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# Could Russia Have Learned from China?

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Just as October is the month for stock market crashes, it seems July must be the month for currency crises. Last year, of course, witnessed the collapse of several Southeast Asian currencies, with a fallout that is still being felt. This year it was Russia's turn. During the first two weeks of July, Russia came dangerously close to defaulting on its international debt. Short-term interest rates reached triple-digit levels, and foreign exchange reserves were nearly depleted. A default would have almost certainly triggered a collapse of the ruble, setting the stage for an Indonesia-style meltdown.

So far, a serious crisis has been averted. On July 14th it was announced that the IMF and a Russian negotiating team had reached a compromise that involves $17.1 billion in new loans, $12.6 billion of which will be disbursed this year, and the rest the following year. In exchange, the Russians agreed to fiscal reforms that will be painful and politically unpopular in the short run, but will hopefully fortify a tottering tax base that has been a constant threat to the sustainability of the current reform-minded government. At least for the time being, the promise of new money seems to have quelled the markets.

These recent events raise the obvious question of how Russia got into this mess. In particular, one question that is often asked is whether Russia could have learned from China. Despite some valid concerns over the integrity of its banking system, China's reform program has achieved a record of success that is the envy of the developing world. Since its reforms began in 1978, China's per capita income has more than quadrupled. In contrast, since Russia's reforms began in 1992, its per capita income has *declined* 20-40%, depending on how large you think the black market economy is.

The reform strategies of Russia and China differed in two fundamental respects. First, in Russia political reform preceded economic reform, whereas in China, political reform seems to be lagging well behind economic reform. Second, there was a dramatic difference in the *speed* of economic reform. Russia pursued a so-called “big bang” approach, which entailed rapid and comprehensive privatization and price liberalization. China, on the other hand, has pursued a “gradualist” approach, which introduces market forces in an incremental manner to an ever widening array of activities. Given China’s success and Russia’s ongoing struggles, many argue that Russian reforms should have been more gradual.

This *Letter* provides a critical evaluation of this conclusion. It argues that the comparison of China with Russia is fundamentally misleading, and that China’s successes offered few lessons for Russia. In fact, in the long run, Russia and China may turn out to be a case of the tortoise and the hare. China got off to a fast start by removing the easy obstacles first, saving the tough ones for later. Russia started slowly by trying to remove them all at once. It remains to be seen who will win the race.

I start by providing a broad overview of economic reforms in China and Russia. Then, following Sachs and Woo (1997), I argue that differences in political circumstances and economic preconditions made rapid economic reform necessary in Russia, and gradual economic reform possible in China.

**China’s economic reforms**

The economic reform process in China began with the Communist Party Plenum of December 1978. This called for an immediate and comprehensive liberalization of the agricultural sector. Agricultural communes were disbanded and replaced by privately run household farms. Although households were not allowed to own land, they were granted 15-year leases that were freely tradeable. (In 1995, these leases were extended to 30 years.) This provided some incentive to maintain, and even improve, the value of the land. Household farms also remained responsible for delivering a quota of output to the state at below-market prices. However, the size of this quota as a share of total output has steadily diminished, so that by the mid-1990s less than 5% of agricultural output was being siphoned off by the state. Currently, state planning in agriculture amounts to a small non-distorting tax. That is, on the margin Chinese farmers now base their decisions on world market prices.

Agricultural decollectivization led to an immediate and dramatic improvement in productivity and rural standards of living. Between 1978 and 1984 agricultural value-added grew on average five times faster than it had during the previous two decades. Per capita consumption in rural areas more than doubled.

In response to this success, the government extended liberalization to other sectors. In 1980, four southern coastal cities (Shantou, Shenzhen, Xiamen, Zhuhai) were designated “Special Economic Zones” (SEZs). SEZs are exempt from many parts of the central plan. Most importantly, firms in these regions are given preferential access to foreign exchange and imported intermediate inputs. Regulations concerning foreign direct investment were also relaxed. These measures produced a boom in China’s international trade. Trade (exports plus imports) increased from 10% of GNP in 1978 to nearly 50% in 1996. Most of this international trade takes place within the SEZs.

Before the mid-1980s, capitalism in China was confined to the farms and the SEZs. However, in 1984, elements of market competition began to creep even into the domestic industrial sector. Large state-owned enterprises (SOEs), located mainly in cities, were given greater autonomy, and more importantly, restrictions on the formation of *new* firms were relaxed. This produced an explosion in the growth of private and semi-private firms. Most of these new firms, so-called Township and Village Enterprises (TVEs), took root in rural districts, and since the mid-1980s TVEs have been the catalyst of China’s growth.

Currently, the large SOEs are the last bastion of Chinese socialism. However, as a share of total output, the SOEs are steadily diminishing in importance. Their share of industrial production declined from 78% in 1978 to only 29% in 1996. Competition from the TVEs is putting increasing financial pressure on the SOEs. During the past few years the SOEs have stayed afloat only because of loans financed by the central bank, i.e., the government has simply printed money to cover the losses of the SOEs. This has raised the specter of uncontrolled inflation.

Most experts agree that restoring the economic viability of the SOEs is the last, and certainly most challenging, item on the Chinese reform agenda. Despite their diminished economic significance, the SOEs remain vitally important to the Chinese people, particularly those living in cities. Due to employment guarantees, few urban workers have left the SOEs to work in the more dynamic TVEs. Instead, employment growth in the TVEs has come almost entirely from the agricultural sector. In fact, the employment share of SOEs has remained virtually constant throughout the reform process. Getting SOE workers into the riskier private sector could be extremely difficult, as the Russian experience well attests.

**Russia's economic reforms**

As noted earlier, political reform preceded economic reform in Russia, with Gorbachev's rise to power in March 1985. From the beginning, Gorbachev had a clear mandate to reform and revitalize the Soviet economy. The USSR was obviously falling behind the West, and Soviet leaders were desperate to maintain their superpower status. Thus, like China, economic reforms were initially undertaken in order to *preserve* the political system. What is often overlooked is that Gorbachev initially tried a gradual Chinese-style reform strategy but failed. The reason gradual reform failed highlights a crucial difference between Russia and China, one that limits the applicability of the Chinese experience to Russia.

The tragedies of the Great Leap Forward (1958-62) and the Cultural Revolution (1966-76) had greatly discredited Chinese communism by the time of Mao's death in 1976. Faith in central planning, in particular, had waned. Consequently, when Deng took over, the bureaucracy was receptive to change, and the old guard in Beijing could not resist. In contrast, Marxist ideology was still very much alive in the USSR during the mid-1980s, and the bureaucracy still had a firm grip on the reigns of power. Moreover, Russian socialism had a longer history, and the bureaucracy had engulfed a much larger share of the economy. Estimates suggest that around 1,200 commodities were subject to central planning in China. In Russia, this number exceeded 25 million!

Thus, whereas Deng was able to push through economic reforms over a relatively limited set of activities, Gorbachev's reforms were sabotaged by the bureaucracy. Local managers and administrators simply used their greater autonomy to line their own pockets. Any reform that threatened the power of the bureaucracy was simply ignored. Massive diversion of state profits caused a collapse in the central government's tax revenue. This precipitated a fiscal crisis that set the stage for future macroeconomic instability, further limiting the scope for reforms while at the same time increasing their necessity and urgency. In the end, it turned out that Gorbachev was unable to accomplish any significant economic reform. By the time he lost control in the autumn of 1991, the economy was in shambles. Drastic action, or "shock therapy," was the only option.

**The importance of initial conditions**

Political differences were undoubtedly a crucial factor in the contrasting reform experiences of Russia and China. However, as Sachs and Woo (1997) note, the structure of their economies also differed, in ways that favored gradual reform in China and rapid reform in Russia.

First, at the outset of its reforms, China was basically an agrarian peasant economy. In 1978, 71% of the labor force was employed in agriculture. Much of the reform process involved shifting workers out of agriculture, where productivity was low, and into more productive pursuits in the TVEs. By all accounts, this reallocation has been very successful. By 1994, only 54% of the labor force was in agriculture. At the same time, due to greater productivity, agricultural output has increased.

Russia didn't have this option. At the start of its attempted reforms, 85% of the labor force was employed in non-agricultural state enterprises. To hire workers, fledgling private firms had to lure them away from state-owned firms, where employment was secure and wages were generous. Thus, before the private sector could get going in Russia, subsidies to state-owned enterprises had to be eliminated. Politically, this is difficult, as China is currently discovering. Gradual liberalization gives managers and local bureaucrats time to plunder state assets, while sudden liberalization causes social unrest.

Evidence that the availability of surplus agricultural labor was more important to China's success than the gradualness of its reforms comes from Vietnam's experience. During 1985-88 Vietnam tried a gradual Chinese-style reform strategy. Like China, Vietnam is an agrarian economy. Unlike China, however, Vietnam had pre-existing macroeconomic imbalances, which caused liberalization to have perverse effects: inflation soared and output stagnated. In 1989, Vietnam switched to a Russian-style "big bang." Inflation stopped and the economy took off. Sachs and Woo (1997) argue that Vietnam's experience proves that there is no necessary link between big bang reforms and economic contraction.

Besides lacking a surplus pool of agricultural labor, Russia's incipient private sector suffered from a second disadvantage relative to China. New firms are risky, and it can therefore be difficult for them to raise capital. Chinese firms had a tremendous advantage in this regard due to the presence of an overseas network of successful Chinese entrepreneurs, particularly in Hong Kong and Taiwan. These individuals had the resources and the desire to establish a beachhead in the homeland. As soon as China removed restrictions on foreign direct investment, this money came pouring in. Russia, on the other hand, had to go begging to the IMF.

## Conclusion

Overall then, the answer to the question in the title appears to be no. The benefits of trade liberalization and a high savings rate are probably the only lessons from China that are directly applicable to industrialized countries. The speed of reform, in particular, is dictated by political exigencies. Russia moved fast because the political situation required it to move fast. If Russia should have moved slower, it was in the political arena, not the economic one.

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## Reference

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