# Lessons from Economic Transition in Russia and China

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In December 1991 the Soviet Union disintegrated and its largest constituent republic, Russia, emerged as an independent state. The political leadership of newly independent Russia embarked on an effort to replace its state socialist system, based on state ownership of enterprises and central planning, by a capitalist market system, based on private property and a market system of coordination. The economic strategy that Russia has relied on to implement this transition goes by several names, the most descriptive of which is the neoliberal transition strategy (hereafter NLTS). This strategy, designed by Western neoclassical economists, calls for limited government involvement in the transition process, relying primarily on individual self-interested initiatives to transform the economy. The other countries that emerged from the former Soviet Union, and the former Soviet Bloc countries in Central and Eastern Europe, have also been following the NLTS.

The other giant state socialist country, China, began its own transition to a capitalist market system earlier, in 1978. China's transition strategy, which might be called a state-directed transition strategy (hereafter SDTS), differs significantly from the NLTS. China's SDTS involves, as the name suggests, a very active role for the state in managing the transition.

By 1996 Russia's historic transition had been ongoing for five years while China's transition was eighteen years old. Everyone agrees that economic performance in China during its transition has been dramatically superior to that of Russia–China's economy has grown very rapidly throughout the transition while Russia's has declined precipitously. Despite the markedly different performance, with few exceptions mainstream neoclassical economists have not altered their belief that the NLTS is far superior to China's SDTS.

We will examine the question of why neoclassical economists have clung to the NLTS despite its disappointing results and despite the presence of an apparently successful alternative. In 1996 the World Bank's annual *World Development Report*, entitled that year *From Plan to Market*, was entirely devoted to analyzing the transition experience of Russia, China, and 26 other countries. We will use this major study to examine the neoclassical response to the Russia/China comparison. First, however, we will review Russia's and China's transition strategy and experience up through 1996, the year of the World Bank study.

## Russia's Transition Experience

The NLTS, sometimes known as "shock therapy," calls for making the transition from state socialism to capitalism very rapidly, within a few years. This strategy relies on three main policies: liberalization, stabilization, and privatization. Liberalization refers to the removal of state restrictions on price-setting and other market behavior. Stabilization aims to bring the inflation, released by liberalization, under control through reductions in government spending and tight monetary policy. Privatization calls for turning state-owned enterprises into privately owned companies. In addition to these three policies, the NLTS also insists upon the immediate cessation of state allocation of resources and the removal of barriers to free international trade and investment. In essence, the NLTS calls for transforming a state socialist system into a capitalist market system by eliminating state ownership of enterprises and state control over the economy, expecting that individual initiative and market forces will thenceforth take over the roles of initiating and coordinating economic activity that had previously been performed by the state.

Starting in January 1992, the Russian government adhered closely to the NLTS. Central planning had been largely eliminated during the last two years of the Soviet period in 1990-91, and the remaining elements of central allocation of resources were terminated during 1992. Nearly all prices were freed from state control on January 2, 1992. Government spending was sharply reduced, dropping from 47.9 per cent of gross domestic product (GDP) in 1991 to only 26.9 percent in the first half of 1995 (International Monetary Fund 1992, p. 70, and 1995, pp. 5, 21), which is below the percentage in the United States. Monetary policy has been so tight that the money supply (M2) fell from 100 per cent of nominal GDP in 1990 to only 16 per cent in 1994 (World Bank 1996, p. 21). Privatization proceeded faster than anyone had expected; by year-end 1994 non-state enterprises accounted for 78.5 per cent of industrial output (*Statisticheskoe obozrenie* 1995, No. 4, p. 41). Russia also quickly established a regime of relatively free imports, free international capital flows, and free currency exchange.

**<<Place Table 1 about here>>**

Since January 1992 Russia has experienced the most severe, prolonged economic decline of any major country in peacetime in this century. Table 1 shows that, during 1991-96, real GDP and industrial production both fell by nearly one-half, investment by more than seventy percent, and agricultural output by one-third. Average real pay fell by just over one-half by late 1995. While every sector of Russian production has collapsed, the output of fuel, raw materials, and metals has contracted less than the rest of the economy (Kotz with Weir 1997, pp. 175-78). A reversal of this rapid and prolonged decline is not yet in sight as of mid 1999. Russia's economic trajectory is turning its formerly diversified economy into one centered around the extraction and export of raw materials, which does not hold out a promising future for Russia's well-educated, largely urban population.

Russia's state and non-state institutions have been unable to pay their employees on time, even at the greatly reduced pay scales. Unpaid wages were estimated at 36.5 trillion rubles ($6.8 billion) in September 1996, which represented approximately 64 per cent of the nation's total monthly wage bill (*OMRI Daily Digest* 1996). An estimated 55 percent of the population is forced to obtain over half of their food by growing it themselves in their tiny backyard plots

(*RFE/RL Newsline* 1999). About 70 percent of transactions are conducted based on barter and other money substitutes.

The human cost of this economic decline has been enormous. Russia's death rate rose from 11.4 per thousand population in 1991 to 15.5 in 1994, before falling to 14.3 in 1996 (*Rossiiskii statisticheskii ezhegodnik* 1994, p. 43, and *Statisticheskoe obozrenie* 1997, No. 1, p. 7). The elevated death rate was fueled by sharp increases in deaths due to alcohol-related causes, suicides, murders, circulatory diseases, respiratory diseases, and infectious and parasitic diseases, the causes of which can be traced, directly and indirectly, to elements of the NLTS and the economic decline that followed its introduction (Field, Kotz, and Bukhman, 1999). The increased death rate during 1992-96 produced an estimated 2.1 million premature deaths in Russia during that period.

Russia's economy was battered further in August 1998 when the Russian government became unable to make payments on its foreign debt, producing a financial collapse. Russia's currency lost about three-fourths of its value in relation to the dollar, Russia's import-dependent consumers took another hit to their living standard, and many of Russia's major banks were driven into insolvency. For Russians this experience seemed the final proof of the failure of the NLTS.

The NLTS has also been applied since 1992 by most of the other newly independent states (NIS) that emerged from the Soviet Union and, since 1990, in the formerly state socialist countries of central and eastern europe (CEE). Economic performance has varied among these states, but all went through severe economic depressions after introducing a NLTS. While some began to grow several years later, none had even reached its pre-transition level of GDP by 1995 (World Bank 1996, p. 173).

**China and the State-Directed Transition Strategy**

When China began its transition to a market system in 1978, Western experts sought to persuade the Chinese leadership to pursue a NLTS. However, this advice fell on deaf ears in China. Instead, the Chinese leaders developed a radically different SDTS.

Rather than simply liberalizing prices, China maintained a dual system of prices, under which state enterprises had to provide a certain quantity of output at the lower plan price, with output above that level sold at the market price. Price controls were kept on many retail goods through 1991, 13 years after the transition began (World Bank 1994, pp. 2, 193).

Direct administrative measures were combined with periodic brief spells of selectively tightened credit to keep inflation under control. Rather than cutting state spending, the state undertook substantial investments in infrastructure to facilitate economic growth. Rather than tight monetary policy, China allowed substantial credit expansion, while directing credit into productive investments by means of government control of bank lending (banks remained state owned and controlled) and direct setting of interest rates. In contrast to the sharp monetary contraction in Russia, in China the money supply (M2) rose, from 25 per cent of GDP in 1978 to 89 percent in 1994 (World Bank 1996, p. 21).

Rather than privatizing state enterprises, the state encouraged the formation of new non-state enterprises by worker collectives, townships and villages, and eventually private individuals. The state continued to pour investment funds into state enterprises, which remained under state control. Central planning was not immediately dismantled, but was retained for the state sector, although it was loosened over time. The new non-state sector of the economy grew rapidly, producing about 55 per cent of GDP by 1995 (World Bank 1996, p. 15). In agriculture individual families were given free use of a plot of land, but they did not become owners of the land and could not sell or lease it. The land remained public property.

While China has welcomed foreign investment, it has retained significant protection of its domestic market. The Western powers have sought to pressure China into opening its market to imports, but so far this has not been successful.

Although gradualism is an important feature of the Chinese strategy, the differences between the SDTS and the NLTS go well beyond the matter of the speed of transition. Rather than seeking to directly convert the state-owned, planned economy into a private, market-based one, China sought to use its state-owned, planned economy as a base for launching a new non-state, market-based sector. China's strategy was a "two-sector" one, in contrast to the "one-sector" approach of the NIS and CEE states. While China sought to encourage a growing sector of non-state enterprises, to do so successfully it retained and improved its state sector.[1]

The economic performance of China since 1978, as measured by macroeconomic indices, has been one of the best in the world. Real GDP grew at an average rate of 9.4 per cent per year during 1978-95 (World Bank 1996, p. 18). GDP did not decline in any year during that period, never falling below a 3 per cent per annum rate of increase. Since 1995 economic growth has remained rapid–GDP grew by 8.9% in 1997. Agricultural output rose at a 6.2 per cent annual rate in the decade after 1978. Such rapid growth tends to create inflationary pressures, but these have been successfully contained without resort to the tight fiscal and monetary policy demanded by the NLTS--the average rate of consumer price inflation in China during 1978-95 was a moderate 8.4 per cent per year, compared to Russia's rate of 513 percent per year during 1991-95 (World Bank, 1996 p. 18; Kotz with Weir 1997, p. 179).

Average living standards have risen rapidly in China since the transition began. While inequality may have increased, the degree of income inequality in China has been much lower than in Russia, indicated by a gini coefficient of 38 for China compared to 48 for Russia in 1992-

93 (World Bank 1996, p. 69).

The rapid growth in china has not been confined to the non-state sector. During 1978-91 the real output of state enterprises grew at 7.7 per cent per year, compared to an overall annual GDP growth rate of 8.6 per cent for that period (Naughton 1994, pp. 477, 479).

China's SDTS has not been without serious economic and social problems. Environmental and job safety concerns are mounting. China's growth may not be able to keep up with the millions of peasants who are continuing to leave their villages in search of employment. Crime and corruption have apparently been spreading. However, by the usual macroeconomic indices, China's SDTS must be judged a remarkable success.

**The Response of Mainstream Economics to the Russia/China Comparison**

Russia in 1991 and China in 1978, despite their similarities as large state socialist countries poised to embark on a market transition, differed from one another in many ways besides their different transition strategies. Nevertheless, the macroeconomic records of the Russian and Chinese transitions are so dramatically opposite to one another that it strongly suggests that the latter was based on a workable strategy while the former was not. Although many of the NIS and CEE countries tried the NLTS--each having its own unique history, institutions, and immediate pre-transition circumstances--none escaped a severe economic downturn that left negative net growth after five or more years.

Some Western economists doubted the efficacy of the NLTS from the start. As the evidence of severe transition difficulties in CEE and the NIS mounted, the ranks of the critics grew. However, the critics have been drawn mainly from the margins of mainstream economics, particularly specialists in the Soviet economy and those attuned to institutional and historical problems of economic development.

The critics have pointed to six problems with the NLTS, especially as applied to Russia: 1) building a market system takes many decades and requires an active state role in the process; 2) dismantling the old centralized system of economic coordination before an effective market system can be built leads to economic chaos; 3) sudden liberalization in a formerly tightly controlled economy sets off an inflation that is very difficult to contain; 4) tight fiscal and monetary policies ensure a long depression and also prevent the restructuring and modernization of industry, which require substantial state spending and adequate credit; 5) privatization in a society having no legitimate wealthy class degenerates into theft of state assets with no economic gain for society; 6) a free trade policy in a transition economy exposes domestic producers to superior foreign competition before they are ready to compete.

Mainstream economics has proved largely impervious to the apparently impressive Russia/China contrast, as well as to the arguments of the critics of the NLTS. A good example of the reaction of mainstream economics to the Russia/China contrast is found in the World Bank study cited above, *From Plan to Market* (hereafter FPTM), which seeks to provide a comprehensive analysis of the experience of economic transition (World Bank 1996).[2] A look at FPTM provides a window into the reaction of mainstream economics to the uncomfortable Russia/China contrast.

FPTM does make one concession to the critics of orthodox neoliberalism. It hedges on the importance of immediate privatization. Perhaps feeling the pressure of the Chinese example, it states that "the need to privatize is not equally urgent in all settings. Slower privatization is viable." However, it quickly adds that slower privatization is "not necessarily optimal" (p. 50). Perhaps it is being suggested that, if China had immediately privatized, its growth rate would have been even higher than 9.4 per cent per year.

Despite its documentation of China's remarkably rapid transition growth, and of the severe depression experienced by Russia (and the other NIS and CEE countries), FMTP avoids drawing the most obvious conclusion. It does so by 1) downplaying the severity of Russia's economic collapse; 2) attributing the differential Russia/China records to different initial conditions rather than different transition strategies; and 3) suggesting that China's impressive achievements occurred in spite of, rather than because of, its different strategy. These three points will be examined in turn.

*Downplaying the Severity of Russia's Economic Collapse*

While admitting that large declines in output occurred in NIS and CEE, this is qualified by the remark that "Official data overstate the output decline" (p. 18). The usual culprit of growing unreported economic activity is cited. Yet, in the case of Russia, government statisticians include estimates of unreported activity in the official data. It would be difficult to explain why they would systematically underestimate such activity, thereby making the Russian government look bad.

In the face of five or more years of negative net growth in 26 of the 28 transition countries, FPTM refers to "a short-term drop in living standards" in "some of the countries undergoing transition" (p. iii). Economists do not normally consider five years to be "short-term." At another point even short-term problems are forgotten. FPTM states that during the transition only “overbuilt sectors” should contract, yet in Russia all sectors have experienced large declines. Surely Russian agriculture, food processing, and textile industries were not overbuilt relative to people’s needs. Here we see a victory of prior belief over actual experience.

Some important aspects of Russia's collapse are found in the charts and tables but left unremarked upon in the text. The most egregious omission is the lack of comment on the collapse of investment in Russia, the rest of the NIS, and the CEE countries. While economic progress requires more than just high investment, the latter is a necessary part of any path leading to modernization and rapid growth.

*Initial Conditions and the Russia/China Record*

FPTM attributes China's impressive growth record, in contrast to the sharp economic declines of other transition economies, mainly to "China's favorable initial conditions" (p. 19). The major differences in initial conditions between Russia and China cited in FPTM are that China had a much lower level of per capita income, a much larger share of agriculture in total employment (71 per cent vs. 13 per cent for Russia), a much more limited social safety net, and a more decentralized economy and political structure. The report concludes that “Differences in initial conditions and structural characteristics therefore explain a good deal of the divergence of transition outcomes” (p. 21). While the differences between China and Russia cited above do suggest that China had the potential to achieve a faster growth rate during transition than did Russia, it is difficult to see how these initial conditions could explain the collapse suffered by Russia. Indeed, in a later section of the report which addresses the output collapse in CEE and the NIS, it points to three main factors: demand shifts due to liberalization, the dissolution of CMEA (the Soviet Bloc trade association) and the Soviet Union, and supply disruptions due to the disappearance of central planning "before new market institutions could develop" (pp. 26-7). The first and last of those three factors are aspects of the NLTS--measures which China's strategy avoided--yet the conclusion that the strategy chosen played a key role is not drawn. The possibility that "overzealous stabilization" might have played a harmful role--one that lasted for many years--is discounted on the grounds that the evidence allegedly does not support this claim, although no support for this conclusion is provided (p. 26).

*China's Achievements Happened in Spite of, Not Because of, its Strategy*

The matter of China's transition experience is posed in FPTM in the following way: "Why has China been able to reform in a partial, phased manner and still grow rapidly ... ?" (p. 19). This is viewed as a "puzzle" (p. 19), since the authors assume that China's strategy is obviously inferior to the NLTS. As was noted above, FPTM answers this "puzzle" by attributing China's rapid growth to its favorable initial conditions -- basically, to being underdeveloped and not so centralized. They state that "Institutional development is ... crucial for sustaining the momentum of the reform" in China, worrying that China is lagging in this respect in that "China's banks ... are less market-based than those of CEE" with "many loans ... still allocated through a central credit plan" (pp. 13-15). They evidently discount the possibility that China's state-owned, state-directed credit system might be contributing to its very high rate of domestic investment, in contrast to the low rate of investment in the CEE countries with their market-based credit systems.

In a similar vein, FPTM worries that China has "a state sector that remains a drag on the economy" (p. 23). Why it is a drag on the economy is not explained, probably because it is thought to be obvious that state enterprises are inherently inferior to private enterprises and hence must be a drag on the economy. This "drag on the economy" not only grew nearly as rapidly as total output since 1978 but has provided a stable and reliable source of inputs, and market for outputs, for the new non-state sector.

FPTM states that the evidence provides "the clear message that sustained and consistent reform pays off" (p. 17). Yet FPTM characterizes the most successful reform of all, that of China, as a "piecemeal" approach. Within the framework of the authors of FPTM, China's approach is seen as "inconsistent," since it combines plan and market, state and non-state property, fixed and free prices.

**Concluding Comments**

It is not difficult to figure out why most mainstream Western economists have continued to support the NLTS, despite the dismal economic results it has yielded in Russia and elsewhere, and despite the presence of an alternative strategy that has worked quite well. The NLTS emerged as an application of the textbook economic theory that has made up the core of mainstream Western economic thought for generations. That theory holds that private property and free markets are the optimal economic institutions. The deduction was made that, if private property and free markets are optimal, then privatizing property and freeing markets from state control is always desirable, and the faster the better.

However, the abstract static equilibrium model, which underlies the textbook claims of the optimality of private property and free markets, cannot have much to say about best mode of transition from one economic system to another. If ever there was a disequilibrium matter, transition is it. Experience seems to be showing that the conclusions most economists have drawn about transition strategy, based on the standard neoclassical equilibrium model, are unwarranted.

The evidence strongly suggests that the NLTS followed in Russia is an unworkable means to convert a state socialist system to a capitalist market system, whereas the SDTS represents a viable transition strategy. A case can be made that a SDTS would have been economically workable in Russia in 1992, had its government been disposed to follow such a path at that time. There is also reason to believe that a SDTS could be successfully introduced in Russia even after all these years of liberalization, privatization, and economic collapse (see Kotz 1998).[3] The economic and political power of the IMF and World Bank, and of the leading capitalist governments that stand behind them, would make it difficult for any country among the NIS and CEE to make such a shift in strategy. However, a large, resource-rich country such as Russia could defy these pressures. The real obstacle to such a shift for Russia lies more in the political power of the Russian new rich, who have benefitted from the NLTS despite its disastrous effects on the economy, than in either foreign pressure or domestic economic obstacles to implementing an alternative course of economic development.

**Notes**

1. Despite retaining a sector of state-owned enterprises, nearly all analysts agree that China's economy is becoming a capitalist system. Its SDTS is producing an economy in which a growing share of the large enterprises are owned by wealthy investors, who derive profits from the work of hired wage workers, and in which market forces play the main coordinating role. Such an economy is capitalist, even if the state continues to play an active role in the economy.

2. The report was prepared by a team of nine principal authors.

3. It is beyond the scope of this essay to consider a third alternative–that of Russia abandoning the NLTS, not to adopt a SDTS for building capitalism, but rather to resume the effort to build democratic socialism which began in the USSR in the Gorbachev era.

**Table 1. Economic Performance in Russia, 1991-96**

| Indicator | Percentage Change, 1991-6 |
|---|---|
| Gross Domestic Product | -45 |
| Industrial Production | -49 |
| Investment[a] | -72 |
| Agricultural Output | -34 |
| Average Real Monthly Pay | -52[b] |

a. Gross capital formation.
b. Through October 1995.

<u>Source</u>: Kotz with Weir 1997, 174, 179; OECD 1997, No. 2, pp. 88, 90; *Statisticheskoe obozrenie* 1996, No. 4, p. 24, and 1997, No. 4, pp. 9, 24.

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