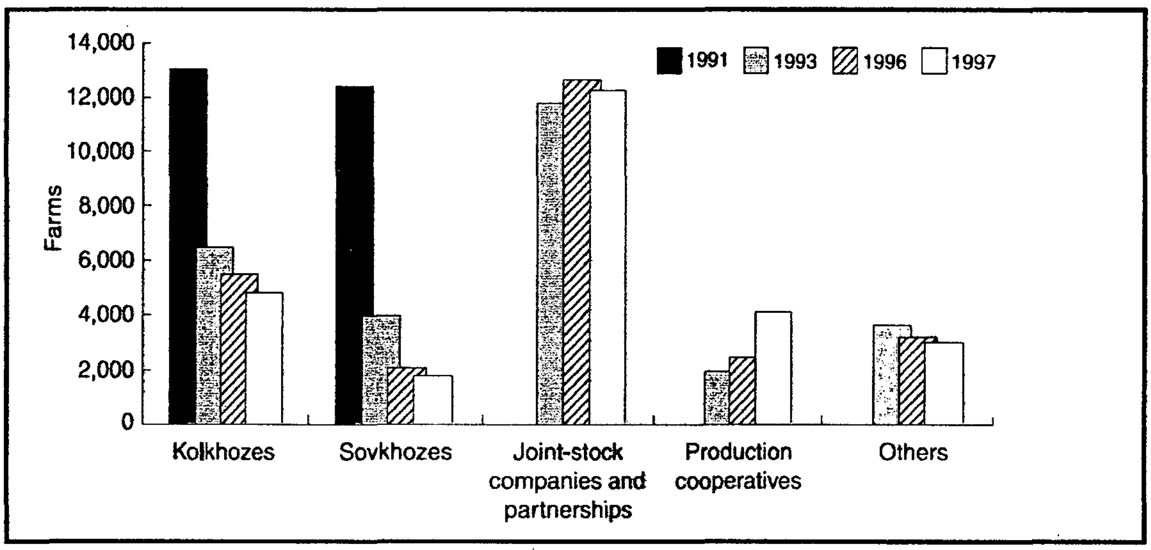
During the first stage of this process, from 1991 to 1993, the legislation concentrated on establishing procedures for determining land and non-land entitlements. During the

[40] Data from the State Statistics Committee of Russia show that the population's real monetary income fell by approximately 43% in the period 1992-1996. Real wages fell by 52%, pensions by 45%.

second stage, from 1994 to 1996, the emphasis shifted to ensuring that the holders of entitlements knew their rights and were able to dispose of them properly. For the move toward de-collectivization, the government sought to stop the "spontaneous" *nomenklatura* privatization, curb the interferences and unnecessary administrative controls, and create rapidly a new class of property owners in this sector. The workers and managers of the collectives were given rights to acquire under preferential terms, substantial parts of the assets of the privatized collectives (Nicolas Spulber 2003).

The government aimed to create an appropriate competitive environment for these changes like, increase its budgetary revenues, and encourage a large flow of foreign investments in this field. The process, started in 1992 on the basis of the Law on Privatization of 1991, focused accordingly on the rapid denationalization and transfer of land and non-land assets to the collectives of workers as well as to pensioners and social workers attached to this sector. The legislation also allowed that non-land assets to be given to the farms' members who chose to establish their own individual farms (ibid: 317).

Figure 1.1: Number of large farms of various forms, 1991–1997 (year-end data).



Source: Data from *Goskomstat* (various years)

The 1993 constitution legalized the private ownership of land and the 1994 Civil Code defined the legal forms of the agricultural enterprises and the procedures for exercising ownership. By the end of 1993, about 95% of large-scale farms registered in the new legal farms-mainly as joint stock farms- and only a few broke up into separate successor enterprises (Figure 1.1). By 1997 a vast majority of large scale agricultural enterprises registered under a new form. They were converted mainly into production cooperatives but changed little in terms of structure, management, and techniques. By 1999 about 27,000 large scale agricultural enterprises controlled 80.4% of the agricultural land and 16 million family household plot owners disposed off less than 5% of the land (Nicolas Spulber 2003).

The decentralization of agricultural policy and of central management allowed regional governments to tailor farm support measures according to their priorities which led to unequal development of the private farming sector throughout the country. The lack of competition in handling, processing, and trading of agricultural products continued to dominate the agro food market. The process of transition was affected by increasing regional disparities in levels of development and poverty and in income patterns (ibid) (Appendix VI).

The state procurement system that established delivery targets and allocated products to the downstream enterprises was officially dismantled at the beginning of the privatization process. But remnants of the old system persisted in the form of so-called food stocks. These stocks purchased at administratively set prices for national reserve and the military, have been run and financed by regional administrators and accordingly have varied throughout the Federation (Nicolas Spulber 2003).

The general process of transition was carried under the aegis of the state without the pressures from the peasantry. Yet, the state failed to encourage numerous farm members to create private farms. The state also failed to use the land more effectively or make more agricultural enterprises fully productive, and has lacked the capacity to create a market environment with effective market channels (ibid: 319).

Industrial Policy

In industry the primary objective of Yeltsin's government was to operate a vast transformation of ownership and thereby remove the state's controls. The subsequent privatization through auctions in the mid-1990s opened the way to big venture capitalists and at the same time weakened the protection of the shareholders and creditors, manipulation of debt offsets and diversion of cash flows and assets to related corporations (Nicolas Spulber 2003:319).

The decree on "On Certain Measures to Provide for State Management of the Economy" in 1994 introduced a system of maintaining performance discipline, a system whereby enterprise directors were responsible to the government not as ordinary hired employees but as persons who have concluded a contract in accordance with civil legislation (CDSP July 13 1994).

The privatization of 1993-94 involved a relatively small redistribution of control to outsiders. The second scheme of "share of loans" implemented from 1995 onwards took place as many of the key resource companies fell into the hands of a small group of financiers, popularly known as "oligarchs". This led to a very sharp increase in wealth and income in few hands and to widespread poverty throughout the country and helped to generate an investment climate marked by corruption and nontransparent business practices. Between 1992 and 1998, the process of privatization affected a total of 25,257 enterprises, most of which were denationalized in 1993-94. Privatization had the greatest effect on the light and the food industries as well as the metal working industries (Nicolas Spulber 2003:320).

Lower government spending and an influx of foreign goods sapped demand for domestic output. Faced with radically changed price structure that raised input costs, many enterprises quickly became insolvent. Severed trade ties with suppliers in the former Soviet bloc and mafia interference with deliveries also interrupted production (Marshall Pomer 2001).

The oil and gas industries were broken down into a number of privatized units, forming a group of giant firms. The government kept important shares of all these companies in its hands. The oil[41] and gas industry became legendary for schemes to launder oil money and manipulate sale prices to move profits into offshore banks and away from shareholders and government authorities (Nicolas Spulber 2003:321).

[41] The major oil companies in operation are Lukoil, Iukos, Surgutneftgaz, Tafneft and Sibneft. Lukoil has been one of the largest vertically integrated companies in Russia (Nicolas Spulber 2003:321).

Table 1.3: Change of Production Index in different branches of Industry (in % to the preceding year)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Whole Industry	-8	-18	-14	-21	-3	-4	2	-5	8	9
Electricity	0,3	-5	-5	-9	-3	-2	-2	-2	0,2	1,8
Fuel	-6	-7	-12	-10	-0,8	-1	0,3	-2	2	5
Ferrous Metal	-7	-16	-17	-17	10	-2	1	-8	14	16,4
Non-Ferrous Metal	-9	-25	-86	-9	3	-4	6	-5	9	11,6
Chemical & Petrochemical	-6	-22	-21	-24	8	-7	4	-7	21	16,1
Machine Building	-10	-15	-16	-31	-9	-5	4	-7	14	16,6
Wood Industry	-9	-15	-19	-30	-0.7	-17	0,9	-0,4	17	11,1
Construction Material	-2	-20	-16	-27	-8	-17	-4	-6	8	7,7
Light	-9	-30	-23	-46	-30	-22	-2	-11	-20	23,4
Food	-9	-16	-9	-17	-8	-4	-0.8	-2,8	7,4	

Source: *Rossiski statisticheski ezhegodnik, M.,* 1999, 2000. *Obzor ekonomicheskoi politiki v Rossii za 2000 god. M., 2000,* pp.492-493.

There was unprecedented production fall in virtually all the branches of industry (Table 1.3). Steel production was down by half within five years and internal consumption of steel fell four-fold. Defence industries had reduced output between 1992 and 1996 three times. Military output production for Russia's GNP was no more than 5 to 8%. Production of consumer goods had suffered a serious setback from acute inflow of cheap merchandise, largely imported by business 'shuttle trips' to neighboring countries (Zafar Imam and N.V Romanovsky 2002).

Commercial Policy

Between 1992 and 1998, during the process of privatization, 43,165 retail stores and 9,922 public catering institutions were transferred to the private sector. In foreign trade, Russia's leadership made significant efforts to integrate the country into the world markets, particularly from 1995 on. Driven by the depreciation of the ruble, inflation rose sharply in 1998 and 1999, severely impacting the country's trade relations. Russia's exports rose between 1992 and 1996 from $53.6 billion to $88.4 billion, stayed at the same level in 1997, and then fell to $73.9 billion in 1998 and to $72 billion in 1999. Imports grew from $43 billion in 1992 to $73.6 billion in 1997, and then fell to $59.5 billion in 1998 and $45.3 billion in 1999 (Nicolas Spulber 2003).

The flight of dollars caused the exchange rate to plummet, generating further inflation as the ruble price of imports escalated. Moreover, with monopoly positions to exploit, enterprises favoured price increases over output increases. By the end of 1992, one ruble was worth less than one twenty-fifth of its value at the start of the year (ibid).

Financial Policy

The very high levels of inflation that plagued the country between 1992 and 1994 were fuelled by the enormous increase in the volume of credits provided by the Central Bank. These credits were to cover the continuous federal government budget deficits fuelled in turn by the support provided to most of the country's enterprises. The government replaced the monetary financing of the deficit with non inflationary borrowing at home and abroad. The government financed much of the deficit by issuing short-maturity treasury bills, GKOs, OFZs etc. As a result of further sharp increases in government spending, the market value of GKOs and OFZs increased steadily, drawing in foreign investors, who by 1997 held in their hands one-third of the issues (Nicolas Spulber 2003).

The Asian crisis in July 1997, which affected all the emerging markets, had a disastrous impact on the Russian Federation, prompting a broad flight of investors and increasing the government's difficulties in attracting buyers for the roughly $1 billion U.S. By August, the crisis became unmanageable. The payment system became largely frozen, imports declined and a major recession started to unfold. To deal with the crisis, the government decided in October 1998 to develop more effective industrial and trade measures concerning notably restructuring failing enterprises, relying on a less liberal foreign exchange regime, and adopting fundamental reforms in social protection (ibid).

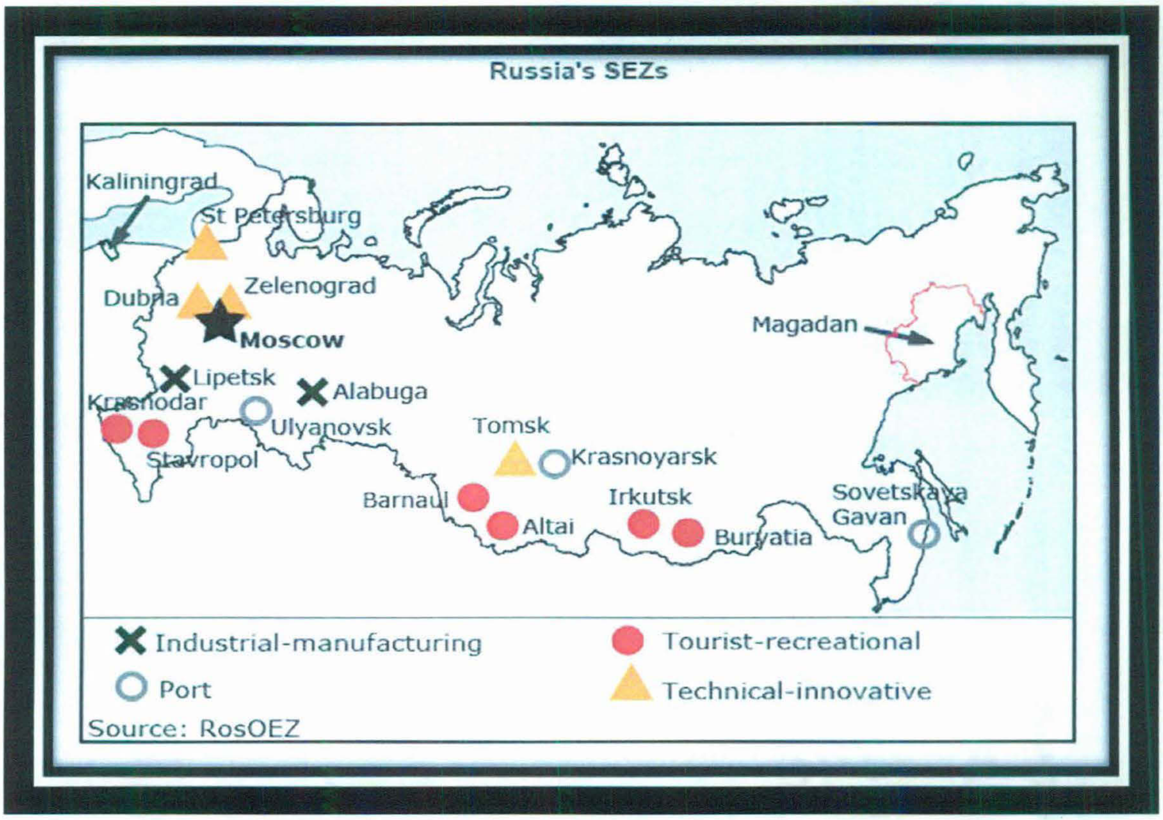
However, Russia's debt situation remained, according to the World Bank, critical, and its credit-worthiness only marginal. Yet, to avoid a further decline, the IMF, in coordination with the European Bank of Reconstruction and Development and the European Union, launched an intensive international effort to support an immediate Russian plan for solving the banking crisis, for restructuring Russia's finances, and for coping with the most pressing reforms, in particular those of pensions, health, and education. The International Monetary Fund, granted $6.8 billion aid to Russia in April 1995, and an additional $10.1 billion in April 1996. IMF lent Russia $13.5 billion from 1992-96 following Russia's commitment to democracy and capitalism (ibid).

Special Economic Zones

Russia's first attempt at making SEZs work on its territory dated back to the final years of the Soviet era. Between 1989 and 2000 a total of 18 free economic zones - as these first-generation SEZs were called - were set up with the primary objective of stimulating the economic development of depressed or border regions. To that end, companies entering these zones were given material tax breaks as well as generous customs and other advantages. However, the zones not only failed to generate any significant new investment but were also a major drag on the federal budget (Jan Cleave and Christopher Granville 2009).

All manner of opaque deals were negotiated between the federal government and regional authorities intent on having zones on their territory. The local governments used the zones as a means to lay their hands on significant federal funds without making any commitment of their own. This procedure was the excessively liberal - and frequently arbitrarily applied and was not based on competition. Acknowledging the failure of its first SEZ experiment, the government disbanded all the first-generation SEZs by 2005, with the exception of Kaliningrad and the Far Eastern region of Magadan (see Map-II) (ibid).

Map-II: SEZ showing Kaliningrad and Magadan-the first SEZs of Russia



Source: *RosOEZ.*

Life Expectancy and Human Development

During the transition period in Russia, reforms resulted in marginalization of the population that could not participate robustly in public life. In addition to the traditionally marginal groups such as homeless people or prisoners, marginalized unemployed workers and illegal labor migrants became more common. Throughout the two decades of transition, people living in poverty multiplied and began exhibiting behavior that contributed to higher mortality risks. Growing marginalization led to increase in mortality, primarily through alcoholism, smoking, improper nutrition, avoidance of healthcare, and psychological stress that affected many Russians during the reform experience (UN Report 2008:26-28).

Russia's population peaked at 148.5 million in early 1993 and has since declined to 142 million in 2007 according to the Federal State Statistics Service. Through transition from 1985, life expectancy decreased more in 1985-2003, by 4.1 years in men and 1.6 years in women, than in 1965-1984, where the decline was by 2.6 and 0.4 years respectively (ibid: 13).

Table: 1.4 Consumption and Mortality Rate

	1990	1997
Kilo Calorie consumed by person	3000	2000
Birth rate per thousand	13,4	8,6
Death rate per thousand	11,2	13,8

Source: *Statisticheski Ezhegodnik, 1999.*

Fall in consumption led to subsistence level, which resulted in growing rate of death, falling rate of birth and decline in life expectancy. As a result, Russia has been witnessing unprecedented depopulation process (Table 1.4).

Critical Appraisal of Yeltsin's Reforms

The reform strategy had many positive after-effects, when compared to Soviet time practices and entrenched stereotypes in economy. Prices slowly came to be determined by costs of production and consumer demand. Quality and workmanship began to regain their roles. Presence of foreign manufacturers was felt inside Russia positively. Some leeway for individual initiatives in economic fields was allowed (Zafar Imam and N.V. Romanovsky 2002).

The official data shows that in 1998 Russian GDP was 57% of its level in 1990 (Table 1.5). The drop in production spreads over all sectors with the exception of finance and credit. It was especially deep in construction, industry, and transport and communications. In terms of the components of final demand, the largest reduction was registered in investment in 1998 which was only one-fifth of its 1990 level.

As Russia's population in 1998 had not changed from the beginning of the decade, so its GDP per capita fell in proportion to the decrease in output. For the first time since the thirties Russia faced significant unemployment. The number of officially registered unemployed reached its maximum in 1996, and fell significantly in 1997 and 1998. The real average wages in the first half of the nineties dropped by more than 50%. In 1996-1997 and in the first half of 1998 it recovered slowly, but following the economic collapse in August, 1998, wages fell again to give a year-long average of 49% of their level in 1990 (Table 1.5).

Table: 1.5 Socio-Economic Development in Russia in the 1990s (1990=100)

	1990	1992	1995	1996	1997	1998
GDP	100	81	62	60	60	57
-Agriculture	100	88	68	65	66	58
-Industry	100	77	51	49	50	47
-Construction	100	59	40	34	32	29
-Transport and Communications	100	79	52	49	48	46
-Trade	100	93	86	87	92	90
-Finance & Credit	100	123	148	146	158	145
-Other	100	86	70			
GDP per capita	100	81	63	60	60	57
Gross Domestic Investment	100	51	31	25	24	22
Employment	100	96	88	88	86	84
-Agriculture	100	104	100	95	89	90
-Industry	100	93	75	72	65	62
-Construction	100	87	69	65	63	56
-Transport and Communications	100	97	90	90	88	83
-Trade	100	97	114	116	148	158
-Finance and Credit	100	123	204	199	194	183
-Other	100	96	95	100	96	96
Average wage*	100	64	45	51	53	49
Unemployment (%) official	......	0.8	2.8	3.5	3.1	2.6

*wage due

Sources: National Accounts of Russia in 1991-1998, p.15; Russian Economic Trends. Monthly Update, 7 October 1999, table 5; The Commonwealth of Independent States in 1998, pp.429-430; Socio-Economic Situation in Russia, January - December 1997, p.7; Review of Russian Economy, III, 1997, pp.109-110; II, 1998, p.35; Russian Economic Trends, I, 1997, p.124; Statistical Handbook 1996. States of the Former USSR, pp.380, 383,385-387 and table 9.

Voices demanding to review the gains of privatization argue that it was promoted for the well being of a small group with numerous violations of the then legislation. As a result, too many privatized units did not belong to socially conscious and effective owners. Moreover, the former administrative bodies were privatized and transformed into companies without due controls of the state or public (Zafar Imam and N.V. Romanovsky 2002).

The 1990s had been economically devastating. Real GDP kept decreasing continually; GDP per capita fell from 26,700 rubles in 1991 to 16,400 in 1998 (Appendix V). The population below the minimum subsistence level amounted to 35 million by 1998. The capitalism that emerged under Yeltsin has been, according to the remark of Gaidar, *"repulsive, ghastly, thievish and socially unjust"*. In the absence of an appropriate legal framework to smoothly monitor the operating market conditions, there existed the problem of widespread criminalization (Nicolas Spulber 2003).

Yeltsin's dilemma lay in the fact that to bury the Soviet communism, he needed to destroy the mechanisms of state control. His speech introducing the privatization programme, given on August 19, 1992: *"...Under no circumstances, Russia simply cannot stand another Communist era. We must persistently continue the transformation and push ahead with the reforms."* But a democracy and market economy itself needed institutions which could not be instantaneously built. Yeltsin's policies were a balancing act between the twin goals of destroying old institutions and creating new ones. This balancing act involved many missteps, compromises and reversals (Andrei Shleifer 2005).

Even before Yeltsin's liberalization, Gorbachev's partial economic reforms created a mixture of plan and market that led to severe shortages. The inability of the law and order institutions to keep up with economic change allowed the mafia and other private enforcers of contracts to perpetuate. The liberalization of economic life alongside the weakness of nascent tax and regulatory institutions led to an explosion of the unofficial economy. The regions and ethnic republics of the Russian Federation pursued their own economic and fiscal policies, aiming largely to increase transfers from the centre (ibid).

There was deepening of the political struggle between the old Soviet power setup and the new president. Yeltsin was unable to seize full control of the institutional framework and had to rely on the intriguing delegates to the Federation Council against the hostile Duma. The parliament, the Communist Party and the entrenched industrial interests resisted almost every measure and even the government could not develop an internal consensus. Politics delayed Russia's reforms and rendered them haphazard and incomplete. By the turn of the century, Russia was a highly imperfect democracy and a highly imperfect market economy but Soviet communism was dead in Russia (ibid: 5).

Yeltsin's period had witnessed an unprecedented decline in Russia's economy. Initially caused by accumulated failures of the Soviet system, it was aggravated by after-effects of the USSR collapse, as well as of shortsighted and haphazard policies of Yeltsin and his governments throughout the period of post-1991 reforms. During Yeltsin rule, Russia GNP was reduced to about a half of 1989 level, machine building production dropped by 55% and agricultural output by 43%. This entire decline caused considerable deterioration of living standards of population. Russia's per capita GNP was about 30% of world averages. Purchasing power of ruble/dollar fell in Russia between 1991 and 1999, 100 and 150 times (Zafar Imam and N.V. Romanovsky 2002).

The government's attempts to control the march toward a free market economy remained in many respects clumsy and ineffective. Russia after Gorbachev's accession was essentially motivated by a massive drive to overcome legacies of what had been termed, "Iron curtain", a self imposed isolation from much of the world. There had developed in Russia an entire range of methods, issues and processes that had been labeled as "shady"[42]. The term "shady" had come to denote all official economic doings, including criminal activities. The share of "shadow" economy in Russia's GNP was up to 20% towards the end of the nineties (ibid).

Several years of inflation, privatizations, declines in output, and unending economic and social crises followed, providing unparalleled opportunities for "mafiasization", theft and widespread corruption. In these conditions the Soviet economy moved not toward free markets, but in many respects toward a manipulated non-cash economy, in which barter became the key in the transitions among enterprises and an instrument

[42] The term "shady" had come to denote all official economic doings, including criminal activities. According to an official estimate, 40% of the total money in Russia was turned over into the shadow economy by 1999.

for avoiding tax payments, subduing small businesses, and obstructing the interests and needs of the consumer (Nicolas Spulber 2003).

According to one of the great moguls of Yeltsin's Russia, Boris Berezovsky, *"by 1996, the real economic power was in the hands of seven top bankers and businesspeople who controlled half of the economy and whose economic power enabled them to even influence the government policies."* The seven in question were all of a group that had financed Yeltsin's presidential campaign in 1996: Vladimir Potanin, of Un-Exim Bank ; Mikhail Khodorowsky, founder of Menatep; Vladimir Vinogradov, founder and chief executive of Inkombank; Vladimir Gusinsky, of Most Group; Mikhail Friedman, president of Alfa Group; Vagit Alekperov, president of Lukoil; and Rem Vyakhirev, chairman of Gazprom (ibid).

Western loans including the International Monetary Fund, the World Bank, the European Bank for Reconstruction and Development and the Group of Seven (G7), extended crucial aid to Russia on its difficult transition to the market. However, the West shut its eyes to the realities of the Russian problems and supported an overvalued ruble that was destructive to industry and spurred massive capital flight (ibid).

Thus, Russia was saddled with an oppressive foreign debt burden. Western aid enticed Russia into adopting ill-conceived, pro-Western policies. Jeffrey Sachs (1994) dismissed criticism of radical reforms as *"politically motivated rather than analytically sound."* (Marshall Pomer 2001) Joseph Stiglitz[43] attacked IMF policy on Russia arguing that the Washington model did not work there.

As said by Grigory Yavlinsky, the trouble was that when the socialist state collapsed, it was not replaced in time *"by a developed institutional framework for a market economy"*. Rather, added Yavlinsky, the managers of the new privately owned enterprises were neither ready nor willing to change their old behavioral patterns to fit into a new economic environment. They continued to trade in barter and to set up small enterprises parallel to their "privatized" center. The 1994 estimates indicate that

[43] *Globalization and its Discontents,* Joseph Stiglitz (2002).

the outflow of monetary resources from the production sphere into the exchange sphere through the commercial banking system was equal to approximately 14% of GDP (Nicolas Spulber 2003).

As said by Yeltsin,

> "The tragedy of Russia in the 20th century consists largely in the fact that, despite many attempts, it has not succeeded in carrying a single reform through completion. Not so much because of resistance from reactionaries as because of the weakness of reformist forces and their destructive struggle among themselves. The main factor is that society has been lacking in the elementary patience needed to achieve result." (Rossiiskaya gazeta December 2 1992)[44].

Neither Gorbachev nor Yeltsin followed a realistic transition programme. Gorbachev delayed action on reforming the price system and badly mismanaged government finances. He disempowered institutions that curbed corruption and malfeasance. Yeltsin ignored the macroeconomic problem of maintaining demand for Russian output. Investment collapsed while transfer of control over natural resources sapped government revenues and entrenched unscrupulous elite. Both Gorbachev and Yeltsin gave undue priority to speed, in one case "acceleration" and in other "shock therapy". They did not proceed in a pragmatic and measured fashion. More ideological than realistic, they brought an end to the system of centralized control without providing a viable mix of market and government (Marshall Pomer 2001:15).

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[44] Yeltsin's speech at the Seventh Congress of Russian People's Deputies.

Chapter 3

Economic Reforms in China under Deng Xiaoping

Chapter 3

ECONOMIC REFORMS IN CHINA UNDER DENG XIAOPING

"There is no fundamental contradiction between socialism and a market economy...the overriding task in China today is to throw ourselves heart and soul into the modernization drive. While giving play to the advantages inherent in socialism, we are also employing some capitalist methods—but only as methods of accelerating the growth of the productive forces. It is true that some negative things have appeared in the process, but what is more important is the gratifying progress we have been able to achieve by initiating these reforms and following this road. China has no alternative but to follow this road." (Deng Xiaoping 1985)

Since the late 1970s, China underwent a series of transitions unparalleled in both pace and magnitude. The economy has progressively moved away from central planning arrangement to a market-based one, and from a relatively closed system to one that has integrated into the world economy. The transitional process has been remarkably smooth and outstandingly successful when accessed by the social and economic indicators. During the period of 1979 to 1997, real GDP in China grew at an average rate of 10% per annum. During this period productivity growth accelerated, and output and trade climbed up. Real income per capita in China has increased four times from 1979 and 1996. Since the late 1970s, inflation in China has been kept under control. The Asian Financial Crisis that broke out in 1997 had only slight impact on the performance of the Chinese economy (Wei Ge 1999:1-2).

There were various reasons due to which the Chinese authority felt the need of initiating economic reforms. The Cultural Revolution taught the Chinese leadership the important lesson that economic development is the key to maintaining its power. The proposition of economic development became even more compelling after the 1989 Tiananmen Square incident, because it was the only source from which the government would gain its legitimacy. The fast economic development of Japan and the "Four Little Tigers" of Hong Kong, Taiwan, Singapore, and South Korea also inspired China to go for economic development. At the same time, the political will of the Party for economic reforms was also shaped by the geopolitics. The pressure from the East Asian countries in the early 1990s was growing in the form of "East Asian Miracle" and increased foreign investment from that region. The collapse of Soviet Union in 1991 changed the geopolitics forever. The Party felt that its power would be undermined if the newly democratized countries quickly caught up with China in terms of economic development. Unlike Russia, Chinese reform has never relied on economic advice. China's reform agenda has been shaped by the Chinese themselves. China has witnessed the development of capitalism in the name of building "socialism with Chinese characteristics" (Yingyi Qian and Jinglian Wu 2003:38-41; EPW 2008:5).

The healthy growth over the past two decades has been both a cause and consequence of China's ongoing process of economic reform and system transformation. China has made remarkable progress in reshaping its once highly centralized economic management system. The reform has evened agricultural production and boosted productivity growth in that sector. Extensive reforms have also been carried out in areas of taxation, investment financing, banking, foreign exchange management, trade, wages, prices, social security and welfare systems. China has actively utilized its foreign direct investment (FDI). In 1996, FDI in China was tuned to $42 billion (Wei Ge 1999:2-4).

Economic reforms and opening up were the two factors that put the Chinese economic transition on an irreversible path and brought change and development to its economy and society at large. Instead of implementing the transition in a big-bang, top-down radical manner, which came to be known as Shock Therapy, economic transition in China has proceeded in a step-by-step, evolutionary manner, building on a basis of trial-and-error and pragmatism. There has been full utilization of foreign capital and expansion of international trade in China's opening up process. Since the 1980s, the endeavours in the area of international trade have been remarkable due to the steady inflow of foreign capital, technology, and information (ibid: 4-5).

Chinese economic progress was accompanied with political relaxation but no democratization, and even relaxation was substantially curtailed after 1989. China's superior growth performance partially reflects the advantages China enjoyed from having started the reform process a full ten years earlier than Russia. The Chinese economic process has been resilient and profound and accompanied by accelerated economic growth. China's development is quite broad-based and reflected in substantial sustained improvement of living standards (Attar Chand 1997).

Reform Process under Deng Xiaoping

During the pre-reform period in China, growth in services was neglected. Between 1952 and 1978, services actually declined from 29% of GDP to 24% of GDP in China. The degree of shortage of basic consumer goods was much greater than in the Soviet Union. Employment creation was relatively slow. As most industry was capital-intensive and services were neglected, new labour requirements were modest. Between 1952 and 1978 the total labor force grew by 191 million (from 207 to 398 million). Much of the industrial investment was not only capital-intensive, but also relatively demanding technologically (Barry Naughton 2007:80-81).

After Mao's death the new Chairman Hua Guofeng, embarked on a political coup and arrested the radical Maoist leaders[45], with the backing of old cadres and the indirect support of Deng Xiaoping. Hua proved to be politically incapable and by 1979, Deng effectively took charge of the party and launched the "economic reform". By the mid-1980s, the "reformers" were in firm control of the CPC and state. They began to push for market reforms in the state owned enterprises (Minqi Li 2008:82-83).

During the Third Plenum of the 11th Central Committee of the Chinese Communist Party (CCP), in December 1978[46], the People's Republic of China (PRC) started off with the transition to capitalism under the leadership of Deng Xiaoping. This marked the end of the "Maoist" path of development in China. China's "market reforms" began in agriculture with the process of de-collectivization. In the Third Plenum of the 12th Central Committee of the CCP held in 1984, administered pricing gave way

[45]The so called "Gang of Four" led by Jiang Qing, Mao's wife.

[46]In China and some other East Asian countries with centrally planned economies, the transition began much earlier, although initially with the prime objective of improving rather than abolishing the planned economy (EPW 2008).

to market pricing. The 14th Congress of the CCP in 1992 led to the mass privatization of the state owned enterprises (EPW 2008:5).

The ruling elites were divided into factions as regards to the approach to be applied for transition to market economy. The right wing[47] was led by Zhao Ziyang, the Party's General Secretary and the Prime Minister. This wing was in favour of a Chinese version of Shock Therapy, that is, the full scale liberalization and privatization instantaneously. The "left" wing[48] was led by Chen Yun, who was a veteran communist leader, were in favour of a "socialist planned economy" where the state would control commanding heights (Minqi Li 2008:84).

Through most of this period the key policy-maker was Zhao Ziyang who was the premier from 1980 until 1987. Zhao Ziyang's reform was achieved by establishing new operational mechanisms in accordance with the market economy, while leaving the old structure largely intact (Barry Naughton 2007:91).

The 1989 crackdown of the pro-democracy movement, that is, the Tiananmen Square incident[49], led to adverse domestic and international repercussions for China's economic globalization. The central leadership debated the direction of the reforms, and the conservative elements in the party, especially the ideologues, who were on the ascendancy, openly questioned the ideological implications of economic reform. Nonetheless, the Deng Xiaoping leadership was able to re-legitimize the reform course by pointing to the benefits the country had gained from the initial stages of globalization (Yongnian Zheng 2004:3).

In January 1992, after securing the army's support for "reform and openness", Deng Xiaoping made his famous "southern tour" to mobilize local support for further and

[47]Usually referred to as the "radical reformers" in Western literature.

[48]Usually referred to as the "conservatives" in the Western literature.

[49]The demonstrations in Tiananmen Square (1989), referred to as June Fourth Incident in China have been described as the greatest challenge to the communist state in China since the 1949 revolution. They were called to coincide with a visit to the capital by Soviet leader Mikhail Gorbachev, by students seeking democratic reform. Troops were used to clear the square and hundred to thousands of people were killed in the massacre (BBC June 4 1989).

more radical reform. At the 14th Party Congress held in September 1992 the CPC for the first time endorsed the "socialist market economy[50]" as the goal of reform, which was in the Chinese political context, a euphemism for capitalism. The SETC[51], that is, China's State Economic and Trade Commission, became the top agency in charge of macroeconomic coordination (*hongguan tiaokong*) within the Chinese central government during the 1990s (Minqi Li 2008:85; Joo-Youn Jung 2008:107).

In 1993, the Communist Party's Economic and Finance Leading Group, headed by Party Secretary General Jiang Zemin, worked together with economists to prepare a grand strategy of transition to a market system. The outcome was the "Decision on Issues Concerning the Establishment of a Socialist Market Economic Structure" adopted by the Third Plenum of the 14th Party Congress in November 1993. The November 1993 decision marked the beginning of a new direction of economic reform. First, the decision called for building of market-supporting institutions, such as formal fiscal federalism, a centralized monetary system, and a social safety net. Second, the decision made the commitment to "property right reform", thereby legitimizing the privatization of the state and collective owned enterprises (Yingyi Qian and Jinglian Wu 2003:36-37).

The ninth five-year economic plan by the Eighth National People's Congress (NPC), adopted on March 5, 1996 contained the guiding principles for the next stage of the country's economic development and industrial readjustment (Maria Weber 1998:75). The 15th Party Congress held in September 1997 made a major change regarding ownership issues. State ownership was relegated to a "pillar of economy" and private ownership was elevated to an "important component of the economy." The 15th Party

[50]The Chinese socialist market economy is different from "market socialism" as advocated by some East European reformers in 1970s and 1980s. In market socialism, the market is a stimulated one, which is to serve the purpose of socialism based on public ownership. In contrast, in a socialist market economy, the word socialist is the adjective, and the goal is market economy (Yingyi Qian and Jinglian Wu 2003).

[51]SETC was dismembered in 2003 and reform-or-regulatory-oriented new agencies were created in its place.

Congress also emphasized on the rule of law[52]. Both private ownership and the rule of law were formally incorporated into the Chinese constitution in March 1999. An amendment of Article 11 of the constitution placed private businesses on an equal footing with the public sector by changing the original clause (Yingyi Qian and Jinglian Wu 2003:37).

Gradual Reforms

Gradualism in China has not been much the result of a particular theory of reform, as it is the result of political deadlock and compromises within the CCP between the conservative reformers and the liberal reformers, and a general lack of consensus in the society at large. The conservative reformers enunciated Chen Yun's[53] doctrine of a "bird cage economy": the central plan is the cage and the bird is the economy. The premise was that without central planning, production would be in chaos; that is, without the cage, the bird would fly away. The amount of market activity that was to be tolerated to keep the economy working was analogous to the amount that the cage needed to be swung to create the illusion of greater space that was required to keep the bird happy (Wing Thye Woo 1999:8).

On the other hand, the liberal reformers rejected the bird-cage ideal as a bird-brain idea because they recognized that the capitalist market economies had been more successful than the socialist planned economies. The East Asian developmental experience convinced the liberal reformers that only a market economy that was open to the outside world could promote long-term economic development (ibid: 9).

Due to these basic differences in economic strategy, partial reform was the compromise solution as both conservative reformers and liberal reformers were able to implement part of their programmes. This repeated factional struggle and compromise is the primary reason why the CCP has continually altered its stated goals for economic reform (ibid: 9).

[52]Chinese leadership gave priority to the rule of law rather than democracy. The rule of law is a cornerstone of a modern market democracy but does not directly and instantaneously threaten the governing power of the party.

[53]Chen Yun was one of the most influential leaders of the People's Republic of China and one of the top leaders of the Chinese Communist Party.

When China's reformers faced serious macroeconomic imbalances in 1979–1981, they used the institutions of the planned economy to cut back investment and relieve pressure on the economy. Rather than combining stabilization and reform into a single episode—as in a "big bang" transition—the Chinese used the instruments of the planned economy to shift resources toward the household sector and relieve macroeconomic stresses at the very beginning of reform. This strategy created favourable conditions for the gradual developments of the markets. Inflationary pressures were vented off as supplies grew, rather than being resolved in a quick transition from suppressed to open inflation (Barry Naughton 2007: 96).

Stages of Economic Transformation in China

China's transition[54] to capitalism comprises of the following points:

(1) the gradual receding of the state control over the economy, a process that brought about a shift in economic control without privatization; (2) the steady growth of foreign investment; and (3) the gradual emergence of a rational-legal system to support these economic changes (Doug Guthrie 2008:39-40).

Once Deng wrested power from the conservative factions of the party, his tasks included:

- Transforming incentives in the agricultural economy.
- Forcing the central government to give local bureaucrats some measure of economic control over the localities they govern.
- Creating a system that kept in place the planned economy while at the same time giving autonomy over the local enterprises.
- Beginning a process that would address the economic burden that the social security system posed for Chinese enterprises.
- Facilitating the development of a private economy.
- Attracting foreign direct investment (ibid: 41-42).

[54] *Gaizhi*, a Chinese term meaning "transforming the system," has become a major phenomenon in most parts of China.

Phase I (1978-83): This phase gave emphasis to agriculture. Procurement prices for major crops and prices for above-quota output were raised sharply. Subsidies were increased to help cushion the impact on consumers. The contracting of land and output quotas to rural households proceeded rapidly on local initiative. This "bottom up" experiment was officially sanctioned in 1981. Household contracting soon became universal and lease terms lengthened, promoting long-term investments (Alan Gelb, *et al.* 1993:5).

The first stage saw the emergence of markets. Markets for consumer goods began to emerge on a sporadic basis but played a very limited role in the overall economy. The government interference in economic activity was still very pronounced, and non-market institutions and relations retained an upper hand (Shaoguang Wang 2008:52).

The first industrial reforms came in the area of foreign investment. In 1979 a Joint Venture Law was passed and in 1980 four special economic zones were opened up. Foreign direct investment rose to exceed $3 billion per year, mostly from Hong Kong. Phase I also saw the start of wide ranging changes in the distribution systems that proceeded throughout the reform period. Material supply was progressively de-linked from the plan, while retail commerce was deregulated more rapidly. After some informal sale of above-quota industrial goods at premium prices, state enterprises were allowed to buy and sell in free markets. Meanwhile, certain key inputs remained controlled, particularly in rural areas (Alan Gelb, *et al.* 1993:5).

Phase II (1984-88): The second stage witnessed the emergence of market systems. At this stage labour market, capital market, foreign exchange market and land market emerged. Though market principles such as exchange, the law of demand and supply, and competition began to work, yet they did not make a big foray into the non-economic areas (Shaoguang Wang 2008:52).

This stage saw the consolidation of a formal “dual pricing” system and the progressive enlargement of the role of free prices. The dual pricing system aimed at setting marginal decisions through market pressures while leaving a measure of control over material and enterprise profitability to the plan. By 1988 only 30% of retail sales were made at plan prices. Market prices exceeded plan prices by a premium which rose steadily up to 42% as macroeconomic demand pressures intensified in the course of decentralization. By 1985 75% of state commercial companies had been sold or leased to private owners; by 1990 hordes of private and cooperative firms, as well as joint ventures, had entered the commercial system. At the same time, the Yuan was devalued and a variety of other measures was introduced with the intention of opening up international trade to market forces on a limited basis (Alan Gelb, *et al.* 1993:5-6).

Phase II saw two important reforms in the area of industrial property rights. Rural Township and Village Enterprises (TVEs) actually had their roots in earlier programme of rural industrialization, but in 1984 local governments were given permission to pursue a TVE-based development strategy to help absorb labour released by the agricultural reforms. Together with growth of urban collectives, the explosion of TVE activity resulted in progressive diversification of industrial ownership away from the SOEs in favor of the so-called "non-state" sector, although most of this was still within the public domain. The second major industrial reform in Phase II was the adoption after 1987 of the contract management responsibility system. Performance contracts with enterprise managers specified profit remittance, productivity and sometimes innovation targets. To increase the range of management discretion, all new workers after 1986 were to be hired on a contract system (ibid).

Phase II saw important series of reforms to decentralize[55] resource allocation away from government. These included reform of enterprise taxation in 1984-85, which replaced remittances by negotiated profits taxes. In 1986, central government entered into a "fiscal contract responsibility system" with local governments, which had in fact long been responsible for the collection of almost all taxes. Finally, initial steps were taken in Phase II to lay the basis for a commercial financial system but this was limited by the partial nature of other reforms, in particular, of ownership. Development of stock markets on a limited basis, did not take place until some years later (ibid: 6-7).

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[55]Decentralizing management and progressively introducing market forces made little sense in an environment where all industrial profits were remitted to the state (Alan Gelb, Gary Jefferson and Inderjit Singh 1993).

Phase III (1989-90): Macroeconomic stabilization and the political crackdown following Tiananmen Square involved the temporary re-imposition of a range of direct controls. Plan prices began to be adjusted towards market levels. Phase III also saw the acceleration of trade and payments reform. Progressive devaluations in Phase I and II had depreciated the real exchange rate relative to the dollar by over 50%. As domestic demand was reined in, exports responded. Foreign exchange trading centers were opened, and the black market premium fell, to a minimum of only 7% in 1991. By then, about one-third of international transactions were taking place at the parallel market rate (ibid: 7).

Phase IV (1991 onwards): This phase marked a return to active reforms with further mercerization[56] and decentralization. There was also significant reduction in surplus labour in the state sector and some privatization of state enterprises. Growth picked up, with some signs of overheating. Social-sector reforms began in areas such as health and housing, though on a cautious and experimental basis (ibid).

In the initial stage while the basic institutional framework of central planning remained intact, the reform was carried out incrementally to improve incentives and to expand the scope of the market for resource allocation. It was a great success as it generated rapid growth, improved people's living standards, and eliminated shortages. During this period, China's GDP grew at an average annual rate of about 9%, or 7.5% on a per capita basis (Yingyi Qian and Jinglian Wu 2003:31-35).

In contrast to Russia the reform process was supported by the population as everybody benefited from it. The non-state sector soon became the engine of growth and industrialization. Accompanying the rise of non-state sector was the development of markets. In the later stage of its reforms China decided to abolish the planning system altogether and set the establishment of a modern market system as the goal of reform (ibid).

[56]This phase included the growth of final markets.

Economic Transformation in China

China began its transition to a market economy almost thirty years ago under an authoritarian and hierarchical political system. The hierarchical political system shaped the process of market transition, and the political hierarchy itself has been restructured in response to the forces unleashed by economic transition (Barry Naughton 2008).

The Chinese refer to their reform program as "*Gai ge kai fang,*" which translates as "change the system, open the door." The whole reform program is often referred to in brief as the "open door policy." This highlights that a key component of Chinese reform has been trade liberalization and opening up to direct foreign investment, but not opening the capital account more generally to portfolio flows (David Dollar 2007).

There was no particular scheme underlying China's sequence of measures. Some were experimental, sanctioned by the center only after successful local implementation. Although the rural reforms had somewhat of a "big bang" character, urban and industrial reforms were gradual and piecemeal (Alan Gelb, *et al.* 1993:4-5).

China's market transition began at the end of 1978 with a wide-ranging reassessment of nearly every aspect of the command economy. It was in the countryside that reforms succeeded first, and it was the dramatic success of rural reforms that cleared the way for continuing more profound changes. The institution of contracting land to households spread rapidly throughout rural China and became nearly universal by the end of 1983. Agricultural production began to surge. Helped along by higher prices and the increased availability of modern inputs such as chemical fertilizer, production climbed rapidly through 1984. By 1984 grain output had surged to 407 million metric tons, more than one third higher than in 1978. The centuries of a China fundamentally short of food were over as well. The number of workers in township and village enterprises (TVEs) that is, the locally run factories, increased rapidly and output from this sector surged as well. Moreover, rural incomes increased rapidly, and reforms gained the support of the bulk of the rural population (Barry Naughton 2007:88-90).

The most characteristic feature of China's initial departure from the planned economy was the "dual-track system". Rather than dismantling the plan, reformers acquiesced to a continuing role for the plan in order to ensure stability and guarantee the attainment of some key government priorities. This two-tiered system stimulated the incentives of the enterprises, as anything that firms produced above the plan could be sold within China's newly emerging markets at a market price. The system also provided valuable flexibility by allowing the state firms to transact and cooperate with non-state and foreign sectors (ibid: 91-92; Dough Gutherie 2008:45-46).

Successful rural reforms reinforced a certain approach to the reform process. Rural reforms had been achieved with little economic or social disruption, largely because of "dual-track system". When farmers contracted for their land, they agreed to turn over a certain amount of grain to the government and the rest was released to the market. Reformers saw in this experience a model of using contracts to stabilize some crucial sectors of the existing economic system while freeing up other sectors. Reformers sought to extend this approach to industrial and commercial reforms. Reform overall was decentralizing, shifting power and resources from the hands of central planners to local actors, while core interests were protected, often through contracts. By 1993, though, this particular pattern of reform had largely run its course. The market sphere had expanded sufficiently that the economy had "grown out of the plan" (Barry Naughton 2007: 90).

Reduction of the state's monopoly led to rapid entry of new firms. Entry of new firms combined with adoption of market prices on the margin led to enhanced competition. Competition eroded initially high profit margins for state firms and induced the government, as owner of the firms, to become more concerned with profitability (ibid: 97).

In the later phase Zhu Rongji established himself as the leading voice in policy making in mid 1993. Zhu Rongji's reform was characterized by a rebuilding of the institutional structure to make it appropriate for a market economy. During the Ninth NPC in 1998, Zhu declared that his new administration would accord highest priority to the reform and reorganization of the State Council and its various ministries. Many factors pushed Zhu to initiate radical reforms. It seemed to Zhu that an unwieldy government structure and a slow process of bureaucratic reform were responsible for the lack of SOE[57] reform. Internal and external pressures then demanded a rather radical institutional rebuilding. Internally, with the progress in SOE reform, the numbers of unemployed and "*xia gang*" ("off-post") workers were increasing drastically and posed a serious threat to social stability. Outwardly, the 1997 Asian financial crisis had sent the Chinese leadership a strong signal that without rapid reform of China's SOEs and its financial system, China would not be able to avoid the misfortune that many other Asian countries had experienced. Lastly, bold reforms were needed to create a strong and efficient government (Yongnian Zheng 2004).

The shift in transition strategy around 1992–1993 meant that China's approach to transition became less distinctive than it was previously. There was no longer a polar opposition between "big bang" and "gradualist" transitions. Sachs and Woo (1994), argue that the success of China's early reforms were actually due to the advantages of underdevelopment, which gave China a relatively large, flexible, rural economy that served as seed-bed of reform. The early reforms were successful precisely because they were effectively adapted to the specific challenges and opportunities provided by China's situation at that time. Second-stage reforms were then dramatically recast and adapted to a whole new set of challenges and opportunities (Barry Naughton 2007:107).

Economic Reform in various Sectors

Price Liberalization

Under the command economy, prices in large industrial organizations were controlled by the state. Price reform has followed the course of gradual reform. Government control of pricing began to change officially with general reforms in 1979 and then, more specifically, with the October 1984 Reform Declaration (Doug Guthrie 2008:55).

Price reform started in what is known as the "dual track" mechanisms. The dual track implied a two-tier pricing system for most goods: a single commodity had both a

[57]State Owned Enterprises.

(typically low) state-set planned price and a (typically higher) market price. Prices were freed up to a margin while planned prices were maintained for planned quantities, which were frozen for some time. As a result, true domestic market prices for all goods were established as early as in the mid-1980s (Barry Naughton 2007:92; Yingyi Qian and Jinglian Wu 2003).

Rural Reform

Deng Xiaoping's reforms began with China's rural areas in late 1970s. Initially, agricultural output and rural income increased significantly. But economic growth in rural areas slowed down considerably in the mid-1980s. By the late 1980s and early 1990s, most rural areas were in a state of stagnation and even degeneration (Dale Jiajun Wen 2008:86-87).

Before 1978, most Chinese farmers were organized into collective communes. From 1978 the entire commune system was put through a major overhaul. The first step was the implementation of the family contract system. This system broke up the communes and gave land contracts to individual families. In September 1980, the government undertook de-collectivization of agricultural production. This involved a series of measures to replace the commune-based system with "family based household production system" (ibid).

Other new agrarian policies included abolition of the state monopoly on grain purchase, introduction of market prices for farm produce, and development of rural industry. Alongside these changes in agricultural organization were a series of institutional reforms. A new constitution promulgated in 1982 provided for the abolition of communes, and from 1983 onwards their administrative functions were transferred to township (*zhen*) or village (*xiang*) councils (Norman Flynn, *et al.* 2001:4)

Table: 2.1 Per Capita Annual Total Income and Annual Net Income of Rural Households

Year	1978	1980	1985	1990	1995	2001
Total Income	152	216	547	990	2,338	3,307
Net Income	134	191	398	686	1,578	2,366

Source: The National Bureau of Statistics, China Statistical Yearbook, Beijing: China Statistics Press, various years.

With the commencement of rural reform in 1978, China became self-sufficient with regard to food production within two years. By doubling the incomes of its farmers, rural reforms also had political appeal because they immediately benefited 800 million people. Under the "household-based agricultural system" (Table 2.1) assets once owned by the communes were sold to the farmers at low prices, allowing the new household-based businesses to accumulate the necessary start-up assets at a relatively low cost. Commune land, distributed to individual households, was converted into household land or "family plots" in which farmers were granted "leasehold" on the land and then granted a high degree of autonomy and flexibility in production and sales, as long as certain production quotas owed to the state were met (Lan Cao 2000:28-31).

Under a "contract responsibility system," farmers organized by household units contracted with the state to sell a set quantity of produce at state price, but any surplus generated above the established quota was sold at free market price. Through the introduction of markets "at the margin," which were parallel to the central plan, and the institution of a "dual-track pricing system," gross farm output increased within ten years by 138% (ibid).

The reform immediately resulted in a rapid growth in agricultural production and a sharp rise in rural incomes for the peasants, which they used to finance new enterprises without having to rely on state loans. As agricultural productivity increased, greater agricultural surplus was available for non-farm development. This led to the emergence of non-farm industrial production and corresponding markets in rural and suburban towns and townships. This, in turn, led to the mushrooming of non-state enterprises, most notably, the township and village enterprises (TVEs), which soon became the driving force for China's economic growth (Lan Cao 2000:30; Yongnian Zheng 2004:2).

Among the emerging firms in the new, non-state sector, TVEs have demonstrated one of the most remarkable growth and output rates. Between 1981 and 1990, TVE output grew at an average rate of 29 % per year while exports grew at an average rate of 66% per year (Table 2.2). Within the rural sector, TVEs accounted for three-quarters of rural industrial output, or more than one-quarter of the national total (Lan Cao 2000:31).

Table: 2.2 Number of TVEs and TVEs Employment (thousand unit/thousand people)

Year	**1978**	**1980**	**1985**	**1990**	**1995**	**2000**
Number of TVEs	1,524	1,425	12,225	18,504	22,027	20,847
Number of TVEs employees	28,266	29,997	69,790	92,648	128,621	128,196

Source: The National Bureau of Statistics, China Statistical Yearbook, Beijing: China Statistics Press, various years; the TVE Bureau of the Ministry of Agriculture, Annual Statistical Bulletin and Financial Statements of TVEs Nationwide, 2000.

Industrial Reforms

At the core of China's process of industrial reform has been the reform of thousands of large and medium-size state-owned enterprises (SOEs). At the start of economic reform in the late 1970s, Chinese industry was largely state owned and urban. In 1978, SOEs delivered 78% of industrial output and employed 76% of all industrial workers. Despite its success in expanding industrial production, the pre-reform system's weaknesses, which included limited autonomy for firm managers, strict controls on labour mobility, and weak material incentives, stifled improvements in quality and productivity, which stagnated at low levels throughout the 1960s and 1970s (Loren Brand, *et al.* 2008:571). A revamp of the foreign trade system in the early 1980s ended the monopoly of the state trade corporations over the export-import

business, and thousands of Chinese companies were allowed to trade internationally (Satyananda J. Gabriel 2006).
Reform of China's state-owned enterprises (SOEs) had been a major aim since urban reforms began in 1984. Inspired by the success of the rural household responsibility system (HRS), the government introduced a contracting system into the state sector that required SOE managers to meet various performance targets— including targets for sales, profitability, and capital accumulation—in return for a share of the profits (Ross Garnaut, *et al.* 2005:2).

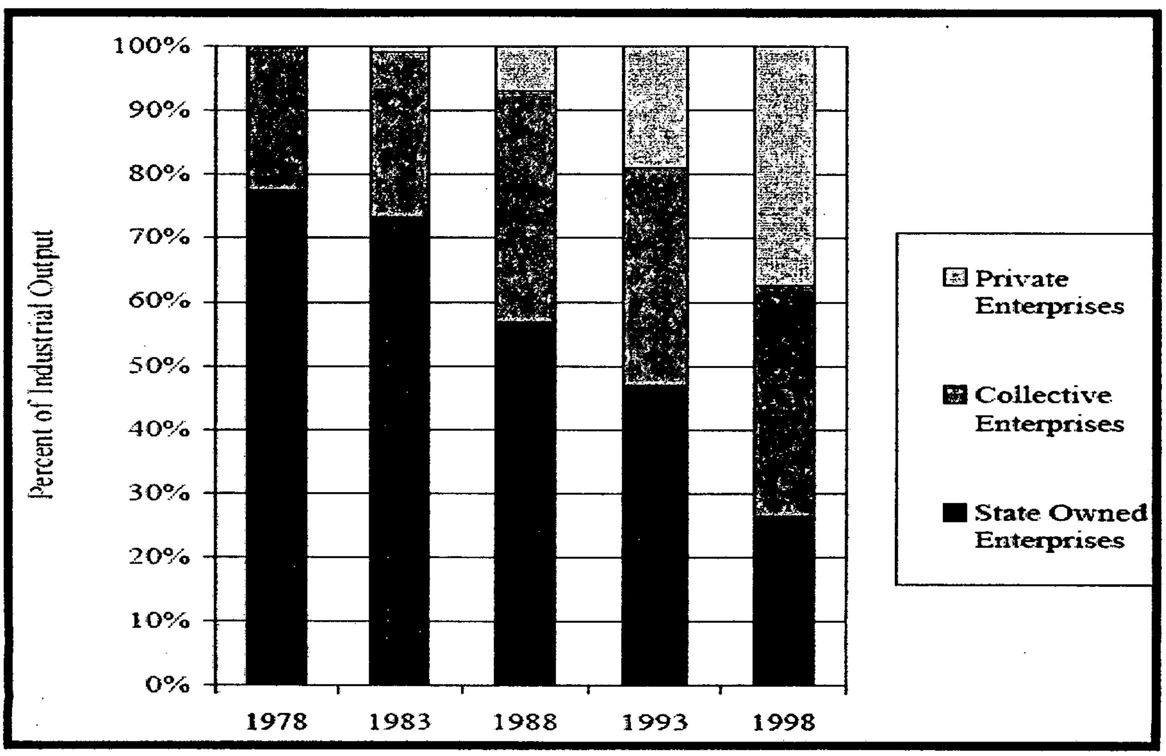
The initial phase of reform in the state sector consisted of two key components: increasing incentives and autonomy at the firm level, and the introduction of a unique system of dual-track pricing that partitioned both inputs and outputs into plan and market segments, with plan quotas transacted at official prices and market exchange relying on flexible prices that increasingly reflected forces of supply and demand. Parallel initiatives allowed the entry of new firms into an increasing number of sectors formerly reserved for state enterprises. SOEs in many sectors experienced growing competition from both TVEs and foreign linked firms (Loren Brandt, *et al.* 2008:572).

By the late 1980s the government had decided that the best way to reform small SOEs was to lease them out, with the manager paying the state a fixed proportion of the firm's profit. The opening of the Shenzhen Stock Exchange in 1990 and the Shanghai Stock Exchange in 1991 enabled SOEs to issue shares to the public. The Chinese government ensured that it would not lose control of listed SOEs, however, by requiring that a proportion of the state's shares in the firm could not be sold. In 1995, after extensive discussion, the central government decided on the policy of *zhuada fangxiao,* or "keeps the large and let the small go." The state decided to keep between 500 and 1,000 large state firms and to allow smaller firms to be leased or sold (Ross Garnaut, *et al.* 2005:2-3).

In 1987 the central government introduced the contract responsibility system (CRS) on the basis of the *li gai shui* ("tax for profit") system for SOEs. This system was introduced on an experimental basis in the 1980s, and was implemented nationwide after 1987. The CRS generated a strong incentive for enterprises to improve economic efficiency because it gave them greater autonomy in decision making. But the CRS was also diagnosed as a major cause of fiscal decline because enterprises could retain all or most of their above-quota profits. To increase government revenues, the central government implemented another round of tax reform in 1989, the tax plus profit system (*li shui fen liu*). SOEs were required to pay corporate income taxes first, and then submit a portion of their profits to the state. The result of this reform effort was still not satisfactory. SOE managers were more concerned about bargaining with the government to secure the best possible tax arrangement than about competing with other firms (Yongnian Zheng 2004:111-112).

In the 1980s, the reform of SOEs in China was focused mainly on improving enterprise governance with the emphasis on a progressive increase in managerial autonomy and accountability. However, no substantive results were achieved. During the period 1993–97, the main thrust of the SOE reform efforts was towards the establishment of a "modern enterprise system," which was incorporated into the comprehensive economic reform package adopted by the Third Party Plenum in November 1993 (ibid: 131-132).

Figure: 2.1 Percentage of Industrial Output Derived from State, Collective, and Privately Owned Enterprises in China



Source: National Bureau of Statistics of China, various years.

The initial reform stage delivered large increases in output particularly outside the state sector. The share of SOEs in industrial production plunged from 77.6 % in 1978 to 54.6 % in 1990 and 34.0 % in 1995 (Figure 2.1). Exports expanded rapidly, with foreign-invested firms and TVEs playing major roles in overseas sales (Loren Brandt, *et al.* 2008:573).

In 1998, the government formally introduced a new concept, the shareholding system. It technically was a Chinese form of "privatization in disguise." For the large and medium SOEs, the reform attempted to improve enterprise governance but the emphasis was on "corporatization" or transforming the SOEs into independent modern corporations. Thus, some merged, some broke up, some sought foreign partnership, and some were listed on stock exchanges at home and abroad. The smaller SOEs were given more options and greater flexibility to choose their reform paths. Many of them began to engage in potentially competitive activities that did not need the presence of the state (ibid: 132-133).

Fiscal Reforms

From 1980 onwards the central government no longer planned the expenditures of local governments nor did it issue mandatory fiscal targets. In order to control the deficit and improve the fiscal situation, the central government brought in the contract responsibility system (CRS) in 1987 in some rich areas. A major aim of this system was to require local governments at all levels to balance their revenues and expenditures. This became an effective tool for local governments to seek greater power in relation to the central government (Yongnian Zheng 2004:113-114).

All these fiscal reforms led to drastic decline in state revenue. Consolidated government revenue as a ratio of GDP fell continuously, from 34.4 % in 1979 to less than 20 % in 1989. Government deficits increased, becoming a major cause of inflation which led in turn to mass dissatisfaction. In 1994, the central government established a new, federal style taxation system, and introduced some major institutional changes into the relations between the centre and the provinces. These institutional changes shifted fiscal power from the provinces to the centre to a great degree (ibid).

Monetary Reform

Since economic reform was first initiated in the agricultural sector, the Agricultural Bank of China (ABC), which focussed on deposit and lending activity in rural areas, was established in 1979. The Bank of China (BOC) was separated from the People's Bank and became an economic entity directly subordinated to the State Council (Yongnian Zheng 2004:121).

In 1980, China joined the World Bank and the International Monetary Fund. To meet these changes, the China Investment Bank (CIB) was formally created in 1981 to control the disbursement of project funds provided to China by the World Bank. Again, after China became a member of the Asian Development Bank in 1986, the CIB assumed responsibility for the disbursement of funds from that bank. Several other important changes took place in the 1980s, the most important of which was the creation of China's Central Bank in 1984 (ibid).

In 1994, the leadership introduced a rather radical reform programme in the banking sector. The main thrust of this reform was 1) to set up a strong and independent central bank, with the primary responsibility of maintaining monetary and exchange rate stability, and 2) to commercialize the banking system in which the state-owned specialized banks would operate on a commercial basis (ibid: 121-122).

In 1995, China enacted the Central Banking Law, Commercial Bank Law, the Negotiable Instrument Law, and the Insurance Law, which together provided the rudimentary legal framework for financial supervision and the proper functioning of the financial sector. Meanwhile, competition was gradually introduced into the banking system and this helped to speed up the development of China's financial sector. Meanwhile, some large regional banks were established, including the Guangdong Development Bank, the Shenzhen Development Bank etc. The entry of new financial institutions created a more level playing field for all financial institutions, both state and non-state alike. In 1999, both operational and geographical restrictions were further relaxed, so as to allow foreign banks to engage in domestic currency business in more cities and more provinces (ibid: 122-123).

As a result of the gradual process of reform, along with the dynamic growth of China's economy and foreign trade, China's financial sector experienced remarkable growth in the 1990s. By the end of 1999, China could boast a fairly comprehensive banking and financial structure (ibid: 123).

The Asian financial crisis had a major impact on the regional and the world economy, including China. The crisis triggered a new wave of multifaceted financial reforms in China. Among others, the reform of the central bank, more than anything else, reflects how the central government has attempted to exercise its control over China's economy through the greater use of financial instruments. What made China different from the crisis-ridden Asian economies was China's healthy and stable external economic position. On account of its strong export performance and rising trade surplus, China did not have current account deficits (Yongnian Zheng 2004).

The financial reform has consisted of strengthening the independence of the central bank, converting state owned banks into genuinely commercial entities, and the development of a disciplined capital market. All reform measures introduced so far were aimed at increasing the role of the "invisible hand" of the market in the allocation of resources and thus laying down an institutional framework for a market economy (ibid: 127-128).

Trade and Investment and Foreign Exchange Reform

Throughout the reform period, the government restricted the right to engage in foreign trade. Nevertheless, there was a rapid and substantial expansion in the number of domestic firms granted trading rights. From the initial 12 firms directly controlled by the Ministry of Foreign Trade, this expanded to about 800 firms by 1985. A decade later, the number of trading firms stood at 12,000. The authorities devalued the official exchange rate in stages, from RMB[58] 1.5 to the dollar in 1981 to 8.7 in 1994. In addition to substantial real devaluation, Chinese exporters were allowed to retain

[58] RMB stands for *renminbi* (sign: ¥; code: CNY), is the currency of the People's Republic of China (PRC), whose principal unit is the yuan , subdivided into 10 jiao (角), each of 10 fen (分). The renminbi is issued by the People's Bank of China, the monetary authority of the PRC.

part of their foreign exchange earnings, individuals were allowed to hold foreign exchange, and capital outflow restrictions were relaxed (Lee Branstetter and Nicholas Lardy 2008:635-639).

Whereas FDI in China in the 1980s had been overwhelmingly dominated by Hong-Kong and Taiwan-based investors, seeking to exploit relatively low-cost labour in the special economic zones (SEZs) for export processing, in-flows diversified in the 1990s. Hong-Kong and Taiwan-based investors continued to play an important role, but Japanese, American, and European firms also increased their FDI into China, much of it focused on the domestic market (ibid: 641).

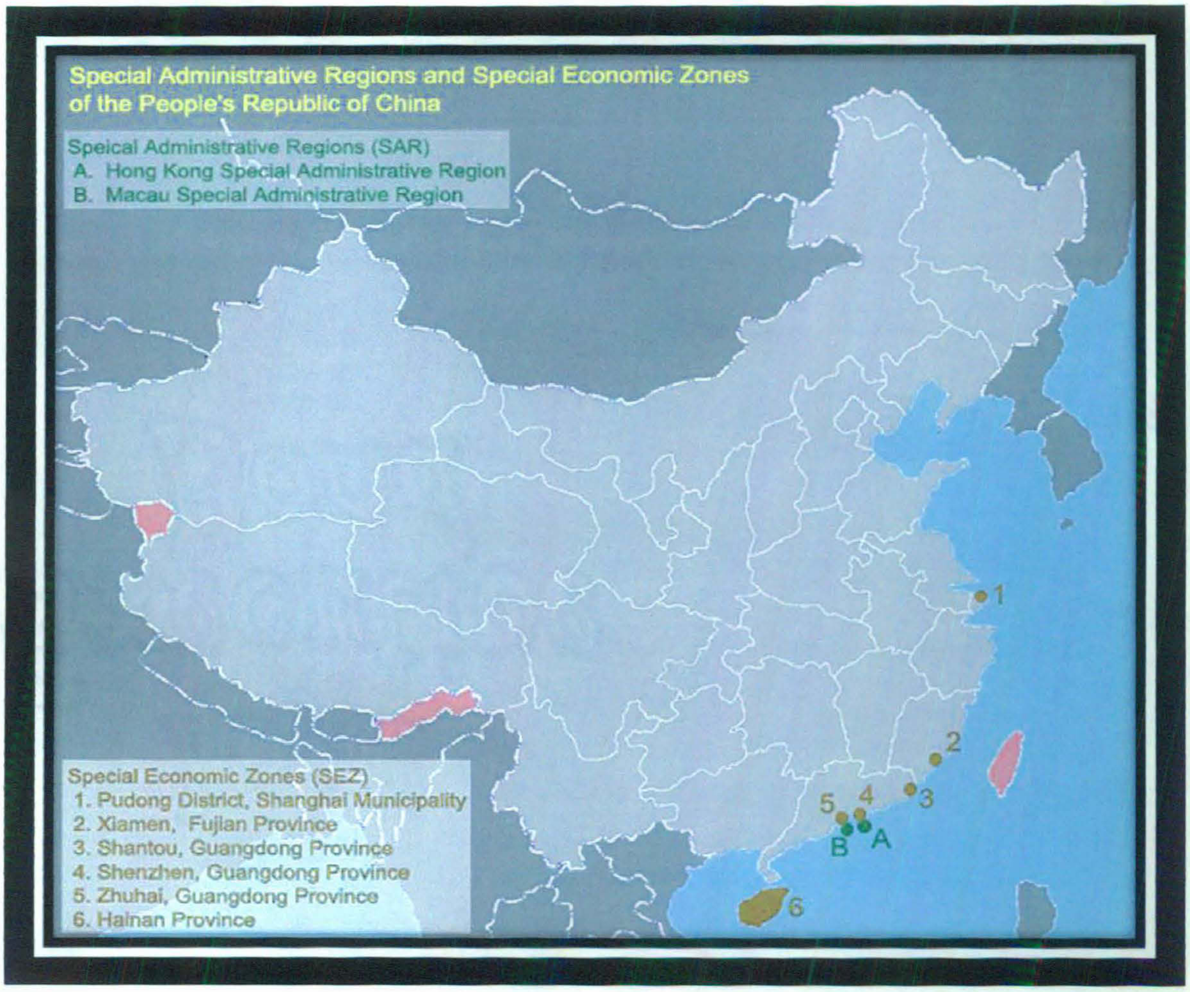
Expanding trade and FDI have contributed to Chinese living standards, Chinese consumers have benefited from price declines and an increase in the quality and variety of goods consumed, and China has been able to alter its pattern of industrial production to conform to its comparative advantage. China's increasing openness to trade and FDI has also fostered a much greater degree of competition in Chinese product markets than would have otherwise existed. The speed with which FDI increased in the early 1990s also generated problems. Most foreign firms targeting the domestic market were required to form a joint venture with a local Chinese firm, usually a state-owned enterprise (SOE). Many firms forged alliances with enterprises that turned out to be far less efficient (Lee Branstetter and Nicholas Lardy 2008).

From 1988 to 2000, actual or utilized FDI increased at an average rate of 23% per annum to reach a cumulative total of US$339 billion. FDI had contributed most significantly to China's phenomenal export growth where foreign-invested enterprises (FIEs) had grown to account for almost half of all exports from China. China has emerged as a major trading economy in the world. China's exports increased at an annual rate of 17% from US$13.7 billion in 1979 to US$249.2 billion in 2000. For six years in a row after 1993, China was second to the US in the world for foreign capital inflow. During the 1990s, China sucked in about half of all foreign direct investment that went to the developing economies. On top of that, China has built up one of the world's largest foreign exchange reserves. In 1999, its forex reserve surpassed US $150 billion (Yongnian Zheng 2004:4-6).

Special Economic Zones

The Special Economic Zones[59] (SEZs) were set up as an experimental step in the late 1970s. The SEZs have played a pivotal role in China's overall economic transition during the past two decades. According to Wei Ge (1999:6), "*Without the successful operation of the SEZs, China's reforms would have not gone so far, and the transitional process would have not been so smooth.*"

Map-III: SEZs in China



Source: http://en.wikipedia.org/wiki/File:PR_China-SAR_%26_SEZ-English.png

The most direct and immediate impact of the SEZs on the Chinese economy was the successful operation of the zones. In 1995, Shenzhen SEZ ranked first in the nation in terms of per capita GDP. The attractive policy incentives offered to foreign investors,

[59] SEZs are characterized as a geographic area within a country where certain economic activities are promoted by a set of policy measures that are not generally applicable to the rest of the country. Institutionally SEZs reflect the fact that the government conducts its economic policies in such a discriminatory manner that certain geographical regions, economic activities, and interest groups are favoured over others (Wei Ge 1999).

the improved infrastructure and facilities, and the market oriented economic and legal reforms helped to sustain a continued foreign capital inflow and accelerated technology transfer. As the SEZs economies continued to open and reforms began to deepen, competitiveness enhanced, entrepreneurship flourished and the overall economy soared. The remarkable export expansion in the SEZs together with persistent trade surplus led to an increase in foreign-exchange earnings, permitting the country to finance its import of capital goods and key materials (Wei Ge 1999:109-111).

The development of SEZs did not take place at the expense of the rest of the domestic economy. As the SEZs continued to expand, the zones became not just cost-free to the state finances, but they became revenue generating. The tax revenues generated by the Shenzhen SEZ from 1979 to 1995 grew at an average rate of 50% per annum. While the costs associated with the SEZ operation were negligible, the benefits to the Chinese economy were immense. The other parts of the country were able to benefit from the SEZ operation in fostering a faster pace of economic growth (ibid: 111-112).

A growing number of ventures were established jointly by SEZ and domestic firms entailing sizable investments by SEZs. By the end of 1995, Shenzhen had poured a cumulative amount of more than 15 billion Yuan worth of investments in 1,400 projects in domestic regions. The formation of the Hong Kong Special Administrative Region (HIKSAR) and the implementation of the "one country, two systems" policy in governing the territory made Hong Kong the largest and most sophisticated SEZ in China (Wei Gi 1999).

The technologies embodied in these projects were generally more advanced than in purely domestic projects. Moreover, foreign capital and technologies were increasingly channeled through the SEZs to various domestic destinations. Using their established networks with overseas markets and their know-how in conducting foreign trade, the SEZs over time emerged as an intermediary through which products manufactured by domestic enterprises were transshipped to international markets. Thus, the combined result of the SEZ was improved resource utilization, accelerated economic growth, and increased income (ibid: 113-115).

Building upon the confidence and experience gained in the SEZs, the Chinese leadership took step in the mid-1980s to gradually open up the economy. In 1990, 13 free trade zones were set up in the coastal area. The policy measures developed in the SEZs have been adopted by other regions to attract capital. As a laboratory, the SEZs were active in experimenting with various types of social welfare systems, ranging from housing, pensions, medical care, and unemployment compensations. To create a favourable business environment, a comprehensive legal structure was set in place in the SEZs. As the centerpiece of the gradualist approach toward economic transition and development, the concept of the SEZ has shaped the course China's economic transition (Wei Ge 1999).

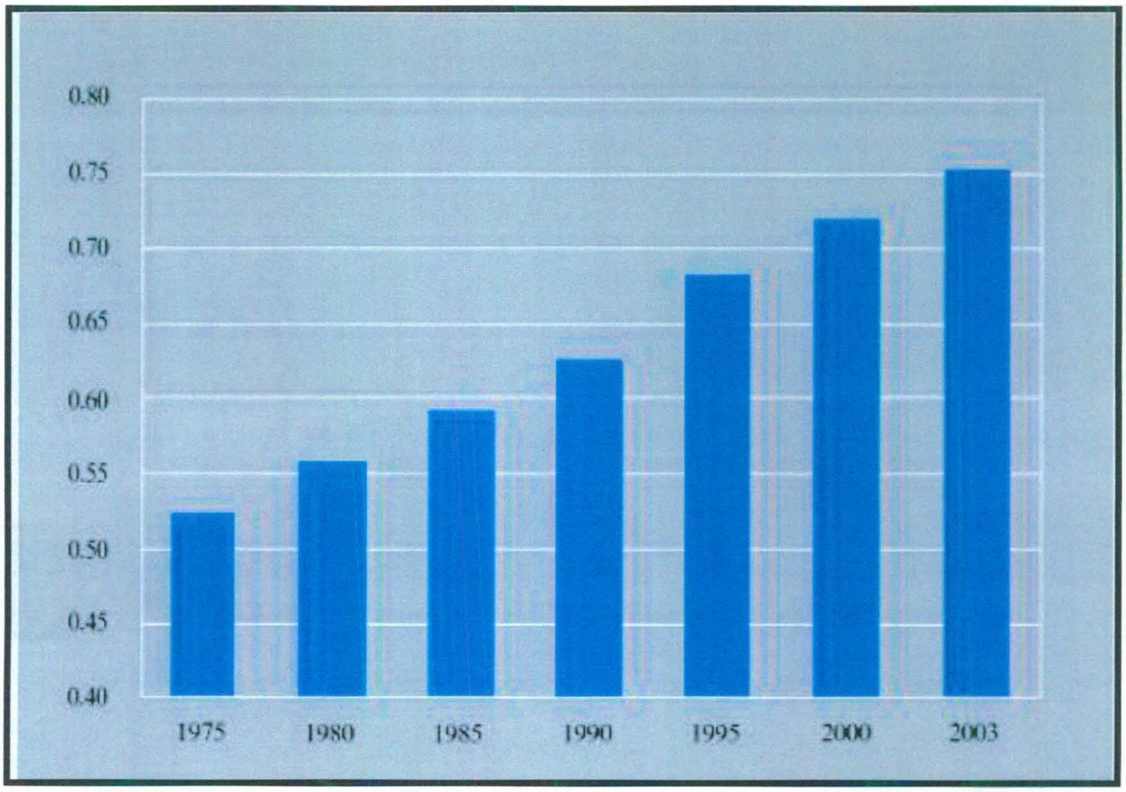
Life Expectancy and Human Development

At the start of China's economic reform in the late 1970s, the post-Mao Chinese leadership established population control as one of its top policy priorities. Having witnessed rapid population growth during the preceding decades, the leadership believed population control to be a key measure for ensuring growth in per capita income (WANG Feng and Andrew Mason 2008).

Demographic changes in China have been affected by the shifts in traditional demographic parameters – mortality, fertility, population growth rate, and age structure as well as due to migration and urbanization which were unprecedented in world history. Population redistribution is inextricably tied to the broad social and economic transitions that China has undergone (ibid).

During the last two and a half decades, China has transformed from a "demographic transitional" society, one where reductions in mortality led to rapid population growth and subsequent reductions in fertility led to slower population growth, to a "post transitional" society, where life expectancy has reached new heights, fertility has declined to below-replacement level, and rapid population aging is taking place (ibid).

Figure: 2.2 Changes in China's Human Development Index (HDI)



Source: Based on data from the UNDP, 2003; 2005.

The blind pursuit of high GDP growth rates in China gave rise to rising income inequality and increasing human insecurity. The reform that followed was a transformation of development philosophy. Chinese policymakers gave priority to rapid aggregate growth. This concern with growth made them less willing to sacrifice growth for such goals as balance and equity (UNDP 2005; Shaoguang Wang 2008:52-54).

Since adopting the groundbreaking reform and opening-up policy in the late 1970s, China has made considerable progress in human development as measured by the rise in almost all human development indices. These improvements stem from both economic and social progress. China's HDI rose continuously in the past 20 years, from 0.557 in 1980 to 0.755 in 2003. Its global ranking rose from 101st in 1991 to 85th in 2003 (Figure 2.2).

Evaluation of Chinese Reforms

From 1978 to 1996, the Chinese economy grew at an average annual rate of 9.9%, with a corresponding increase in the living standards of its people (Appendix IV). China's actual practice of reform and opening has proved that both planning and the market are effective means for regulating the economy (Peter Nolan 1994:13-15).

Table: 2.3 Annual Growth of China's Economy in Reform Years

	1979-1984	**1985-1995**	**1996-2000**
GDP	8.8	9.7	8.2
Agriculture	7.1	4.0	3.4
Industry	8.2	12.8	9.6
Services	11.6	9.7	8.2
Foreign Trade	14.3	15.2	9.8
Import	12.7	13.4	9.5
Export	15.9	17.2	10.0
Rural Enterprise Output	12.3	24.1	14.0
Population	1.40	1.37	0.90
Per Capita GDP	7.1	8.3	7.1

Note: Values are in percent. Figure for GDP in 1970-1978 is the growth rate of national income in real terms. Growth rates are computed using the regression method.

Source: China Statistical Yearbook (various issues)

The reform era has brought fundamental, transformative changes not just to agriculture but also to the entire rural economy. While the annual growth of agriculture averaged about 5 % (Table 2.3) throughout the entire reform period, the growth rates of the economy as a whole and of the industrial and service sectors were faster. Since 1985, the growths of industry and services have been two to three times faster than agriculture.

The successful outcome in China may, have been partially the result of correct economic policy choices, while the economic policies adopted in Russia may have been more or less incorrect. In the late 1970s China did not establish a stable set of "market socialist[60]" institutions. Although the pace of advance was uneven, there was a consistent push forward in reforms, broadening out from agriculture to the small

[60]Because China has been ideologically circumscribed by "market socialism", that is, market-based but only compatible with socialism.It had to opt for a form of privatization that allowed the reformers to argue for market-oriented reform while promising that the state sector itself will be insulated from market encroachments (Lan Cao 2000).

scale non-farm sector and eventually penetrating the large scale industrial sector (ibid: 15-16).

The reform process in China has often been characterized as gradual and incremental or in Deng Xiaoping's words, "*crossing the river by groping for stones*"[61]. The reforms were undertaken initially on an experimental basis in some localities before they were applied to the whole country. By implementing first those policies that were likely to be successful, the leadership was able to build up political support for further reform. This was important in avoiding social unrest and political conflicts that could derail the whole process. Chinese experience demonstrates that it takes much longer to develop a market economy and that the costs incurred in a slower transition are likely to be outweighed by the benefits (Barry Naughton 2007:86).

A distinguishing feature of the Chinese reforms is the attempt to preserve the socialist character of the economy. Thus, the authorities have not pursued a strategy of mass privatization as in Russia. The second major feature is the progressive decentralization of economic decision-making. Local authorities have used their growing autonomy to strengthen their hand in resource-sharing with the centre and in taking initiatives in such areas as investment (ibid).

The success of the first phase of reform can be explained by the government's emphasis on entrepreneurship and, consequently, the creation of new firms rather than the restructuring or destruction of existing ones. It is only in this new, non-state sector that the fundamentals of a market economy have been established. Economic growth in China has come primarily from the non-state sector. In 1978, 78% of national industrial output was derived from state-owned firms; by 1993, state firms accounted for only 43% of such output and non-state firms 57% (Lan Cao 2000).

The special role played by Hong Kong and, to a lesser extent, Taiwan also played an important role in China's successful economic reforms. The capital and expertise from Hong Kong played a very important role in enabling Guangdong province and, to a lesser extent, neighboring Fujian province, to grow fast in the 1980s. China

[61]This term is frequently attributed to Deng Xiaoping, but was in fact first used by Chen Yun.

enjoyed the advantage of the strong capitalist tradition stretching back at least a thousand years. The Jiangnan area (northern Zhejiang and southern Jiangsu provinces) and Guangdong province were advanced areas of capitalist production for many centuries before the European Industrial Revolution. Even in the adverse political conditions of the first half of the twentieth century great industrial progress occurred in these areas (Peter Nolan 1994:15).

Since the late 1970s, marketisation and opening up acted as twin engines which brought dramatic changes in China. Opening brought China into the world economic system. Foreign Direct Investment (FDI) in China has played a catalytic role in the development of a market based economy. FDI and Special Economic Zones have also contributed to the greater integration of China into the world economy through joint ventures with domestic firms. By its open door policy, China has gradually integrated into the world economic system. But China has been able to overcome its high dependence on foreign inputs only by raising its own capacity for technological innovation and by government measures to promote exports and investment overseas (Mark Wang, *et al.* 2002).

Its opening was more selective, and an airlock was retained between world and domestic prices. China had been able to balance its inward and outward openness. The state played a strong and continuing role in managing China's openness. Earlier that role was overt, as trade was conducted through state trading corporations, and controls over inward and outward investment were tight. Later the government took the lead in opening up the economy to the movement of commodities, people, capital and technology and in reducing the degree of formal control over many of those flows (ibid: 29).

Deng Xioping played a crucial role in China's economic transformation. Deng Xiaoping tried to restart China's economy without affecting the dictatorship of the CPC. He sought *perestroika* without *glasnost.* In the late 1970s he developed a set of political and economic reforms to replace the restorationist programmes of Hua Guogeng. He established the "four cardinal principles"- a commitment to Marxism-Leninism and Mao Zedong thought, Party leadership, socialism, and the existing state structure-as limits to permissible political discourse. The incremental nature of the

Chinese reform- starting with the easier problems first, where the gains were likely to be rapid, and where the benefits would outweigh the costs helped in the development and maintenance of popular base for the reform programme. Great credit must be given to Deng Xiaoping, who used his prodigious political skills and standing within the Chinese Communist Party to manage the tensions within the reform coalition and to supervise the amelioration of the problems created by reform (Harry Harding 1987:90-94; Peter Nolan 1994).

While the Chinese state has played an extremely important role in pushing the process of economic transformation and globalization, it also inadvertently created serious problems. The close links between the government and businesses led to widespread corruption among party cadres and government officials. Towards the end of the 1990s, smuggling became very prevalent and beyond the control of the central government. Smuggling damaged China's economy and reduced central revenue (Yongnian Zheng 2004).

China's economic reforms have succeeded in decentralizing decision-making processes down to the local and enterprise levels. Decentralization broke up the command economy, but it also resulted in a disaggregated state consisting of numerous decentralized agencies and departments from various central, regional, and local ministries and their respective branches, each eager to exercise jurisdiction over the firm and correspondingly, extractive authority over firm assets (Maria Weber 1998).

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Chapter 4

Comparing Transitions of Russia and China

Chapter 4

COMPARING TRANSITIONS OF RUSSIA AND CHINA

"Broadly speaking, most observers would conclude that China's path to the transition has been a success so far, while Russia's path has not been. I argue that the failures of the reforms in Russia and most of the former Soviet Union are not just due to sound policies being poorly implemented. I argue that the failures go deeper, to a misunderstanding of the foundations of a market economy as well as a misunderstanding of the basics of an institutional reform process". (Joseph E. Stiglitz 1999)

Both Russia and China started the course of transition with different historical setting and varied set of human and physical endowments.A decade after the beginning of the transition in Russia, and two decades after the beginning of the transition in China, the picture is mixed. In stark contrast to these failures experienced by Russia has been the enormous success of China, which created its own path of transition[62] (Joseph E. Stiglitz 1999:127-128).

While comparing the economic transformation of Russia and China the following points should be taken into consideration: i) fast versus slow liberalization and opening up of the economy; ii) comprehensive top-down versus experimental bottom-up reforms; iii) the need to establish full private property rights at the beginning of reform; iv) the implications of reforms for welfare and distribution. (Alan Gelb, *et al.* 1993:2)

State and Transformation

While countries like Russia have followed Western advice, that is, constructing market institutions at a rapid pace, immediately removing the state control over the

[62]Rather than just using a 'blueprint' or 'recipe' from Western advisors, China carved out its own transition path.

economy, and rapidly privatizing property; China has taken its time in implementing institutional change. The state has gradually receded from control over the economy, taking the time to experiment with new institutions and to implement them slowly and incrementally within the context of existing institutional arrangements. The gradual nature of this process allowed the state sector to remain, at least in the early years, the anchor of the economy that it had been in the pre-reform era, creating some degree of stability throughout the process (Doug Guthrie 2008:38-39).

A distinguishing feature of the transition process in China is that the process was started by the incumbent governments, with the initial objectives of raising income and growth by introducing incentives, modifying the traditional planning system, and opening up the economy to the outside world. The reform process was therefore gradualist in nature though, in specific areas it was quite far reaching and evolved over time (Doug Guthrie 2008).

In contrast with the experience in Russia, in the case of China, we see that strong guidance from the state has led to a high level of stability in a process that inevitably leads to social upheaval. In the two-and-a-half decades of economic reform in China, the state has consistently and methodically guided the reform process, maintaining control over the majority of the industrial economy and tightening fiscal constraints for the inefficient state sector at only a gradual rate. More than this, the state has experimented with, and gradually introduced, the policies and laws through which the new markets that increasingly govern economic processes in China have been constructed (ibid).

China's departure from the conventional wisdom that prevailed in Russia by merely adopting a traditional form of privatization that occurs when the state withdraws altogether from certain economic activities and creates an opportunity for private entrepreneurs to act in such fields has produced a prosperous non-state economy only tenuously connected to the state sector. Instead of destroying the state sector, and in the process causing economic downturns triggered by the destruction of the old economy before alternative market forces have been introduced, the Chinese model remained focused on retaining the state sector until an alternative non-state economy could be established (Lan Cao 2000).

The Russian state in the late 1980s and 1990s remained comparatively weak. The state constantly equivocated and retreated on encountering more or less tough resistance from other centres of power and competing interest groups (Vladimir Mau 2003:6). The state[63] had lost control and influence over highly important social and economic processes on which the reliability of the economic situation, social stability and tranquillity among nationalities were based. In essence there was a crisis in the system of management (Izvestia November 26 1990).

Gorbachev's reforms weakened the capacity of the state to define and implement policy goals. Under Gorbachev the main administrative agent of the Soviet system, the Communist Party of the Soviet Union (CPSU)[64] lost its 'leading role'. No new institution emerged to fill the void (Michael McFaul 1995: 224). When Yeltsin came to power various laws and decrees governing competition policy in Russia were passed during the 1990s, but their effectiveness was weakened by their poor and inconsistent administration (Paul Hare and and Alexander Muravyev 2002).

Strategies of Transformation of Russia and China

The Russian experience of privatization represents the more dominant and favoured approach to privatization from the Western viewpoint and was characterized by immediate privatization of the state sector, including the swift transfer of assets from the publicly owned state enterprises to private hands. On the other hand, "privatization with Chinese characteristics" emphasized on the retention of the state sector with the simultaneous creation of a parallel non-state sector designed to supplement the state sector and to serve as a social "shock absorber" in the event that the state sector itself is to be eventually "privatized" or as Chinese officials prefer it, "corporatized"[65] or "securitized" (Lan Cao 2000).

[63]As noted by Yu. D. Maslyukov, Chairman of the USSR State Planning Committee, 1990.
[64]In February 1990, Article Six of the Soviet Constitution was amended to remove this phrase.
[65]The distinction between "privatization" and "corporatization" or "securitization" rests on the terms' ideological significance to Chinese officials, who view "corporatization," the conversion of a state-owned enterprise into a shareholding company, or "securitization," the subsequent sale of such shares on a securities market, as ideologically compatible with "socialism with Chinese characteristics." On the other hand, "privatization"stemming from the word "private" and identified with the institution of private ownership without necessarily ensuring the preservation of the state as the agent of the "entire people" in the social ownership of the means of production is considered to be anathema from an ideological standpoint to the state's official adherence to socialism (Lan Cao 2000).

In the early phase, China's policymakers emphasized dual-track reforms, permitting only gradual relaxation of central controls in the existing state sector, and allowed the large-scale expansion of township and village enterprises (TVEs) that greatly expanded economic activity. The gradualist strategy changed somewhat around 1993 with the increased competition within the economy and rising influence of market forces (Jan Svejnar 2008).

The policymakers in the former Soviet bloc developed transition strategies that focused on abandoning the centrally planned system and substituting it with a market system in the context of macroeconomic stabilization and microeconomic restructuring, along with institutional and political reforms. While China adopted a relatively gradual and unified overall approach, albeit with much experimentation at the local level, the implementation of transition strategies in Russia was relatively fast. Russia followed the Shock Therapy in accordance with the "Washington Consensus" (ibid).

Russia went in for rapid privatization so that it would help to create powerful political forces that would move forward the broader agenda of economic reform. Fearing a reversion to a Communist state, one needed not only to lock up what successes one could, but to create a political force in favour of the market economy. Thus, Russian reforms were politically motivated to prevent the return of communism (Joseph E. Stiglitz 1999).

Russia transferred its state assets to private entities without regulatory safeguards designed to lower transaction costs which impaired market growth and led to inefficiency. China's strategy for state-sector privatization was radically different, in both motivation and implementation, from Russian privatization. China avoided the costs of premature privatization suffered by Russia by first fostering a thriving non-state sector[66] (Lan Cao 2000).

[66]Largely in agriculture and rural industry.

The strong growth performance in China following the onset of the transition may also reflect three key elements of the reform strategies adopted in the region. First, while reforms in China have indeed been partial, leaving the large state-owned enterprises and the financial sector until late in the process, they have nevertheless been quite radical in the areas in which growth has been most dynamic, such as agriculture, foreign enterprise entry, and creation of new rural enterprises. Second, the reform process facilitated and encouraged the development of new small and medium-scale enterprises[67]. In China, the township and village enterprises grew rapidly, accounting for an increasing share of industrial output and exports. Third, the reform strategy in China was characterized by pragmatism and flexibility, with different reform approaches often allowed to coexist and compete for a period (World Economic Outlook 2000).

The reform approach taken in Russia, particularly with respect to privatization, was fundamentally flawed in emphasizing radical reform over gradual institutional development (IMF 2000). In almost all respects its transformation has differed from the swift, comprehensive and fundamental pattern that has been widely advocated in Russia. China's reforms have often been introduced on an experimental basis, with some provinces and special zones moving far more rapidly towards markets and pluralistic forms of ownership. Rather than attempting to "cross a chasm in one leap", China has negotiated a series of small steps, moving from planned towards market socialism while retaining an authoritarian communist government (Alan Gelb, *et al.* 1993; Stanley Fischer and Alan Gelb 1990).

Russia wanted to shed the legacy of Communism as quickly as possible to begin a rapid convergence to the model of big-bang economic reform. For these reformers, it was of critical importance to free prices as quickly as possible, to let the price system begin to work. In China system transformation would have to take place concurrently with economic development, and indeed that the process of economic development would drive market transition forward and guarantee its eventual success (Barry Naughton 2007).

[67] Even though property rights were never well defined in China.

Sequencing and Pacing of Reforms

Administrative feasibility ensures that all reforms cannot be instituted simultaneously. The fundamental reason for sequencing reforms is that some changes are preconditions for others: for example, macroeconomic stabilization is needed if price reform is to be successful. It is necessary to develop systems and skills that have to be in place for markets to work. Financial liberalization is extremely risky unless a sound system of accounting, auditing, regulation and supervision is in place, and unless the macro-economy is stable. The need is to introduce groups of complementary policy reforms, sequentially. The reform path to be followed by a country depends on the state of the economy, tolerance of the population for the disruptions that may accompany the reform process, and on the political situation in each country (Stanley Fischer and Alan Gleb 1990).

For a country like Russia, which faced high inflation and balance of payments deficits, macroeconomic stabilization should have been the initial priority (ibid). The reformers in Russia claim that it was politics that hindered them: it inhibited the reforms from occurring at the pace and in the manner which they recommended. However, this stand of the reformers has been criticized by Joseph E. Stiglitz (1999) in the following words, *"But this claim has a certain unconvincing ring to it: Remember, one of the key arguments for the pace and sequencing of reforms recommended was that it was best given the political situation. Clearly, the advocates of shock therapy misjudged the politics"*.

There were three different perspectives with regard to sequencing in Privatization: (a) Proceed with privatization as fast as one can; it is more important that privatization occurs than how it occurs; (b) Proceed with privatization as soon as one has put into place an appropriate framework for privatization itself, but not to wait for an appropriate legal structure, including a regulatory and competition framework, to be in place and; (c) Only proceed with full privatization when there is the appropriate legal framework in place (Joseph E. Stiglitz 1999).

Economic reform in the USSR was commenced in haphazard fashion under Mikhail Gorbachev. The sequencing and coordination of reform measures has posed particularly severe problems in Russia. Gorbachev's foot dragging on privatization and his procrastination over the issue of private property delayed the development of a true private sector and cost Russia precious years in creating a working market system. When prices were liberalized in 1992, therefore, Russia's underlying industrial structure remained highly monopolistic and prices surged. While entrepreneurs and workers were encouraged to acquire state assets, confiscatory tax rates eliminated legal (as opposed to black market) profits and the incentive for new investment. Expansive fiscal and credit policies stimulated by high industrial and agricultural subsidies produced high inflation, undermining the process of economic stabilization. Macroeconomic stability, vital to private sector development, particularly in economies undergoing major structural reform was lacking in Russia (R. Sean Randolph 1994).

Sequencing of Russian reforms differed from those recommended by many experts and international financial institutions (IFIs) and those experienced in Central Europe and Baltic region. In Russia mass privatization process was launched prior to macroeconomic stabilization and liberalization of domestic and external markets were completed (Marek Dabrowski 2003).

China's overall reform programme is best characterized as a gradual or sequential process. The favourable sequence of reforms in China came about through its trial-and-error approach to reform. Instead of following a pre-determined blueprint, China adopted new measures through experimentation. Each new policy was field-tested and determined to be successful in selected pilot districts before the policy was applied nationwide and the next measure introduced. The gradual approach to reforms adopted by China, beginning with the strengthening of market institutions and incentives and moving towards the opening up of markets, led to high rates of growth and poverty reduction (Joachim von Braun, *et al.* 2005).

The Chinese sequence-agriculture first, foreign investment and trade second, and industry and financial market reforms later was politically wise in China's particular situation. Political resistance may have been much greater had China tried to implement the reforms in all sectors at the same time (Shang-Jin Wei 1995: 157-158). A key factor in China's ability to reform the economy without sacrificing political control is the timing and sequencing of its foreign direct investment (FDI) liberalization (Mary Elizabeth Gallagher 2002).

Transition and Initial Conditions

Despite a common legacy of planning, the transition economies started off under different circumstances. There were substantial differences in terms of the initial level of development, macroeconomic distortions, integration into the trading system of the socialist countries, extent of prior reforms etc. For Russia, the collapse of the Soviet Union in 1991 was the defining political and economic event, as a result of which it began its transition to market economy. Reforms in China started earlier, but without a radical political change. Economic performance measured in terms of growth and inflation depends on initial conditions, economic policies and regional tensions (Martha de Melo, *et al.* 1997).

The reform process began in the late 1970s in China in the aftermath of the Cultural Revolution. China started out with more favourable initial conditions than Russia. Compared with the latter, its political situation at the start of reforms was more settled; its economy had larger agricultural sectors and it was less integrated with the CMEA[68] system. On the unfavourable side, the dominance of agriculture meant that per capita incomes were low and these countries were initially more isolated from the international community (IMF 2000).

The Chinese economy was still largely agricultural, with a large pool of surplus labour. Thus, initial reforms, permitting greater private sector activity in agriculture and relaxing entry into industry in rural areas could generate large increases in output. In Russia where most people were securely employed by large, notwithstanding inefficient, public enterprises, there was no alternative to tackling the problems in the state owned industrial sector, which inevitably resulted in a period of substantial economic dislocation. In particular, China enjoyed a relatively strong fiscal position when initiating its reform efforts and has succeeded in avoiding major

[68]The CMEA, Council for Mutual Economic Assistance, was an essentially bilateral system of trade relations, with the Soviet Union being the dominant trading partner of each of the smaller East European countries. Payments among CMEA countries were expected to be made in hard currencies, at world prices, from the beginning of 1991.

macroeconomic crises[69] (World Economic Outlook 2000).

In Russia there was little history of market-oriented entrepreneurship. For entrepreneurship to succeed, certain skills need to be developed in practice skills which Russia had no opportunity to develop. They had acquired skills in evading government regulations, in arbitraging the inefficiencies in government regulations for private profit, and operating at the chasm between the legal and illegal world. Few had the necessary capital for entrepreneurship, especially after inflation eroded what little savings people had accumulated. The banking system also had no experience in screening and monitoring loans (Joseph E. Stiglitz 1999).

The institution of bankruptcy which is a crucial part of a market economy had little or no precedent in Russia. A variety of available models for bankruptcy codes had evolved over centuries in the market economies, and each was integrated into the specifics of Russian economy. A transplant to an alien environment could not take firm root in the absence of an independent and competent judiciary, trained in to the basic tenets of bankruptcy (ibid).

While only 18 % of China's workers were in state-owned enterprises at the start of Deng's reforms in 1978, the share in Russia was effectively 99% at the start of Gorbachev's reforms in 1985 and 91 % at the start of Yeltsin's reforms in 1991. Thus, Soviet Union had no reserve of labour outside of the SOE sector that could provide the engine of growth for a new non-state sector. Only by ending the subsidization of the state sector was it possible to free resources for the new sectors in the economy. Two-track gradualism could not work in that context (Wing Thye Woo 1999).

In the early 1980s, 62% of Soviet GDP came from the industrial sector. In China in the early 1980s, industry produced 47% of GDP. China's employment structure was close to that of a typical low-income country, with around three-quarters of the population still employed in agriculture. Soviet Union had a much lower proportion of

[69]Stabilization in China has taken place in distinct cycles. Typically, reforms led to rising domestic demand and inflationary pressures, which—given the limitations of macroeconomic instruments—prompted the authorities to tighten administrative controls and slow down reforms to maintain macroeconomic stability (Stefan E.Oppers 1997).

the workforce employed in the farm sector (Peter Nolan 2004:8-9).

Both China and Soviet Union had a lower proportion of employment in the service sector. Under China's reforms the service sector's share of employment rose from 14% in 1978 to 23% in 1991. Most Soviet workers were employed in the state sector, which included state services, notably government administration, as well as state farms. In China, only a small proportion of the workforce was in these sectors. The Soviet state sector was from homogeneous. There were wide differences in average income and large differences in labour force growth rates between regions (ibid: 10).

At the start of the reform, Russia's infrastructure was more developed than China. It had vast natural resources and a much more educated and skilled labour force than China. In the mid-1970s the vast bulk of the Chinese population was a semi-literate peasantry; over one-third of them lived in dire poverty. Around 35% of the adult population was estimated to have been illiterate. Russia in 1980s was a highly urbanized country. Its achievements in basic education compared favourably even with the advanced capitalist countries (ibid: 11-14).

Over-extensive social welfare system existed in Russia during the pre-reform period which reduced job mobility, encouraged longer spells of unemployment and more resistance to accepting new jobs. High levels of social welfare spending were a major factor in the large budget deficits, thereby contributing to overall macroeconomic instability. In contrast, China's structural change was accelerated by the absence of social guarantees in the countryside. Rural workers flooded into the cities in search of jobs at extremely low pay and were absorbed by the mushrooming export and construction sectors (Jeffrey Sachs and Wing Thye Woo 1994).

According to Jeffrey Sachs and Wing Thye Woo (1992:102-104):

> "It was neither gradualism nor experimentation, but rather China's economic structure that proved so felicitous to reform. China began reform as a peasant agricultural society, EEFSU [Eastern Europe and the former Soviet Union] as urban and over industrialized.....In Gerschenkron's famous phrase [China] had the "advantage of backwardness".

China was largely an agrarian nation with a relatively stable macroeconomic situation, reforming at a time of rapid growth in world trade. Russia, on the other hand, had a large inefficient industrial sector, a rapidly deteriorating macroeconomic situation, and embarked on reform at a time when much of the world was moving into recession, and the old Soviet trading system (CMEA) was collapsing.

Shock Therapy Vs Incrementalism

Russia started with the "bang bang" approach, and went for mass privatization. This led to the emergence of "phony capitalism", dominated by the oligarchs, and caused sharp output declines and high unemployment which aggravated absolute poverty. China adopted a "gradualist" approach to privatization, which helped it to achieve spectacular economic growth (Sadrel REZA 2007:276).

Russia implemented drastic reform packages variously known as big bangs or shock therapies aimed at transforming the economy into free market economies as rapidly as possible. The reform liberalized most prices overnight and decentralized enterprise decision-making. These institutional changes were followed by sharp declines in output and macroeconomic instability. In contrast, the economic reform in China took quite a different approach. Instead of leaping into the market, China's reform introduced markets at the margin, parallel to planning. The controlled institutional changes were followed by rapid economic expansion in China and a relatively stable macro-economy (Wei Li 1999).

Political and ideological considerations were some of the factors that prompted Russia to engage in speedy and mass privatization of state-owned enterprises and China to favour insulation of the state sector from private economic encroachments and preservation of social ownership. Chinese reformers argued against ideological in favour of economic pragmatism. China took a politically induced path that allowed it to avoid many of the economic problems associated with Russian privatization (Lan Cao 2000).

Central planning in Russia was dismantled with the collapse of Communist governments. Decisions about what to produce, how much of each good to produce, from whom to buy intermediate inputs, and to whom to sell outputs, were decentralized down to enterprises. The post-Communist governments vowed to establish market economies based on private ownership through big bang or shock therapy. Big bang officially started with overnight price liberalization on most goods, accompanied by some measures to liberalize international trade and finance, to stabilize the macro-economy and to privatize state industries (Wei Li 1999).

The struggle for regime survival subjected China's leaders to a strategy of gradualist economic reform. The economic success of the gradualist reform strategy in turn has been a precondition for the political resilience of the Chinese Communist Party. The gradualist transition provided opportunities for individual leaders to develop coherent political strategies despite the formidable economic changes occurring (Barry Naughton 2008).

Gorbachev, at the end of the 1980s, was on the periphery between "gradual" and "big bang" approaches. A product of the apparatus himself, Gorbachev tried to completely restructure political power and got rid of much of the traditional CP hierarchy. He accumulated enormous personal power and faced few systemic constraints. He tried to create a new political system under the umbrella of his own power, expecting to lead a democratic Russia. However, lacking effective instruments, experience, or clear economic objectives, Gorbachev was unable to shape effective economic policies and adopted sometimes radical but often inconsistent policies. He pushed the economic system toward the precipice of some kind of big bang because he was eager to tear down the old political system (ibid).

Under Yeltsin, the "big bang" reforms were brought about only after political regime change and were implemented to consolidate those changes. The political calculus behind most big bang reforms was precisely the inverse of that behind gradualism in China. Destruction of the authoritarian hierarchy and the irreversibility of change were seen as positive side effects of big bang reforms. Cautious and gradualist strategies were rejected in part because they involved compromises with CP power holders who democratic reformers feared might claw back political and economic power. Rapid privatization in particular was favoured precisely because it created independent sources of political power (ibid).

The Chinese chose the path of incrementalism to a market economy and non-ideological pragmatism. Russia chose the shock therapy as the post-Soviet reformers saw anything that grew organically out of Soviet or Russian reform attempts as still bearing the stigma of communism. They wanted to make a clean break by using the "window of opportunity" (Joseph E. Stiglitz 1999).

Advocates of a "big bang" approach to transition have argued for a fast and comprehensive implementation of all major reforms. Speed was of the essence, they argued, as governments adopt reforms as fast as possible and attempt to create irreversibility for these reforms (Barry Naughton 2008). In Russia, the leasing movement was stopped dead in its tracks in favour of voucher privatization. Throughout the countries of the former Soviet Union, official announcements emphasized that voucher privatization was necessary to speed up the process (Joseph E. Stiglitz 1999).

The political economy argument in favour of gradualism was that an appropriate sequencing of reforms would provide demonstrated successes to build upon, thus creating constituencies for further reforms. In China, the success of de-collectivization built support for later reforms. Similarly, it was thought that successful entry of small and medium enterprises could build support for later reforms in the state sector (Gerard Roland 2001).

The "Washington Consensus" took an ideological and fundamental approach to reform as opposed to an incremental, remedial, piecemeal, and adaptive approach. The controversy was more about the attempted use of a shock therapy approach to "install" institutions— where it might more aptly be called a "blitzkrieg" approach. Historically, the shock therapy approach to changing institutions is associated with Jacobinism in the French Revolution and with Bolshevism in the Russian Revolution (Joseph E. Stiglitz 1999).

According to Joseph E. Stiglitz (1999):

> "The irony of it all is that the modern critique of utopian social engineering was based particularly on the Bolshevik approach to the transition from capitalism to communism, and the shock therapy approach tried to use many of the same principles for the reverse transition".

The most common early argument against gradualism was that it was impossible. Anders Aslund (1992) reflected and supported a remarkable consensus argued jointly by all the main international financial organizations. Today, the remaining supporters of the big bang approach recognize that Chinese gradualism was indeed feasible, but sometimes still argue that what was possible in China was not possible in Russia. An alternative explanation is that gradualist transition paths were possible in either environment but that political considerations were more important than economic considerations in determining the transition path adopted (Barry Naughton 2008).

The critics of gradual reform were apprehensive that the forces at play, that is, the old vested interests would somehow manage to reassert themselves, unless their power was broken. They worried, too, that the momentum for change was limited, and one had to seize the opportunity while one could (Joseph E. Stiglitz 1999).

The shock therapy advocates in Russia underplayed the importance of social, organizational, and informational capital; they underestimated the impediments to the creation of new enterprises; and they paid little attention to the issues of corporate governance. For example, on the voucher model, real "corporate governance" of the firms would reside in the voucher investment funds sometimes staffed by the political allies of the reformers (ibid).

Critics of the "big bang" approach argue that the emphasis on speed destroyed the organizational arrangements among existing enterprises which contributed significantly to the output collapse. This collapse, when combined with price liberalization and deep cuts in government spending, in turn led to sharp increases in poverty and income inequality. Badly sequenced reforms especially in Russia led to vested interests becoming entrenched and blocking further reforms (IMF 2000).

A more basic criticism of market fundamentalism is that it greatly underestimated both the importance and difficulty of creating the institutional infrastructure needed to underpin the operation of market economies. According to this view, reform should occur in an evolutionary manner that adapts existing institutions to new needs pragmatically and gradually, as has occurred in China. In this view, market fundamentalism was flawed because it eliminated institutions that could have been useful in the early stages of transition. It emphasized financial reform, while underestimating the process of ensuring enforcement of laws, reforming the organization of government, and developing self-enforcing norms that foster entrepreneurship. In the absence of core market-oriented institutions other reform efforts had unintended and negative consequences (ibid).

Other researchers, however, dispute these criticisms, noting that output was already beginning to fall before the transition began, that the organizational arrangements inherited from central planning were unsuited to the market, and that privatized firms have in many cases restructured more rapidly than those left in the hands of the state. They also note that the most unequal allocations of wealth and pronounced increases in income inequality and poverty occurred largely in countries where reforms were implemented only partially, and could be manipulated by vested interests for their own benefit (ibid).

<u>Economic Reform in Various Sectors-A Comparison</u>

Privatization

Standard neoclassical theory argues that for a market economy to work well there must be both competition and private property. In case of Russia, state assets were given away to one's friends and cronies; and the incentives for doing so were especially strong as the politicians conducting the privatization exercise got a kickback, either directly or indirectly as campaign contributions. In Russia, privatization was conducted in ways that were widely viewed as illegitimate and in an environment which lacked the necessary institutional infrastructure. Thus, the longer-run prospects of a market economy were actually undermined. The private property interests that were created contributed to the weakening of the state and the undermining of the social order, through corruption, for example, the presence of strong oligarchs in Russia (Joseph E. Stiglitz 1999).

On the other hand, China proceeded slowly with privatization. Indeed, significant privatization of TVEs (Towns and Village Enterprises) occurred only about fifteen years after their founding, and substantial privatization of larger firms commenced only about two decades after the start of China's transition. This method of privatization was originally viewed by many strategists as being too slow. Yet, it provided much-needed managerial skills and external funds for investment in the privatized firms, it generated government revenue and effective corporate governance, and it turned out to be relatively fast, taking about six to seven years (Jan Svejnar 2008).

Russia opted for rapid mass privatization and relied primarily on subsidized management–employee buyouts of firms. This method had the advantage of speed (two to five years), but it led to poor corporate governance as the existing management could not improve efficiency. The method also did not generate new investment funds and skills, and it provided little revenue for the government (ibid).

Banking System

Russia, allowed spontaneous growth of new banks from the bottom up, resulting in the creation of hundreds of banks virtually overnight. In Russia banking system was used more as a mechanism for financing the state deficit through tax collection and placement of the government debt (Sadrel REZA 2007:302).

In the development of a banking system, China first gradually supplemented the traditional Soviet-style mono-bank system with new banks and financial institutions. Both China and Russian economies have experienced problems associated with soft budget constraints in state-owned banks and failures of new private financial institutions (Jan Svejnar 2008).

Trade and Exchange Rate

In Russia state trading monopoly was abolished in 1992, when the exchange rate was also unified. By 1996, foreign trade liberalization was completed, and full current account convertibility was introduced. In the aftermath of the Asian Financial Crisis[70], the exchange rate was devalued in 1998 and range of currency restrictions was

[70]Asian Financial Crisis also led to the imposition of some trade restrictions by regional governments.

introduced and reversed the convertibility of the currency leading to multiple exchange rate regimes. The exchange rate has since been reunified along with the removal of some other restrictions in the middle of 1999, as a pre condition of the new IMF programme. Moreover, accession negotiations with the WTO, which began in 1993, have continued for tariff offers both on trade in goods and services but the process remains incomplete and Russia is yet to gain entry into the organization (Sadrel REZA 2007:298).

China steadily liberalized its foreign trade system which led to substantial increase in the merchandise trade to GDP ratio, from 27% in 1987 to 41% by 1997. China eliminated mandatory planning for exports and imports, and greatly increased the role of market forces. It lowered tariffs and abolished market impediments as part of the country's deal with the US in 1999 for WTO accession. China unified its exchange rate in 1994 leading to depreciation of the official exchange rate by about 50% (ibid).

Labour and Social Institutions

During the Soviet period, substantial social benefits were provided through the state or state enterprises. The labour market was both inefficient and inflexible as the productivity was low, and the structure of employment appeared "old-fashioned". The Russian government attempted to reconstitute the framework of social protection and to reform labour market institutions to bring them more into line with the structures found in advanced industrial economies. As a result of the changes induced by these various pressures, the labour market became flexible. However, increased competition in traditional industrial sectors undermined the security of both earnings and employment enjoyed by workers in such sectors as engineering and light industry. As a result, employees, especially skilled industrial workers, experienced deterioration in their relative economic status in most industrial market economies (Alastair Mc Auley 1998).

For almost two decades, China administered its labour and social system through the SOEs, with urban workers enjoying considerable protection and job security and the rural population receiving only limited social transfers from the central government. An important difference is that the population in China was much more rural than that in Russia, and the benefits provided by the government to the urban Chinese were huge relative to the incomes and benefits available to China's rural residents. The Chinese system hence induced greater urban–rural income inequality (Jan Svejnar 2008).

Legal System and Institutions

The major systemic transformation in Russia required completely new laws and institutions; yet it did not succeed in rapidly developing a legal system and institutions that would be highly conducive to the preservation of private property and the functioning of a market economy. China initially maintained and gradually reformed its legal and institutional system as it proceeded with its gradual economic reform (ibid).

In Russia, the Law on Ownership and Property (1990) allowed private enterprises to engage in any activity not prohibited by law. It also established the right to private ownership of land. The 1994 Civil Code laid down the legal forms for various business entities besides state enterprises and cooperatives[71]. A law on Competition and Restriction of Monopolistic activities on Markets of Goods was enacted in 1991. This law was later amended in 1995 creating anti-monopoly authority and banning a broad range of anti-competitive conduct. Further, a Law on Bankruptcy, enacted in 1993 and revised in 1998, was designed to encourage FDI. However, property rights were not well defined and it led to "extra-legal" formations, collectively referred to as the "mafias". The above mentioned reform-oriented laws adopted between 1990 and 1995 were often in conflict with other legislations and created many complications (Sadrel REZA 2007:300-301).

In China, the new constitution was promulgated in 1982 in which it was stated that socialist modernization was the nation's primary task. An amendment to the constitution in 1998 allowed private enterprises to exist and expand within the limits of law. This amendment also allowed transfer of land ownership in line with legal

[71]The types of corporations provided were joint stock and limited liability companies, full partnership and trust partnerships.

provisions. Yet, in China the legal system was not independent of the Communist Party (ibid).

Social Sector

The economic reforms brought in Russia social inequality and injustice in terms of not only current income but also savings, housing, the consumption of socially significant goods and services, health, and level of education (Lan Cao 2000).

By May 1997 the standard of living of the average Russian was only half that in December 1991. According to the Ministry of Labour, at least 25 % of those employed in the major branches of industry faced inadequate occupational safety and health conditions, and in some branches (metal trade, chemistry) this figure exceeds 40 %. Life expectancy for women fell from 74 years in 1986-1987 to 71.2 in 1994 and from 64.9 to 57.6 years for men. The number of those employed decreased from 73.8 million in 1991 to 65.4 million at the end of June 1997 due to declines in large and medium enterprises, especially in machine-building and light industries (Joseph Prokopenko 2000).

In China, Income inequality had risen during the reform period, propelled by the rural-urban income gap and by the growing disparity between highly educated urban professionals and the urban working class. There had also been increases in inequality of health and education outcomes. Poverty has increased from the mid-1980, in the sense that per capita income of the poorest sections of the population has increased less than the income of other groups. Economic reforms however, had created a labour market in which people could search for higher pay, and a result of this was that salaries for educated people had gone up dramatically (David Dollar 2007; World Development Indicators 2006).

SEZ and Economic Reform

Both China and Russia have used SEZs to help work toward economic development goals. Whereas China's SEZs have been successful at attracting FDI, Russia's have not. Until the recent passage of the new legislative framework, the incentives offered by SEZs such as Kaliningrad[72] were not guaranteed by law. The lack of trust and confidence within the investors is indicative of the main impediment to FDI inflow into Russia. Moreover, the economy and political system in Russia was fraught with instability and corruption (Tyler Curtis, *et al.* 2006:7).

In comparison to China, Russia lacked a large investment-minded diaspora. China located its SEZs to take advantage of investment from the large diaspora population. Russia did not have the same diaspora population, located in nearby enclaves and prepared to invest in the SEZs (ibid: 7-9).

The regions in which SEZs had been established in Russia lacked the resources needed to develop the zones so that they would be attractive to outside investors. Infrastructure needed for effective development of the territory was inadequate, and regional resources were not mobilized for this purpose. Russia lacked the prerequisites which made China's SEZs effective and led to its economic growth, as well as settling both economic and political crises during the 1990s (ibid).

China's central government strategically allowed for the establishment of carefully monitored SEZs in certain geographic locations in order to boost regional development. Russia did not experience economic growth driven by regional development. Russia under Yeltsin designated people in favour of economic liberalization and marketization as governors of regions with the expectation that they would establish more open market economies, including SEZs. However, this enhanced the opportunities for corrupt gains and provided additional assets that were mobilized for holding on to political power by the regional leaders (ibid: 8).

Although SEZs were established in Russia in order to take advantage of their geographical location, they did not benefit from location in the same way as Chinese SEZs. Many Russian SEZs, including SEZ Kaliningrad, were located in coastal provinces. These regions lacked the resources needed to develop the zones so that they would be attractive to outside investors. Infrastructure for effective development

[72]The SEZ Kaliningrad was first introduced in 1991. In 1996 a Russian Federal Law was enacted specifying its design and the SEZ regime has been extended and reformed by a law enacted in April 2006 (Special Economic Zone for Kaliningrad).

of the territory was lacking, and regional resources were not mobilized for this purpose (ibid: 9).

Economic Performance of Russia and China in the Transitions Years

The outcome of Russia's reforms has been very different from the experience of China. Rather than the lacklustre performance of Russian reform socialism through the 1980s or the precipitous fall in output which accompanied radical reform programmes after 1990, China doubled per capita income in one decade. Relative to post-socialist transition of Russia, China has moved slowly on price and market liberalization. And with the partial exception of agriculture, it did not affect a decisive allocation of property rights to private agents (Alan Gelb, *et al.* 1993).

China has generally performed well, although economic performance has varied across provinces and regions. In terms of GDP[73] growth, China's performance since 1978 has been unexpectedly strong, while that of Russia had been disappointing to disastrous in the early to mid-1990s (Table 3.1) Unlike China, which grew fast continuously since the start of the reforms, Russia experienced large declines (45%) in output at the start of the transition (Appendix III & IV) (Jan Svejnar 2008).

Table: 3.1 Economies in transition: annual growth (% per annum)

	1986-89 (Average)	1990	1991	1992
China	8.7	4.1	7.7	12.8
Russia	2.4	-2.0	-9.9	-19.9

Source: China Statistical Yearbook 1992; IMF, Economic Review: Russian Federation 1992; World Bank, World Tables 1993, and IMF, World Economic Outlook 1993.

Inflation

Russia experienced at least one year when inflation was above 2,000%. Sometimes these bouts of inflation rose after lifting price controls; in other cases, the inflation

[73]Calculating the evolution of GDP is difficult for the early phases of the transition because the communist countries used gross material product, a measure that ignored the production of services. Moreover, the dramatic entry and growth of small firms during the transition was not well captured in the official statistics.

grew out of financial sector crises. However, by the late 1990s, policymakers had shown that they could reduce inflation rates with considerable effectiveness (Jan Svejnar 2008).

While China experienced a 15–25% annual inflation in the 1993–1995 period, for most of the 1980s, 1990s, and 2000s, it kept inflation below 10 %. In effect, since 1997, China had achieved considerable price stability. Unlike Russia, China never experienced hyperinflation or major monetary overhang, and hence did not have to impose highly restrictive macroeconomic policies that might obstruct its rapid and steady rate of economic growth. It also achieved a rapid rate of growth while for the most part avoiding high rates of inflation (ibid).

External Debt and Financial Crises

In Russia, external debt in 1990 was 148% of GDP and in 1988 Russia defaulted on its sovereign debt. China launched its transformation without foreign debt and gradually became a major creditor to the rest of the world, accumulating sizable foreign exchange reserves. It has also avoided the worst effects of the Asian financial crisis because it was sufficiently insulated from the global financial markets and substituted domestic public investment for falling external demand (ibid).

Budget and Taxes

Russia initially struggled with declines in tax revenues, as many producers avoided paying taxes either by operating through barter or by accumulating tax arrears. The situation was particularly difficult as the government were facing demands for new public expenditures, including infrastructure and the new social safety net. China has proceeded gradually in reforming its tax system and ensured adequate budgetary revenues from the rapidly growing economy (Jan Svejnar 2008).

Domestic and Foreign Investment

Russia's overall investment climate had not been robust because of high inflation, a plunging GDP, an unstable exchange rate, an uncertain legal and political environment, and the capricious enactment and implementation of tax and regulatory regimes. The Foreign Investment Law of 1991 in Russia provided the statutory foundation for the treatment of foreign investment. The law provided for "national treatment" of foreign investments; that is, foreign investors and investments were to be treated no less favourably than domestically based investments. By the end of 1995, foreign investment in Russia since 1991 had totalled an estimated US$6 billion (ibid).

Throughout the 1980s and 1990s China maintained a high rate of investment. In this sense China has joined the East Asian tigers. China also generated a significant inflow of foreign direct investment (FDI) that had a positive effect on the modernization of China's economy as compared to Russia (ibid).

Failure of Russian Reforms

The failures of the reforms that were widely advocated in Russia go far deeper to a misunderstanding of the very foundations of a market economy, as well as a failure to grasp the fundamentals of reform processes (Joseph E. Stiglitz 1999). To Joseph Stiglitz (1999), for instance, the failure of rapid privatization in Russia "*was not an accident, but a predictable consequence*" of the absence of competition policies and the institutional and legal infrastructure needed to support a successful reform effort.

The immediate results of the Russian reforms in the absence of appropriate institutions turned out to be disastrous. The privatization programme degenerated into a management-employee buyout arrangement which led to widespread asset-stripping (Sadrel REZA 2007:277-278).

While opposite view is taken by some Russian observers and policymakers such as Boris Fedorov (2000) and Andrei Illarionov (1998), is that the reform strategy was the correct one, but never implemented, in part because of the leniency shown by the advanced market economies and international financial institutions. Illarionov (1998) writes that ". . . *the IMF's attitude towards economic policy carried out by the Russian authorities was and remains timid, inconsistent and subject to permanent compromise...*"

The reform policies in Russia got derailed because of certain special factors. Fischer and Sahay (2000) write that the source of Russia's unsuccessful economic reforms lay largely in the "*failure to drive ahead with reforms after 1996 elections, when powerful vested interests strengthened their hold on political and economic power, deepening corruption.*"

The difficulties and setbacks suffered by Russia during transition were examined by former Prime Minister Yegor Gaidar, who argued that Russia was lacking for the creation of an effective market economy at the end of 1991. There was no well developed, firmly established private sector and no clear-cut rules defining the relations between state enterprises and their owner. There was no competitive, de-monopolized market environment. There was no system of financial institutions to ensure the effective redistribution of resources. There was no well-developed labour market, and labour mobility was restrained by traditions and lingering administrative restrictions. Russia did not have its own banking and monetary system, its own borders or its own customs (Yegor Gaidar 1992).

Those advocating rapid privatization faced the dilemma that there were no legitimate sources of private wealth within the country with which privatization could be accomplished. Governments thus faced essentially four alternatives— sales of national assets abroad; voucher privatization; taming "spontaneous" privatization; or "illegitimate" privatization. The latter was the route Russia chose after 1995 in the "loans-for-shares[74]" scheme. This led to widespread corruption (Joseph E. Stiglitz 1999).

Privatization in Russia was not carried out in a legitimate fashion. It was conducted on the basis of Presidential decrees rather than Duma approval. When Yeltsin came to power he tried to strengthen his position by issuing various decrees for the smooth initiation of the economic reforms. The decree on "On Stage by Stage Constitutional Reform in the Russian Federation", No.1400, dissolved the Congress and the Supreme Soviet (Nezavisimaya gazeta September 22 1993). According to Joseph E. Stiglitz

[74]In the loans-for-shares deal the private entrepreneurs lend to the government, with the shares of government enterprises as collateral.

(1999*), "Since the whole process was widely viewed as illegitimate, this "robber baron" privatization put market capitalism to even greater disrepute than perhaps the indoctrination of the Communist era".*

Moreover, the declining confidence in the economy and the government made the country even less attractive to foreign investors. The oligarchs found that they could extract more wealth from asset stripping than from redeploying assets in way that would provide the foundations of wealth creation (Joseph E. Stiglitz 1999). Foreign involvement during Russia's privatization was virtually negligible, and most of the FDI entering Russia - whether for wholly new undertakings, or related to privatization and restructuring - was heavily concentrated in just four areas, that is, Moscow City, Moscow oblast, St Petersburg, and Leningrad oblast.

Success of Chinese Reforms

China was able to avoid the failure suffered by Russia as it followed a more flexible and "gradualist" reform programme. China also lacked the market supporting institutions. However, it brought about changes in the form of "incremental reform" (*zengliang gaige*), that is, introducing dramatic changes outside rather than inside the existing core of central planning. While this held back essential enterprise reforms and privatization, overall it contributed to remarkable GDP growth, sometimes referred to as the "Chinese puzzle" as it is inexplicable (Yingyi Qian and Jinglian Wu 2003; Sadrel REZA 2007:278).

The success of gradual reform in China can be attributed to two factors. First, as Barry Naughton (2007) has argued, through gradual reform, the government retained its role as a stabilizing force in the midst of the turbulence that inevitably accompanies the transition from plan to market. Institutions such as the "dual-track" system kept large state-owned enterprises partially on the plan and, at the same time, gave them incentives to generate extra income through selling what they could produce above the plan in China's nascent markets. Over time, as market economic practice became more successful, the plan part of an enterprise's portfolio was reduced and the market part grew. Enterprises were thus given the stability of a continued but gradually diminishing planned economy system and the time to learn the practices of setting prices, competing for contracts, and producing efficiently (Doug Guthrie 2008).

Second, the government gradually pushed economic control down the government administrative hierarchy to the localities. With economic control came accountability, and local administrators became very invested in the successful economic reform of the villages, townships, and municipalities under their jurisdictions. Thus, pushing economic responsibilities onto local administrators created an incentive structure much like those experienced by managers of large industrial firms (ibid).

Whereas Russia made only faltering steps towards a market economy, China was able to point to a dynamic indigenous private sector and significant inward investment, notably in the coastal regions of the south and east. China also registered consistently high rates of economic progress (Norman Flynn, *et al.* 2001).

The emergence of foreign linked joint ventures, and eventually of wholly owned foreign firms, as major elements of China's economy brought millions of Chinese workers, engineers, and managers into direct contact with the technical standards, engineering processes, and management practices needed to compete in global markets. Growing foreign presence strengthened the demand for new reform initiatives (Loren Brandt and Thomas G. Rawski 2008).

Despite the authoritarian nature of China's political system, pre-reform policy structures allowed widespread experimentation and regional variation within broad guidelines set by the central leadership. Starting with the restoration of household agriculture in the late 1970s, China has implemented a long sequence of increasingly coherent, focused and gradual economic reforms. China's reforms consistently focused on mobility, price flexibility, competition, and openness. China's economic gains to the success of reform can be attributed in activating these key elements in the economy (ibid).

Foreign direct investment in China rose very rapidly in recent years, aided by the establishment of free trade zones in coastal areas. China has also gained increasing access to other private financing flows, foreign bank loans in particular (World

Economic Outlook 2000). China opened up the country's coast for foreign investment, initially by setting up four special economic zones with fiscal incentives and tax concessions, which attracted huge amounts of FDI and thereby led to the growth of the non-state sector. Since 1992, there was rapid proliferation of open economic zone (Sadrel REZA 2007:296).

Comparing Similarities between Russia and China

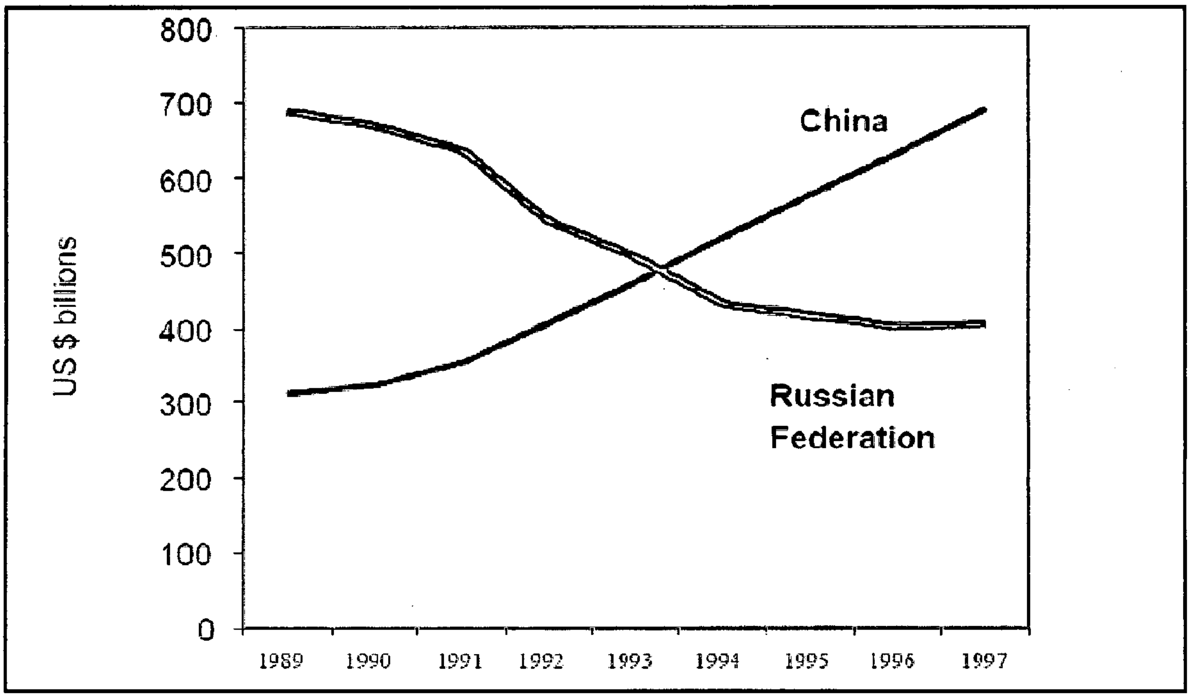
Reforms led to economic inequality in both the countries. In Russia, on the other hand, there had been an aggravation in the incidence of poverty. However, in China it had been more regional in nature accompanied by a decline in absolute poverty (Sadrel REZA 2007:303-304). Both countries opened to the outside world and introduced legal reforms. Yet, the law enforcement mechanisms remained weak in both the countries (ibid).

In both the countries, there were soft budget constraints for enterprise managers, compounded in Russia due to easy administrative constraints. Both the countries saw the emergence of the growing private sector. While private sector in Russia was being managed by the mafia groups and thus, operated in a non-competitive environment, the growth was more robust in China, although Government policy had been biased in favour of SOEs (Sadrel REZA 2007:303-304).

Both Russia and China have faced problems with carrying on the privatization process. Corruption had been rampant in both the countries. Russia faced the problem of acute political corruption and criminal practices rampant in both economic and political sphere. China was confronted with the problem of political and bureaucratic anxiety. However, in Russia it had taken the form of organized crime. Due to this, the market economy in Russia had been dubbed as "phony capitalism". This problem was further compounded by non-payments and the preponderance of various kinds of barter arrangements thereby creating "virtual economy" (E. Sam Overman 1995; Sadrel REZA 2007:303-304).

Both Russia and China achieved low returns in terms of civilian technical progress from their investment in science. Russia's scientific expertise would have been hugely attractive to foreign investors if the correct institutional environment, such as enforceable legal framework would have been constructed and steady growth of demand ensured (Peter Nolan 2004:12).

Figure: 3.1 Russian and Chinese GDP (1989-1997)*



** Measured in constant 1987 US$*

Source: Statistical Information and Management Analysis (SIMA) database

In spite of the expectations, market reforms in China proved to be successful, while it did not occur in Russia. It is clearly evident in the comparison of the GDP of the two countries (Figure 3.1). So over the decade beginning in 1989, while China's GDP nearly doubled, Russia's GDP almost halved; so that while at the beginning of the period, Russia's GDP was more than twice that of China's, at the end it was a third smaller.

Comparing Differences between Russia and China

While China maintained continuity in its political and social system, the old Soviet system collapsed causing social and economic disruptions in Russia. Russia attempted a full transformation of the economy within a short time. The absence of market supporting institutions led to widespread "theft" of the state property and the emergence of oligarchs. In contrast, China proceeded gradually following a dual track approach. The rationale was that first, it would avoid resistance from strong vested interests and second, it had already achieved spectacular economic growth in the pre-reform period, that is, 1977 and 1978 (Sadrel REZA 2007:304).

In China, cross-regional competition was the driving force in the transition process as well as the competition generated by foreign firms and domestic non-state firms. On the other hand, Russia witnessed "managed economy" by the extra-legal groups. There had been a huge concentration of wealth and though FDI occurred in certain sectors there also appeared significant capital flight. Privatization in Russia helped in minimizing the fiscal problems arising from loss-making SOEs. Yet, it also meant the plundering of a considerable amount of national wealth. Government policies towards new business entrants also appeared hostile due to a complex tax system, highly statutory tax burden and arduous regulatory requirements (ibid: 304-305).

The main policy differences between Russia and China have been macroeconomic. China was more cautious than Russia in its monetary policy. China also faced serious macroeconomic imbalances but has tended to manage them more appropriately and with better results. Its monetary policy was never as reckless as Russia. Russia was subjected to severe macroeconomic mismanagement which contributed to a flight from rubles in 1990 and 1991. Under the system of price controls, the monetary expansion worsened shortages and widened the gap between official prices and black-market prices (Jeffrey Sachs and Wing Thye Woo 1994:112).

Russia had 14% of the labour force in agriculture and 32% in industry when it started off with its reforms in 1985. In comparison, China had 71% of the labour force in agriculture and only 15% in industry at the beginning of its reforms in 1978. Under central planning the Soviet Union developed a considerable division of labour, but one that was inefficient and difficult to reorient. Since pre-reform rural China had much less division of labour, creating a market-based division of labour was much easier (Jeffrey Sachs and Wing Thye Woo 1994).

Moreover, China was able to exploit a comparative advantage in virtually unlimited supplies of cheap, albeit unskilled labour, and build a major new economic sector, as it were, alongside the old; Russia could not (Nigel Harris and David Lockwood

1998:79-80).

As said by Martin Dimitrov (2008:28),

> "...countries with an abundance of natural resources often experience the so-called resource curse, essentially delaying the diversification of their economies while encouraging corruption and in the long run slowing down economic growth. Ultimately this can have disastrous consequences for political stability. Indeed, countries rich in natural resources may turn out to be far less stable than resource-poor countries in which high growth is based on productive activity."

Despite the huge potential attractiveness to foreign investment, the amounts invested in Russia have been negligible as compared to China. The fact that Russia failed miserably to attract foreign direct investment as compared to China is attributable to massive instability caused by policy choices in politics and economics. The conditions of political stability, secure property rights and a guaranteed share of income from the investment were missing in Russia. This was due to criminalization and corruption and strong links between the Russian government and the "private" Russian oil companies. Post-1978 China attracted substantial direct foreign investment as it provided political stability, cheap labour costs, reliable investment guarantees and rapid growth which made it attractive as a potentially huge market (Peter Nolan 2004:11; 32-33).

Russia is one of the world's richest countries in raw materials, many of which are significant inputs for an industrial economy. Russia accounts for around 20% of the world's production of oil and natural gas and possesses large reserves of both fuels and is also self-sufficient in nearly all major industrial raw materials. China has massive coal reserves. However, it has not been to locate large oil and natural gas reserves. China's continued need to depend heavily on coal as the main source of energy was a substantial burden during the reform period (ibid: 32-33).

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Chapter 5

Conclusion

Chapter 5

CONCLUSION

While setting in motion the economic transition process and liberalization, policy makers need to know what policies would be the most feasible for the respective countries, the appropriate time period when the reforms should be initiated and how best to carry out the reforms in the political and economic setting of the countries. The economy needs to be in a decent shape to endure the treatment. An important question which needs to be considered is-sequencing, that is, what aspect of the reform should go first, second, and so on. Again this depends on a country's social, economic and political situation. Experience shows that economic reform will benefit a country in the long term only if social and macroeconomic stability are preserved in the reform process. Without stability, good plans or reform strategies cannot be implemented.

In the absence of these circumstances, a country may be much better off adopting a gradualist approach and should steer clear of colossal and radical changes. Various alternatives should be first explored on a smaller scale before exposing the entire country to major policy shocks. Like SEZ, for example, provides a laboratory in which policy-makers are able to ascertain problems, sort out issues, develop policy measures, and test and assess the outcomes. Gaining necessary experience first in the SEZs allows the policy-makers to avoid possible lapses when the rest of the economy is brought onto a transitional path, thereby increasing the chances of success. A good reform target is to make a significantly higher marginal contribution to economic growth while keeping the cost of transition as low as possible. Without support from the majority of the population no profound reform is likely to succeed.

The study begins with the research on three hypotheses: first, radical liberalization of Russia's economy without installation of appropriate institutional framework resulted in economic instability and disorder. Second, Russia's failure to follow cross-regional competition like China as well as competition generated by foreign firms and domestic non-state firms, led to its unsuccessful economic transformation. Third, Russia's SEZ lacked adequate mobilization of regional resources, infrastructure facility and legal status together with unstable economic and political system, the pre-requisites which made China's SEZs effective and led to its economic growth. In the preceding chapters the above mentioned hypotheses have been successfully proved.

The second chapter begins with the discussion of the economic reforms adopted by Russia in the period between 1985 and 2000. It discusses the reform policies adopted by Gorbachev and Yeltsin and their critical appraisal. Rapid privatization schemes promoted by the standard Western advice did not establish or lead to controlling owners motivated to restructure enterprises towards long-term economic success. Beginning with the presidency of Boris Yeltsin in the early 1990s the communist planned economy and the centrally political arrangement were demolished. The government also introduced parliamentary elections and passed laws to create a more independent judiciary.

Large portion of the Russian public remained dissatisfied with reform. Corruption pervaded the country, and the income gap between a small group of rich oligarchs and the general population widened over the years. In the context of Russia the importance of institutional reform was recognized at the beginning of the transition, but in practice it was given too little attention relative to macroeconomic developments. Yeltsin failed to lay down the proper institutions for a political system or for a market system, both of which require a very strong, durable institutional infrastructure.

The third chapter describes the economic reform pursued by Deng Xiaoping in China. The chapter highlights the gradual reforms adopted in China and the growth of successful SEZs in Chinese economy. China began privatizing its economy by the state sector and by concentrating on removing barriers to entrepreneurship, allowing new firms to be created, and establishing, gradually but steadfastly, a market-oriented economy. Between 1978 and 1996, the country grew at an annual average rate of almost 10 %, mostly because of the proliferation of new firms in the new, non-state sector, established at the margin of and parallel to the old state sector. The initial preservation of state firms, in many cases, served as an anchor for the new firms and stimulated their growth. The new firms, in turn, acted as an economic and social cushion, absorbing workers from the old state sector as it went through the difficult process of restructuring.

Since 1978, when China adopted its open-door policy and allowed its economy to be exposed to the international market, it has adhered to what Deng Xiaoping called *"socialism with Chinese characteristics."* As a result, it produced an economy with one of the most rapid growth rates in the world by steadfastly embarking on a developmental strategy of gradual, market-oriented measures while simultaneously remaining nominally socialistic.

The second and the third chapter help in establishing the first hypothesis. Due to the vacuum in which Russia had to operate for lack of an appropriate institutional framework, there were serious problems with its big-bang approach. Without developing a rule of law, powerful individuals and arbitrary agencies cannot be replaced to inspire public trust. In order to ensure enforcement of the laws, an effective judicial is an obvious pre-requisite. There is also the need for a strong financial sector, which plays an integrated role in channelling savings to most efficient use. Most of the miseries that Russia suffered originated from the absence of these institutions. On the other hand, China adopted the gradualist approach and inched towards institutional changes when the economic, political and social climates were found favourable.

The second and the third chapter also ascertain the second hypothesis that competition is the key to economic development. Deregulation, decentralization of decision making power, and privatization are the best way to promote competition and thereby transform planned economies into market economies. In Russia, privatization took place through both formal and informal processes. Only a fraction of the stock of privatized companies had been sold to the public; as much as 70 %, remained in the hands of workers, existing management and the state. In this ownership structure the first priority of management was to maintain its control position, while that of labour was to protect or increase wages; this did not lead to new investment or improved competitiveness. In many cases existing management had "privatized" unilaterally, had established parallel enterprises or in other word resorted to insider trading.

In China there is a mitigating factor in that there had been considerable regional decentralization that led to the spontaneous emergence of numerous small-scale enterprises throughout the country, which generated some amount of market competition.

Tariffs on a wide range of consumer imports were sharply increased during 1994. Imported goods were restricted from the Russian market, existing monopolies were reinforced and competitive pressures that in other circumstances would have stimulated improved quality and productivity were suppressed.

The fourth chapter compares the economic transformation brought about in Russia and China. Shock therapy and Incrementalism implemented by Russia and China respectively is discussed. Along with this the initial condition existing in both the economies is also highlighted. The similarities and the differences between Russian and Chinese economic reforms and conditions are also being compared and analyzed. The outcomes in the various economic and social sectors are also covered in detail.

China could set its own reform pace because it did not face any sudden and severe shock and its political fabric remained intact. Moreover, the country had already achieved substantial economic growth in the pre-reform years in 1977 and 1978. Russia adopted radical approach as by the time reforms were attempted in the late 1980s; state power and legitimacy had sunk to a level which could preclude adoption of a successful evolutionary strategy.

China embarked on a reform path which was more pragmatic and gradual and responded to specific circumstances by developing transitional institutions rather than adopting any quick fix approach to reforms. China's economic policy emphasized macro-economic control, income equality and regionally balanced development. Finally, even at early stages of reforms, the importance of foreign investment was recognized in the growth process.

The fourth chapter along with the third chapter helps to establish the last hypothesis, that is, Russia's lack of adequate prerequisites for the successful working of SEZs in comparison to China. The fourth chapter compares the SEZs of Russia and China and brings out the reason behind the smooth functioning of SEZ in China. It points out the policy mistakes committed by Russia in dealing with the SEZ operations and also the lack of efficiency in carrying out SEZ related reforms.

The SEZ was successfully used in facilitating the process of economic transition and development in the case of China. The SEZ can play a useful, effective, and beneficial role in facilitating the process of economic transition and development. The Chinese experience of SEZ can be used as useful policy lessons. China's highly structured economy offered a relatively stable climate for business. Lacking the prerequisites which made China's SEZs effective and led to economic growth, as well as negotiating both economic and political crises during the 1990s, Russia did not experience economic growth driven by regional development.

At last the study sums up the work by stressing the fact that in the comparison of the economic transformation of Russia and China, the issue is not so much big-bang versus gradualism but one of achieving macroeconomic stability and quickly shifting factors of production to the most efficient use.

Countries that adopted a two-pronged strategy combining macroeconomic stabilization and comprehensive structural reform were, on the whole, more successful in limiting the output losses at the outset of the transition and achieving robust growth subsequently. The two components of the strategy were equally necessary: a measure of macroeconomic stability had to be secured before countries could proceed effectively with enterprise and financial sector reform, and such stability could not be maintained unless the enterprise and banking sectors were subject to financial discipline and competitive pressures.

A country's political-economic aspects play an important role in the success of the reforms. Limited competition, incomplete liberalization, incentives to go underground, and the uneven rule of law can freeze the transformation in its tracks. Slow economic progress, a reversal of growth, and a collapse of financial stabilization can easily result. Lastly, unfavourable initial conditions are also responsible for unfavourable reforms.

There is no royal road to reform. There is no one key, no panacea. One needs to implement all the different components of reform. Growth comes as a result of a great deal of effort by many people doing the right things over an extended period. The market is necessary but it must be embedded in society. The state must play an active role in the market economy to prevent a disembedded and self-regulating market from dominating society.

The discourse on transitional economies has been circumscribed by a number of incorrect assumptions about the fundamentals of economic reform and the very foundation of a functioning market economy. First, it has been widely assumed that the failure of command economies means that state ownership must be replaced by private ownership, which in turn requires immediate state-sector privatization. Second, divesting the state of its assets in state firms and transferring those to private holders, it was assumed, will result in an efficient restructuring of the firms by the market itself. It is believed that privatization will create the market, which will then force the newly privatized firms to act in competitive, market-oriented ways.

Those were the assumptions that guided the transitional path in Russia. China, however, has proven these assumptions wrong. China has created and embarked on its own path of reform, called as "Beijing Consensus[75]" by some scholars, one markedly different from the "Washington Consensus" model of transition prescribed for and applied to Russia.

The global experience illustrates that economic programmes are most likely to succeed when they are owned by the country that implements them, and that success is not necessarily dependent on support from international financial institutions and

[75]Beijing Consensus used first by Joshua Cooper Ramo in his book "The Beijing Consensus" published in London. The author claimed that the "Beijing Consensus" was to replace the highly discredited "Washington Consensus", the recipes of which "[...] left a trail of destroyed economies and bad feelings around the globe." He described China's approach to development as boiling down to ensure a fair, peaceful and high-quality-growth and to combine the social and economic transformation. The Beijing Consensus, though, has a marked shortage of detailed elaboration and universalism (Alexander Lomanov 2008:31).

bilateral lenders and providers of technical assistance. This was an important lesson of the first post communist decade. While Russia could not successfully carry out its reform programme, China on the other hand had been successful in undertaking the needed reforms. In Russia's case the problems lay chiefly in the political sphere: in the lack of political or social support for reform, and the consequent problems of governance. There is widespread skepticism about the Russian economic reforms of the 1990s.

Each country is sui-generis and therefore needs to adapt policies to suit its own unique circumstances. The lessons from other countries are important, but time and country specific factors should work as a reality check on their relevance and adoption. Some catalytic factors may be needed to speed up critical reform programmes like aspiration to join WTO in the case of China.

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Appendices

Number of Enterprises Privatized, March 1992-August 1994

Month	Total no. of firms privatized	Total no. of firms privatized each month	Small firms privatized each month
1992			
March	1352		
April	2995	1643	1643
May	5855	2860	2860
June	8933	3078	3078
July	12015	3082	3082
August	17230	5215	5215
September	22572	5342	5342
October	29235	6663	6663
November	34932	5697	5697
December	46815	11865	11883
1993			
January	54243	7428	7323
February	57989	3746	3555
March	59495	1506	1071
April	66000	6505	5900
May	68000	2000	1411
June	72000	4000	3142
July	78000	6000	5144
August	81000	3000	2223
September	82000	1000	72
October	83000	1000	159
November	86000	3000	2133
December	89000	3000	1957
1994			
January	91000	2000	1332
February	93000	2000	1295
March	95000	2000	1068
April	98000	3000	2134
May	99000	1000	162
June	102000	3000	1645
July	104000	2000	
August	106000	2000	

Source: Government of Russian Federation. Russian Economic Trends, Vol-2 No-4, p-68, Russian Economic Trends: Monthly update, 17th October, 1994 Table-11.

Results of Voucher Auctions: December, 1992-June 1994

1992	**Enterprises sold each month**	**Total number of enterprises sold**
December	18	18
1993		
January	107	125
February	197	322
March	446	768
April	614	1382
May	577	1959
June	909	2868
July	915	3783
August	902	4685
September	814	5499
October	964	6463
November	962	7425
December	1043	8468
1994		
January	668	9136
February	705	9841
March	932	10773
April	866	11639
May	838	12477
June	1355	13832

Source: *GKI/* Russian Privatization Center.

Appendix III

Index of Real GDP, Russia, 1990-2000

Year	Growth of real GDP	Index of real GDP (1991=100)
1990	-3,0	105,3
1991	-5,0	100,0
1992	-14,5	85,5
1993	-8,7	78,1
1994	-12,5	68,3
1995	-4,1	65,5
1996	-3,6	63,1
1997	1,4	64,0
1998	-5,3	60,6
1999	6,4	64,5
2000	10,0	70,9

Source: Russian State Committee on Statistics, various releases

Appendix IV

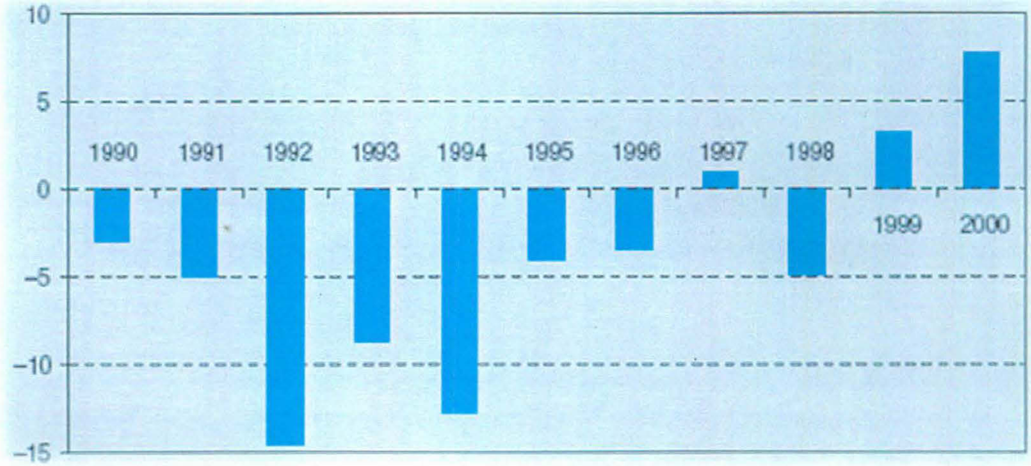
China's Annual Average Real GDP Growth Rates, 1960-2000

Time Period	Average Annual % growth
1960-1978 (pre-reform)	5.3
1979-2005 (post-reform)	9.7
1990	3.8
1991	9.3
1992	14.2
1993	14.0
1994	13.1
1995	10.9
1996	10.0
1997	9.3
1998	7.8
1999	7.6
2000	8.4

Source: Official Chinese data.

Appendix V

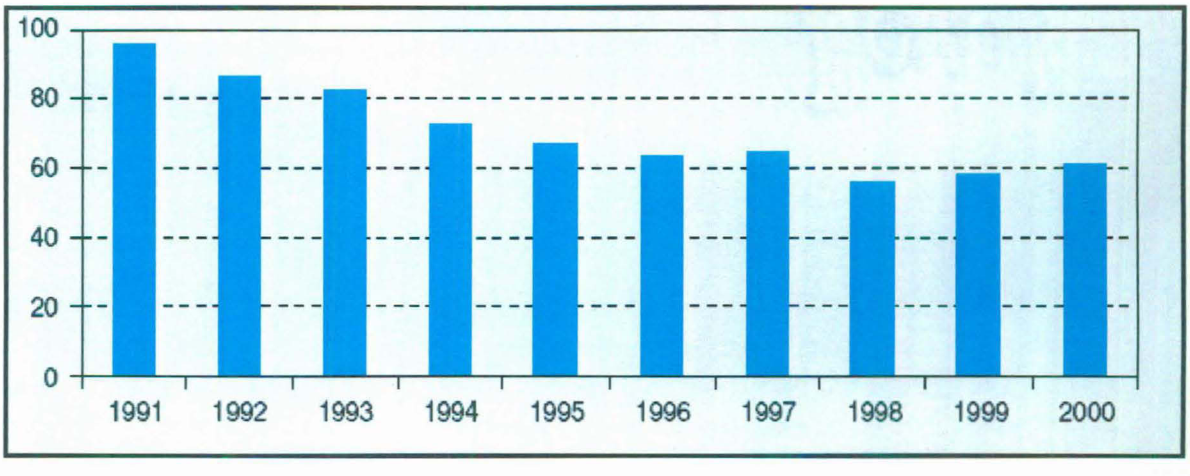
The growth dynamics of the Russian economy in the 1990s Annual GDP increment (in %)



Source: Human Development Report, Russian Federation, UNDP 2002.

Appendix VI

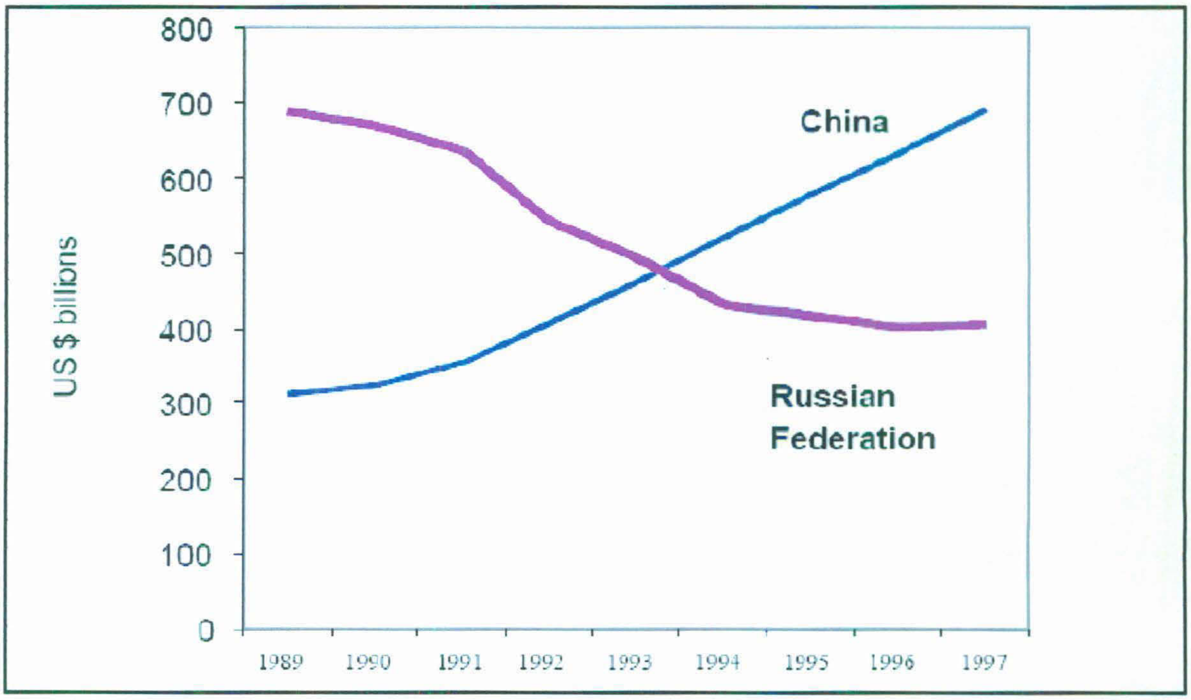
The dynamics of the fall in agricultural production, 1990-2000 (gross agricultural product, as % of 1990)



Source: ibid.

attractive to foreign investors if the correct institutional environment, such as enforceable legal framework would have been constructed and steady growth of demand ensured (Peter Nolan 2004:12).

Figure: 3.1 Russian and Chinese GDP (1989-1997)*



* *Measured in constant 1987 US$*

Source: Statistical Information and Management Analysis (SIMA) database

In spite of the expectations, market reforms in China proved to be successful, while it did not occur in Russia. It is clearly evident in the comparison of the GDP of the two countries (Figure 3.1). So over the decade beginning in 1989, while China's GDP nearly doubled, Russia's GDP almost halved; so that while at the beginning of the period, Russia's GDP was more than twice that of China's, at the end it was a third smaller.

Comparing Differences between Russia and China

While China maintained continuity in its political and social system, the old Soviet system collapsed causing social and economic disruptions in Russia. Russia attempted a full transformation of the economy within a short time. The absence of market supporting institutions led to widespread "theft" of the state property and the emergence of oligarchs. In contrast, China proceeded gradually following a dual track