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Russian Transition – Chinese Reforms

A Comparative View

András Blahó

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UNU World Institute for
Development Economics Research
(UNU/WIDER)

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PREFACE

This paper by Professor Blahó has been a contribution for the planning of a new UNU/WIDER research project on '*The evolving new market economies in Europe and in Asia (China and Viet Nam) — their changing role in the global economy: domestic and external conditions and international consequences*'.

The paper compares the Russian transition with the Chinese reforms. The concept and implications of 'transition' differ from those of 'reform'. Transition in its systemic understanding is considered as a change of the system, a shift to a new one. Reform, on the other hand, is a process which takes place within the same system. In the final analysis, they may be motivated by similar factors and can result in systemic changes. They also have a certain similarity in the sense that deliberate policy actions are needed for their implementation, requiring the active participation of government institutions. The institutional credibility and efficiency in the respective countries may, therefore, have an important influence on the outcome.

Both processes depend also on the initial institutional conditions, macro- and micro-economic patterns. In the burgeoning professional literature on the comparison of China and Russia, different issues have been raised, and the focus has been more on the institutiona differences, the character of the process, the policies and the instruments than on the socio-economic goals and outcomes. While the comparative evaluation of the success of 'transition and of the 'reforms' in a comprehensive way would require not only more precise data and well defined indicators, but also more historical perspective, in all probability one can state with relative safety that, so far, the achievements of these two very important countries of the world in the implementation of the changes have been different, whether measured in the growth of GDP and trade, in the costs and benefits for the people, in contributions to structural improvements and to the increase of international competitiveness.

China proved to be more successful with reforms implemented since the late 1970s. It will be one of the tasks of the project to study the causes in depth and also to look at their future consequences in shaping the transformation of domestic life and global role of the two countries.

I present this paper to the readers as a valuable contribution to the ongoing dialogue about 'shock therapy' and 'gradualism', systemic changes and systemic reforms, and to the better understanding of the perspectives in the changing position of the two countries.

Mihály Simai
Director, UNU/WIDER
June 1994

INTRODUCTION AND DEFINITIONS

The natural starting point of any study dealing with a comparative view of economic transformation and reforms in the former Soviet Union and China should be the definition of the concepts appearing in the title. This, however, can be dangerous in two aspects: first, it can be quite lengthy and cumbersome to dwell on the fine details of definitions and, secondly, the exercise can lead to an almost 'sterile', abstract notion, the use of which would ultimately be restricted. That is the reason why the definition part of this paper shall be kept to a minimum.

The title is intended to make it clear that what is concerned here is the process of change, a movement, as distinct from a completed change from one state to another. Thus, what is meant by transition is a movement away from a system of central planning towards a system of market economy.[1] Contrary to this, economic reform is a partial, although sometimes rather far-reaching, substantive change aimed at improved performance of the system by greater reliance on externalities, on market forces and by extending the application of economic rather than administrative levels of the economic policy within the framework of central planning.

For a comparative study, even if there is a common understanding of the transition and economic reforms in general, a decision is required on what should be compared. Here we encounter two kinds of difficulties. The first concerns the change in the political system of the former Soviet Union, commonly described as the disintegration of the Soviet Union both politically and economically. In order to be able to compare the two processes, we need to analyse certain aspects of the pre-transition Soviet reforms (hence in certain parts of this paper the designation 'Soviet' is fully legitimate). This will mostly concern the Gorbachev reforms up until 1991. Thereafter, the transformation programmes of Russia, as the largest successor state, will be looked at. Russia's importance for the world economy and the world as a whole, hopefully, should not be proved here. Given the vast resources in both material and human wealth in that country and the similarities in certain features of their historical past, a comparison with China, which has already started to enhance these possibilities in the last fifteen years, is warranted. That is why economic reforms and transition programmes in the Soviet Union or Russia will have to be compared to the reform process in China. The second difficulty relates to the types of economic changes. Namely, it must be decided whether actual changes or juridical enactments or rather politically declared reform programmes shall be analysed. In this study the focus is on

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1 For the sake of brevity a critical account of the vastly increasing literature of the new subject, 'transitology' cannot be given here. Instead, the reader is referred to the Special Issue of *Transition – The Newsletter about Reforming Economies*, World Bank, which summarizes not only the annual index of articles but also the roster of all selected articles, new books and working papers reported between April 1990 and April 1993.

actual changes, with special attention to the distinction between the state and process of economic reforms.[2] This way a balanced account can be given involving the results of the ongoing Chinese reforms (already producing both a firm state and a process for change), and the Soviet/Russian reforms/transition, where the process is more pronounced than the state of the economic changes.

All the above point to the close relationship between economic and political reforms. In the transition literature, the marketizing but not democratizing Chinese way is often contrasted with the democratizing but not marketizing Soviet/Russian reform. This study does not intend to discuss this inter-relationship in detail.[3] It would suffice to say that even comprehensive economic reforms might suffer due to lack of political will (as has happened more than once in China and the Soviet Union). At the same time, strong political will can certainly enhance the chances of any economic reform or transformation. Even so, it must be remembered that political reforms, no matter how far-reaching they might be, cannot replace economic reforms. The latter is crucial in order to cure the problems which are the main causes of required changes.

How can one explain the outstanding results of the People's Republic of China and the concomitant failures of reforms in Eastern Europe (not discussed here) and the former Soviet Union? What are the most important economic and political factors behind this development? How can we assess these two seemingly very different ways of economic change? What conclusions can be drawn for other reforming or transforming economies? These are the questions to analyse. As economic reforms alone do not imply a definite economic system but rather a transition from one model of the same economic system to another, the comparability of economic reforms/transformation between China and Soviet Union/Russia depends on the comparability of their initial positions and the objectives aimed for by these reforms.

Hence, this paper will first look at the common features of the Chinese and Soviet economic development. This is followed by an analysis of the special Soviet/Russian features. As especially important policy issues, monetary policies in Russia are discussed in Chapter III and privatization in Chapter IV. Chinese general development characteristics after 1978 are described briefly in Chapter V. Phases of economic reforms in China are succinctly analysed in Chapter VI, followed by a discussion of economic assessment of these reforms in Chapter VII. Property issues in Chinese economic reforms are discussed in Chapter VIII. Policy actions aimed at bringing about a regional financial area are summarized in the next chapter. Chapter X brings together the comparative features of the two countries. Finally, a brief epilogue closes the study.

Because the stage reached by the Russian reforms by early 1994 – whether in discussing transition or in creating the appropriate legal, organizational and economic conditions for market economy – is still well behind that of equivalent developments in China, it is difficult to compare the two countries simultaneously. Therefore, we opted

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2 A similar approach has been followed by Aleksandar M. Vacic. See Vacic (1990:32).

3 A well argumented, lucid explanation of this relation can be found in Brus (1993).

for a way of explaining the Russian phase of economic reforms followed by enfolding of transition first and only thereafter the gist of Chinese developments. This way of explanation might not be as illustrative as a 'real' comparative analysis of policies but it makes it possible to analyse in more depth the different nature of post-1991 transition policies in Russia, unparalleled in China.

Finally, the study does not intend to follow economic and political development in the post-1991 republics; instead, it focuses on the Russian Republic.

The author would like to thank the United Nations University World Institute for Development Economics Research, its Director and staff, several colleagues and friends at the United Nations and other international and Hungarian institutions for the useful comments made on an earlier version of this study. All remaining errors and mistakes are, of course, mine.

The views expressed on this paper are the author's alone. An earlier version of the study had been discussed in Helsinki on 14 April 1994. Helpful comments from J-M. Collette, P. Desai, J. Golebiowksi, U. Kivikari, A. Kuddo, A. Vorobyov, S. Zhukov and R. Yevstigneyev were received. Professor M. Simai's extensive and thorough reading of the first version and WIDER administrative staff's help in finalizing it is hereby acknowledged with appreciation.

András Blahó
Budapest, June 1994

I CHINESE AND RUSSIAN WAY OF REFORMING THE ECONOMY - COMMON CHARACTERISTICS

At a time when Russia and all of the former republics of the Soviet Union – as well as the Eastern European transition economies with the exception of Poland at the time of writing this – are suffering from deep transition recession, the People's Republic of China continues to be the most rapidly developing country in the world. However, one should be cautious to interpret the Chinese experience with the status of straightforward evidence contradicting the Eastern European and Soviet reforms. Still, the results of the Chinese economic reform deserve special attention in three aspects: 1) it seems to prove that a centrally planned economy can be reformed; 2) gradual improvements in the economic policy management can lead to lasting results, thus partly contradicting the 'big bang' theory of economic change; and 3) as mentioned earlier, substantial economic changes are possible without far-reaching political changes in the political system of a country.

Before turning to an analysis of the differences in economic reform/transformation in both countries, it is useful to survey briefly a number of important common features in China and the Soviet Union (at the start of reforms under President Gorbachev) as well as their initial approach to changes in the economic system.

1. Both China and the Soviet Union were great countries not only because of their size and power but because of their potential as well. Economic and political development in these countries have also influenced other economies in the world.

2. In both countries socialism evolved on strong endogenous roots, unlike in Eastern European countries where it was imposed. The political and ideological implications of policy turns for the world socialist movement had to be one of the major factors of designing and pursuing reforms.

3. Reforms had been initiated at the highest political levels in both countries. It must have been realized by the central committees of the respective parties that the non-reformed economic system is not capable of meeting the challenges of economic reality, and the piecemeal attempts at 'acceleration' do not bring results but only deepen the contradictions further.

4. In both countries, the reform process had been foreseen to develop under the guidance of a strong central state and its apparatus. By 1992 already diverging types of economic change emerge, and for a number of reasons which will become clearer with each additional step of our investigation, the actual results of the role of the state in the

two countries differ by now. Nevertheless, the most relevant point in similarity – a strong central role – remains.

5. A fundamental similarity is apparent in the lack of clear economic reform models and processes in both economies: neither the final outcome (the expected state of economy, as mentioned above), nor the proposed path of getting there was indicated in advance. It has to be mentioned right away, however, that the outcome of this development is one of the major distinctions between the two approaches. In China economic reforms did not progress by *fiat* based on clear ideas or blue-prints but on the bases of voluntary actions taken by individuals, enterprises and local governments through a method of trial and error. In the Soviet Union, however, once a reform proposal had been approved by the highest political body(ies) the economic policy steps had been forced on the actors of economic life, without the feedback effect being present.

6. For discussion in this study, it is important to emphasize that important similarities appeared in the intentions and objectives of the two paramount leaders of economic change, Teng Xiaoping and M. Gorbachev. Neither of them intended to dismantle socialism but sought to 'improve' it; not to weaken but to enhance the Communist Party's monopolistic power. Furthermore, the application of the traditional, centrally planned way of managing economic affairs had never been questioned in principle. Only the Russian transformation programme of 1992 broke with this tradition.[4] As A. Åslund (1989:188) warns us, their powers are often exaggerated.

7. Gradualism, as opposed to the so called 'shock-waves type' reform, should also be regarded as a common feature both in China and in Russia during the years of 'perestroika'. Policy steps had been taken in a slow, piecemeal fashion even in times of 'radicalization' of the market-oriented measures in China.

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[4] Role of the two leaders is often contrasted, mostly at the expense of the Soviet reform. The differences of the two countries, largely as a result of their existing conditions in each society caution us to not to anticipate a much wider range of choices for these leaders than is the actual case.

II SPECIAL SOVIET FEATURES OF ECONOMIC CHANGE

1. The years of 'perestroika'

By the end of perestroika (with the *coup d'état* of August 1991), the Soviet Union certainly had progressed into a 'neither-nor' situation, to paraphrase T. Bauer's conceptual framework. At this time and phase of the reform process, the central planning process was already undermined enough to be unable to produce even modest results, but there was no other, alternative system in its place, either. The economy had already left the path of central planning but it had not embarked on another coordination mechanism either, clearly not on the path of market approach. This was the time when the limits and gross inadequacy of the once-dominant approach of artificially constructed models became evident.

In its five years of existence, perestroika showed a large and ever-growing duality between political and conceptual evolution in all walks of life on the one hand, and, on the other the rather stagnant – even radically deteriorating – processes present in every-day life and reality. The development of Soviet economic reform was that of evolutionary change. The focus had been placed on large-scale engineering industry rather than on family farming and small-scale consumer industries (Zhukov and Vorobyov 1992); a steady flow of inconsistent measures had emerged with little or no coordination; at the same time, virtually all sides of the political and economic system had been tampered with. This process was time-consuming, starting in 1985 from technocratic concepts, and extending to the radical proposal to introduce a real market economy with capital markets and convertible currency.[5]

It is not the intention here to go into great details of the reform measures of perestroika. Instead, the reader is referred to Zhukov and Vorobyov (1992), and Vorobyov (1993). Reform measures, even when undertaken, came too late for real results and their conceptual unclarity, coupled with the retarded and watered down implementation, were doomed to fail at the conception. During the Gorbachev-years several mistakes of great importance for the Soviet Union's/Russia's economic and political prospects had been made.

First of all, the primary intention of accelerating the rate of economic growth proved to be a fundamental policy mistake. This idea not only raised unrealistic expectations of improvement by the population but again, quantitative targets came to the fore, the means of bureaucratic coordination, to use J. Kornai's conceptual framework,[6] has remained predominant. In various years, as in 1986, 1989, again in

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[5] These latter concepts are described in the document of the Governmental Committee on Economic Reform, published for discussion in October, 1989. See *Ekonomicheskaia Gazeta* (No. 43, 1989).

[6] See his latest publication (Kornai 1992).

1990, and further in early 1991, different types of administrative restrictions on various non-state activities could be observed.[7] The large state sector was bound to show great degree of inertia, for neither the rewards nor the punishments of partial reforms seemed serious to them. The resulting shortage of consumer goods prompted 'extraordinary measures to balance the consumer goods markets', as described in the October 1989 Programme. It is worth recalling here that in China where the opposite road had been taken (see below), the supply of consumer goods expanded at a truly rapid pace.

Secondly, the proper relation of supply and demand had not been established. Agricultural performance lagged behind plans and the supply of industrial consumer goods proved to be inadequate. The wage policy was based on utopian, paternalistic assumptions; foreign economic policy ('opening') was anything, but. The composition of imports was really irrelevant, the macroeconomic role of foreign economic relations remained basically unchanged. This is perhaps a puzzling statement as the mistakes of other, smaller Eastern European economies in this respect could have warned Soviet policy makers about the dangers of neglecting this policy instrument. Partial opening increased imports, leading to balance of trade problems which, in turn, led to increased indebtedness as a way of alleviating pressures for systemic change. After this stage, indebtedness turned into an independent systemic factor, as Csaba (1992:17) states, '... as it seemed easier to order quantities to be exported than to wait for evolutionary processes of microeconomic adjustment to get through'. All evidence at hand indicates that by late 1991 – just before the systemic transformation – Russia had entered this very stage.

As a third distinctive feature we must state that the reforms between 1985 and 1991 have not seriously attempted to introduce monetary reforms and/or systemic changes. In this period, 1990 proved to be a turning point in Soviet development. For one, Soviet military threat ceased to be a credible policy-making factor. Secondly, traditional components of growth (like raw materials) had lost their appeal, and last but not least, dynamic economic growth was relocating to the Pacific Basin. This was the year when Soviet parliamentarism increasingly became an impediment to radical transformation, projecting the sad events of 1993. Lacking an efficient Parliament, one had hoped to introduce an efficient presidential branch by Gorbachev but in vain. The President fell short of establishing it; no credible transmission belt emerged between the formally almighty centre and the myriad of socio-economic actors of Soviet economy. The economic crisis escalated, giving birth to a new reform proposal by Shatalin.[8] The much-debated – and changed! – plan was still-born. There was no other possibility except to introduce a plan for crisis management under Prime Minister Pavlov.

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7 A detailed account of these and other features of the Gorbachev reforms are summarized in Csaba (1992).

8 The detailed discussion of this plan is summarized in Hewett (1990/1991).

2. Economic policies after 1991

The 1991 August *coup d'état* gave the 'go' sign for populist-nationalist variants of economic proposals.[9] As the centrally introduced economic reforms came to an end, economic realities evolved with ever greater spontaneity. The anti-crisis plan of Pavlov had to admit that the Russian economy had remained on the path of secular recession, conditioned by structural, systemic and foreign economic factors, to which political chaos and governmental decisions (or rather, indecision) would only add. Inflation was to develop into a hyperinflation with all its ensuing consequences. Although one might not think so, the first 'shock-therapy' version of a Russian transformation was elaborated by Yavlinski in and for the Ryzhkov government, which actually supported this idea in May 1990. Actual implementation, of course, could not be put on the agenda for the reasons outlined above.

In brief, these previous attempts at reform have manifested their transitory character. Measures taken to try to change the system in the past have mainly been transitory in nature, and some observers say,[10] have only been taken during times of great pressure to produce results on the economic front. Some of the most important economic indicators between 1990-1993 are summarized in Table 1.

TABLE 1
THE ECONOMY OF THE RUSSIAN FEDERATION
1990-1993

	1990	1991	1992	1993
Gross National Product	..	..	-20.0	-15.0
Gross Domestic Product	-1.6	-9.8	-19.0	-12.0
National income, produced	-4.0	-11.0	-20.0	-15.0
National income, utilized	-4.2	-10.2	..	
Gross industrial production	-0.1	-8.0	-18.8	-16.3
Gross agricultural production	-3.6	-4.5	-8.0	
Gross capital investments	0.1	-15.5	-45.0	-14.0
Housing space	-12.4	-20.0	-23.0	
Retail trade	10.0	-7.2	-39.0	-30.0
Retail prices	..	260	2539	911.3

Source: *Narodnoe Khozyaistvo Rossiskoi Federatsii, 1992* (Moscow: Russian State Commission for Statistics, 1992), pp. 14, 15 and 205. For 1992 *Ekonomika i Zhizn* (Moscow), No. 4, 1993, p. 13. 1993 data are preliminary estimates.

[9] The plethora of economic views represented by political parties and movements before the 1993 December election are explained and analysed in Voinov and Yevstigneyev (1994).

[10] See, for example, the analysis of A. Bohnet and G. Jaehne, analysing, among other things, the initial conditions of the Law on Individual Enterprise (approved on 19 November 1986, enacted on 1 March 1987), and the Law on Cooperatives (enacted on 1 July 1988). See Bohnet and Jaehne (1989:89-92).

Some preliminary conclusions from Table 1: in 1990-1993 the Russian GDP might have shrunk by between 40 and 50 per cent. The level of net investments in 1992 fell already to less than one third of its peak level in 1988.[11] The share of gross investments in the GDP has been falling steadily. In 1990 this share was 17 per cent; in 1992 it was only 9 per cent, and in 1993, 8 per cent (*Kommersant* 1993 December). This implies that even after an upturn, if any, future economic growth will be limited for a considerable period.

[11] In 1992, only 28 per cent of the projected budgetary investments had been implemented; only 49 per cent of these had been put into use. Consequently, the stock of unfinished investments increased. At end-1992 it stood at 3.7 billion rouble, one and a half-times the value of gross investments. *O razvitii ekonomicheskikh reform v Rossiiskoi Federatsii v 1992 godu* (1993:11).

III MONETARY POLICIES IN RUSSIAN TRANSITION

The classical financial system has undergone substantial institutional and deregulatory changes in the years of perestroika. A two-tiered banking system was established in 1987. Thereafter, the number of commercial and cooperative banks has mushroomed, and the five specialized state banks have been reorganized as shareholding companies. By mid-1992, there were more than 1600 such financial institutions, and the number of these banks stood at 1769 on 1 April 1993. By 1 March 1994, this number had swelled to 2041 but in reality only 100 commercial banks were actually handling two thirds of banking activity.

A common problem of the transition policies and the two-tiered banking system is the shortage of capital. Liquidity of the banks is rather low.

In Russia, the Central Bank of Russia has been carrying out an independent monetary policy since 1991, granting permits for banks on Russian Republic territory. The central bank, however, places greater emphasis on stemming the fall in production than on holding the rouble stable.[12] Real interest rates have been consistently negative throughout 1992.[13] Beginning in November 1993, something quite unexpected happened – real interest rates turned positive. At the end of 1993, the real interest rate stood at 5.5 per cent. With this development, there was the chance that money might flow to companies who could use it efficiently. A modest result of the monetary policy – the slower pace of money supply – followed in 1993. Unlike in 1992, when it was 740 per cent a year, the volume of money in 1993 had been increased 'only' by 480 per cent. The monthly rate of credit expansion slowed from 29 per cent in January 1993 to 12 per cent in December of that year.

The cross-ownership between banks and their clients is rather significant. Banks are often unable or unwilling to refuse credits to the enterprises. Most of the newly established commercial banks are owners of a group of enterprises in a particular sector of industrial or agricultural (the so-called 'cross-ownership' syndrome). Strange as it may sound, the financial decisions made by both the bank and enterprise have nothing to do with standard commercial principles (Aukutsenek and Belyanova 1993:38). The main source of credit for commercial banks w as – and still is – credits from the Central Bank of Russia.

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[12] This statement is still true in the light of the fact that in 1993 alone, the bank used about $1 billion to shore up the exchange rate of the rouble.

[13] See the various types of interest rates on banking credits in Zhukov (1993:34-35) Table 13. The refinancing interest rate of the Central Bank was retained at 80 per cent between May 1992 and March 1993, when consumer and wholesale prices increased by a factor of 24 and 34, respectively.

The banks operate at considerable risk. Although the Russian financial system is not yet organized entirely along market lines, it is nonetheless evident that it is not functioning entirely according to the rules of command economy either. Once again, a 'neither-nor' situation is at hand, leading to serious vacillations in financial and monetary policies.

Banks, for their part, do not behave in accordance with market criteria and priorities. Frequently, their real motives are not linked to making profits but to the redistribution of state property and their accumulation of potential property rights by acquiring as many assets as possible.[14] Obviously, many banks are insolvent; their balance sheets full of non-performing loans,[15] and they issue credit at a loss and often to non-creditworthy enterprises. This monetary system diverts the scarce financial resources of the country away from more profitable economic activity.

Monetary policy is limited by the separation of cash and bank account operations. In spite of new laws on assurances and bankruptcy, there are serious legal and technical difficulties in the implementation of contracts, the issuance of loans and the collection of at least a part of the outstanding liabilities.[16] The bookkeeping system, although reformed in 1991, still does not provide full information on the financial situation of enterprises and banks.

The Russian banking system, in spite of the huge increase in the number of banking facilities, is still very concentrated. Less than 4 per cent of the commercial banks had more than 70 per cent of the total financial assets in late 1993.

Basic functional weaknesses of the Russian banking system are as follows:

1. Competition is seriously limited by the oligopolistic structure of the financial sector and by the cross-ownership of banks and enterprises. Most of the banks issue credits almost entirely to their own shareholders only. Credit portfolios are still strongly concentrated on enterprises and sectors, segmenting the market and increasing the risks of banking activities. The process of concentration in this sector could further aggravate the situation.[17]

2. Possibilities of the banks to analyse the creditworthiness of their clients are limited. Macroeconomic instability and distortions of the price system make the situation even worse. Most of the banks do not have qualified experts for this task, and

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[14] This is done mostly in the form of enterprise liabilities to the banks.

[15] The Russian inter-enterprise indebtedness is estimated at around 10 000 billion roubles according to the International Banks for Reconstruction and Development.

[16] According to the law of 1 March 1993 on bankruptcy (enacted in 1994) an enterprise can be declared bankrupt and closed down two and half years after the initiation of bankruptcy proceedings. Every effort must be made by state agencies to reorganize and salvage it during that period.

[17] The first, spontaneous bank concentration was implemented in October 1993. Three big commercial banks – all of them on the list of the 10 Russian largest banks – declared their unification. The Imperial Bank, the Jugorski Bank and the Rossiiski Credit Bank together will have 1500 billion rouble assets ($1.26 billion) financing – as before – mostly the energy sector.

motivation is lacking as well. Standardized economic information on enterprises is scarce.

3. The-so called 'insider credits' are wide-spread; a fact which draws the attention to the moral risks of the Russian financial system.

4. Almost all the banks are weakly capitalized. More than two thirds of the commercial banks have assets worth less than 50 million roubles. Only 19.5 per cent of the banks are valued at more than 100 million roubles,[18] which is paramount to a situation ruled by small banks. No wonder that the capital/liabilities ratios are very low. Even though the central bank increased the minimal capital requirement of new and existing banks from 5 million rouble to 100 million roubles in July 1993, then again to 2 billion roubles (1 million ECU) on 1 March 1994,[19] inflation has already undermined the impact of this legislation.

5. Most of these banks are quite inadequate in attracting personal savings. This is why there is heavy reliance on the interbank market and on the refinancing credits of the Russian Central Bank.

6. Because of these weaknesses in the financial system, both the population and the enterprise sector are reluctant to hold its assets in these banks and prefer to use barter trade and other non-financial ways of trading.

7. With the exception of a dozen well-managed financial institutions, credit portfolio of the Russian banks is rather weak. Commercial banks continue to credit insolvent enterprises, and 'bad loans' are accumulated on a large scale. Enterprise investments are mostly financed by short-term loans.[20]

8. Structural and functional weaknesses of the Russian banking sector limit the opportunities for enterprise structural change. These financial institutions have a negative interest in servicing the evolving private sector.

In addition to these difficulties, Western enterprises claim that the Russian commercial bank sector is incapable of supporting import payments.[21] Apart from all these problems, capital flight out of Russia is substantial. Although exact statistics on this issue are not yet available, capital flight in 1992 alone has been estimated to have been about $10-20 billion. The Russian Ministry of Foreign Economic Relations

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[18] Banks with more than 200 million roubles of capital gave only 5.8 per cent of all commercial banks in mid-1993.

[19] This requirement should be implemented within 5 years. Capital requirement of non-depository banks was raised to 500 million roubles on 1 March 1994.

[20] On 1 April 1993 the share of medium- and long-term loans in the total credit volume of commercial banks was only 5 per cent.

[21] An indirect proof of this situation is the share of hard currency deposits held by the commercial banks. On 1 April 1993 from the total of $11 billion hard currency deposits, only $2 billion was held directly by the Russian banks. The majority of deposits were on accounts with corresponding banks of Russian clients.

estimates that for each $4bn worth of Russian exports, $1bn remains abroad. The sources of this capital flight are: under-reporting the value of exports; overpricing import payments, especially in the case of barter and clearing trade; voluntary postponement of export payments by keeping them in foreign bank accounts; pre-payment of import bills, mostly through off-shore companies, and hiding a part of export payments in foreign bank accounts.

The Central Bank of Russia has questioned the patriotism of the commercial banks because of their loan activities and business policy. The banks were said to be more interested in deals with high profits than supporting the domestic industry. There were some plans to reorganize the previously state-owned special banks – Promstroibank, Zhilsotsbank, and Agroprombank – requesting them to concentrate on the financial needs of production.

The surprise announcement on Saturday, 24 July 1993 by Prime Minister V. Chernomyrdin and Russian Central Bank Chairman V. Gerashchenko that pre-1993 roubles would no longer be honoured the following Monday resulted in an angry and confused public reaction which was close to pandemonium. This reform forced other rouble-zone members either to negotiate a coordinated monetary policy with Russia or to abandon the rouble altogether. For a while the rouble has continuously appreciated in real terms against the dollar (Gusev 1993 and Inozemtsev 1993).[22] The rouble exchange was just one in the series of policy conflicts which have generated economic confusion and disarray. The Parliament's revision of the annual budget, its overturning of the presidential decree on privatization, and direct attacks on reformers backed by the President were other examples of the struggle to control the reform process. A direct clash between the Parliament and the President became inevitable.

Early in 1994, the central bank 'paid' about 4 trillion roubles worth of industrial and agricultural debts of enterprises. There is hardly any other possibility for the central bank in this situation than financing the budget and the enterprises. Therefore, non-monetary ways and means of stopping inflation are looked at.

Since mid-1992, the Russian Central Bank gave the successor states of the Soviet Union substantial rouble financing in order that they would be able to keep up their imports from Russia. The exact amount of this commercial loan from Russia is not known but it could well be above 1000 billion roubles, $2 billion at actual exchange rate. In 1993 these loans were converted into short-term loans and indexed by the dollar exchange rate. The usual condition is London Interbank Official Rate (LIBOR) plus 1-2 per cent; the average term is 7 years.

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[22] The rouble exchange rate was holding at around 1000 to the dollar, while the Russian domestic price level was increasing at a robust 15-20 per cent a month until September 1993.

IV PRIVATIZATION IN THE RUSSIAN TRANSITION

Privatization, considered as one of the most important pillars of the Gaidar-programme, started on 2 January 1992. Great importance has been attached to the expanding private sector. The main idea of the economic policy was to enhance not only the survival chances of the newly established small firms and enterprises but – with macroeconomic policy instruments – to give more strength to these economic entities. New, private businesses were expected to benefit more than the state sector from the accelerated reform. At least according to some well-informed observers (Aukuntsek and Belyanova 1993:37-42), just the opposite happened in many ways: non-state (joint stock companies, cooperatives, small private enterprises) did not benefit more than the state sector. The evolving market elements of the economic policy were not enough to 'push ahead' these new ventures, however, the remaining bureaucratic difficulties were more than enough to 'pull back' the invigorating force of these enterprises.

In the first legislation, state and municipal enterprises have been grouped into four categories.[23] Agricultural privatization had been dealt separately.

Russia's mass privatization programme had proceeded quite rapidly, by the end of November 1993, some 39,000 enterprises had been given to private owners (*Ekonomika i Zhizn* 1994). Quoting the same source, 31 per cent of the state-owned companies (federal, territorial and municipal enterprises) were transformed into share-holding companies, 69 per cent of them had been sold to new owners.[24] According to the latest available official account, in the first 10 months of 1993 some 36,348 enterprises have been privatized; of these 5,794 were enterprises on the federal level. In Russia 11,153 new share-holding companies have been formed, 4,358 of these through commercializing federal property. Between September and November 1993 the speed of privatization had slowed down, mostly due to the less than expected privatization on municipal level (*Ekonomika i Zhizn* 1994).

It can be stated firmly that too high expectations were placed on the advantages of privatization (Hanson 1993:440; Åslund and Layard 1993), although the process has not proved them. E. Gaidar, the ambitious deputy Prime Minister of that time, wanted 50-60 per cent of the state property privatized by 1995.

By mid-1993 more than 96 per cent of the population, or 146 million citizens, had collected their privatization vouchers. The State Committee for the Administration of State Property (*Goskomimushchestvo* in Russian, hereafter referred to by its Russian

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[23] First, companies subject to compulsory privatization; second, enterprises subject to voluntary privatization; third, companies, where privatization first had to be approved by the relevant state or municipal authority; and, fourth, where privatization was prohibited.

[24] The same ratios for 1992 were 10 per cent for the share-holding companies' share and 90 per cent for direct sales.

abbreviation GKI) planned to privatize 5000 medium- and large-size enterprises through vouchers-only auctions. By mid-1993 some 2291 had already been sold.[25] The practical design of the voucher auction programme was defined by two key regulations issued by the GKI on 4 November 1992: the 'Regulation on Selling Shares in the Privatization Process'; and 'Regulation on Specialized Voucher Auctions'.[26] The former defined in general terms the rules governing the sale of shares of companies being privatized; the percentage of equity to be sold either for vouchers or cash; and the schedule for the allocation of shares. More important, it set up a strict schedule for conducting voucher auctions by classifying enterprises into several groups and setting a deadline for privatizing each of them. The second regulation described in some detail the principles and mechanics of voucher auctions. These regulations were drafted and issued by the GKI at the same time as two major elements of the mass privatization programme were being implemented throughout the country.

First, in agreement with the State Privatization Program of 11 June 1992 and the Presidential Edict on Commercialization (No. 721) of 1 July 1992, several thousand Russian enterprises were transformed into joint-stock companies. This transformation entailed choosing one of three options available to enterprises under the privatization programme, drafting a privatization plan, and registering the company with the courts. In November 1992 the so called closed subscriptions had begun.[27] No wonder, that the second option – the closed subscription – became the predominant form of voucher privatization. The share for this type in the overall privatization was 78.5 per cent on 1 November 1993 (*Ekonomika i Zhizn* 1994). This way 51 per cent (or more) will be acquired by workers and managers with fairly easy conditions.

The Presidential Edict on the Development of the Privatization Voucher System in the Russian Federation (No. 1229) increased dramatically the percentage of shares of privatized companies to be sold in exchange for vouchers. For all federally or regionally owned enterprises, which constituted the vast majority of Russian industries, this was set at 80 per cent of 'all the voting and privileged shares of type B'.[28] The proportion was lower for property owned by republican and municipal governments (35 and 45 per cent, respectively), but the respective authorities were allowed to increase these amounts if they wished.

Once the relevant legal work has been completed, the local property committee transfers all the requisite documents (the firm's privatization plan and share ownership

25 Privatization statistics, unless stated otherwise, relate to GKI statistical publications.

26 A excellent, detailed account on this form of privatization is in Djelic and Tsukanova (1993).

27 Distribution or sale of shares to the workers and managers of companies, as permitted under the State Privatization Program. Not only were workers and managers allowed and encouraged, in most instances they were required, to pay for a certain portion of the shares that they acquired with their vouchers.

28 The privileged share gives the holder no voting rights as an owner of the company but does give the holder a priority in terms of dividends. Type A privileged shares are given to insiders (workers and managers), whereas type B privileged shares are held by the state. When sold at voucher auctions, type B privileged shares become ordinary voting shares. Hence, the system provides, in essence, for 80 per cent of all company shares to be 'sold', either for cash or vouchers.

certificate) to the local property fund,[29] which acts as the legal seller. Normally, the fund assumes responsibility for all aspects of the voucher auctions.

Initially, a decentralized privatization scheme seemed inevitable in a country as large and diverse as Russia. There was a tendency toward fragmentation of the markets, since certain populous regions had few large manufacturing companies to put up for sale, whereas other sparsely populated regions had many firms to auction. The absence of a national market for equity, the normal starting point for a mass privatization scheme, became a political problem.[30]

The choice faced by small investors is daunting. Thousands of companies, in all sectors of the economy, are being auctioned off throughout the country. Information about them is scarce and reflects almost without exception an outdated bookkeeping system.

The Russian authorities were hoping from the outset that investment funds would be available to assist people in investing their vouchers at the auctions. Such a system, they calculated, would provide for investment diversification, as funds would be invested in dozens of companies and would reduce, though not eliminate, the financial risk. Legislation followed. Specialized voucher investment funds, as well as their managers, were to be licensed by the GKI or one of its branches. They must sign a contract with the managing firm, establish a depository, exercise financial prudence,[31] submit to regular audits, and disclose their investment policy and results.

Radical privatization ideas – and deeds – of the Gaidar-team have been vehemently criticized inside and outside Russia. Privatization was called to fasten economic decline; enhancing the gap between various parts of the all-Russian economic sphere; breaking up technologically logical production structures; contributing to Russia's 'ungovernable' state. (See a good summary of these claims in Kulikov,

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[29] Local branches of GKI at the republican, regional, and municipal levels and their corresponding property funds are the two major players in Russia's privatization programme. The local property committees report to the federal GKI (and the local authorities) and the local property funds are under the Russian Federal Property Fund which itself is governed directly by the Supreme Soviet. The property committees at all levels are meant to prepare and implement the privatization programme, to manage assets during privatization and to prepare firms for privatization. All property rights reside with the funds. Accordingly, the funds are the legal sellers of all state property. For example, firms belonging to the federal government should be sold by the federal property fund, those owned by regional governments by the regional funds, and so forth. In the event that a lower level fund sells a federally owned company, the approval of the federal fund must be obtained first.

[30] It has been hoped by the GKI and its Chairman, A. Chubais, that interregional holdings of shares will be an important factor in maintaining the unity of the Russian Federation.

[31] The Presidential Edict on the Organization of Securities Markets during the Privatization Process (No. 1186) of 8 October 1992, instructed the funds not to buy more than 10 per cent of the total equity of a single firm and they were not allowed to invest more than 5 per cent of their net assets in a single firm. The new government programme on privatization, approved on 24 December 1993, increased the amount of equity invested into a single firm to 25 per cent. See text of the legislation in *Ekonomika i Zhizn* (1994, No. 2, January), Supplement 'Vas Partner':4-10.

Latisheva and Nikolaev 1993.) The most important negative features mentioned by the authors are as follows:

a) property sale is practically forced and not initiated by economic 'levers';

b) the practice of privatization is not done in accordance with the laws and legislation on privatization;[32]

c) the process of privatization has a strong bureaucratic character;

d) voucher privatization breeds speculation;

e) there is no connection between the stabilization of the national economy and privatization, as one of its possible means;

f) there is a real danger of discrediting privatization by these actions.

The authors are not alone in pointing out the negative features of 'shock-therapy' – the radical transformation. The privatization, as an important part of it, cannot be done from above, by decrees alone. This – as one observer called it – is equal to 'neo-Bolshevism', for private ownership would be 'built' (or would be attempted to be built) as quickly as possible as the Bolsheviks had tried to 'build socialism' (Sato 1992:7).

Privatization in transition economies – Russia is no exception – has historically never been done before. Therefore, Western recipes, no matter how well-intended they are, cannot be correct in assessing the local conditions. What is even more important, privatization should not be reduced to changes in ownership relations only; it is far more important to create a 'private', namely independent entity which is ready and able to take risks and responsibilities; to enhance entrepreneurship in the whole economy; and to try to bring about competent decision-making bodies in enterprises. So far privatization did not – perhaps could not – influence macroeconomic developments. Opponents of radical change (*Rossiiskii ekonomicheskii zhurnal* 1993) suggest that stabilization and privatization should be carried out in tandem with strong structural and industrial policy.[33] Legislation must be simplified and its efficiency improved. Further decentralization is needed, the federal GKI should deal only with the creation of basic organizational-economic conditions of privatization. Republican, regional and municipal branches of GKI should receive more authority.

In answering to these charges, the new State Privatization Program for 1994 (see footnote 28) introduced several changes. First of all, the number of enterprises which could <u>not</u> be privatized has been increased. In addition, the status and financing of these entities have been legislated. Financing must be 100 per cent from the central budget, and if commercialized they must be transformed into joint-stock companies with 100

32 Privatization scandals have been numerous in Russia, the most famous one being in St. Petersburg.

33 Here again, the reader is referred to Voinov and Yevstigneyev's WIDER study on economic thoughts of Russian political parties and movements.

per cent state ownership. A Law on Privatization was to be discussed by the government before 1 March 1994. Other important proposed changes in the 1994 privatization process are:

a) decisions concerning regional privatization which are delegated to the GKI local branches;

b) participation of foreigners in cash and voucher auctions has been made easier by eliminating the need for approval from the Ministry of Finance.[34]

The participation of commercial banks, however, will be limited in the privatization process. They cannot buy more than 10 per cent of the total equity of a single firm, and cannot own more than 5 per cent of the assets. The process of privatization for bankrupt enterprises has been eased: a 'deal' can be made with the local branch of the GKI. The sectors in which enterprises are to be privatized were specified in ranking order as follows: 1. bankrupt enterprises; 2. hotel industry; and 3. housing and communal sector.

From this very short assessment, it is evident that the fight between the government and the sectoral lobbies is leaning towards the requests of the lobbies. The sectoral approach is evident from the legislation; the idea of 'deals' with GKI branches introduces – if not legitimizes – apparent corruption, and, what is worse, removes the fragile elements of economic rationality and introduces more bureaucratic procedures. The new programme is more conservative – one might say, in certain points even reactionary – however, in some of its points, it is entirely sensible. As an evident effect of the elections of 12 December 1993, the composition of the new Parliament is clearly visible on this programme. The government had to slow down the process, decentralize it further, give more power to the branch lobbies and take care to prevent privatization having harmful effects.

Agricultural privatization has been a 'hot potato' for obvious reasons. The sector is too important for the economy to be allowed to be 'left alone' and both the radicals as well as the Civic Union devoted special attention to it. After the failure of their initial attempt at instant decollectivization,[35] the radicals, E. Gaidar and his followers, have tended to treat agriculture (especially socialized agriculture) as a hopeless sector for which they would rather not bear responsibility (Ellman 1993:41). Quite different agricultural policies coexisted in Russia with sharp differences over the suggested agricultural policies among the political elite.

Restitution of private land ownership was, of course, on the agenda. However, it would be harmful to think that masses of enterprising farmers wait impatiently for the restitution of land. On the contrary – Russia never knew wide-scale private ownership

[34] There cannot be reasonable expectations for the large inflow of foreign capital in the near future. According to the *International Investors* rating, Russia is currently the 139th, from around 170 countries. The rating is still declining.

[35] The elimination of the *kolkhoz*-system had been tried in February 1992.

(Csaba 1992:35) and individual use of land. In addition, collectivized agriculture has left a stratum of demoralized and disinterested rural population living under infrastructural development that corresponds to the level of developing countries. Thus, the ground for wide-scale privatization concepts has been anything but ready. In addition, Russia lacks the farming tradition and entrepreneurial spirit on which Chinese and Hungarian reforms, for example, were built. Thus this is one of the most important reasons of the easiness by which efficiency in this sector and through this, that of the whole national economy could be raised in both economies.

The agrarian reforms in Russia after 1992 can be summarized as follows. There were basically four different ways of dealing with the property issue in agriculture: reorganization, privatization, land distribution and structural change. By July 1993, some 23,000 *kolkhoz* and *sovhoz* had been re-registered, as requested by the law, and 8,000 of them opted to keep their original form and ownership.[36] On 1 August, 1993 in Russia there were 261400 independent farms, and they owned on the average 42 hectares (Nefedov 1993:61). In the summer of 1993, private farms accounted for only 600,000 of the 9.9 million agricultural workforce, covering 3.8 per cent of stock farmland and 2 per cent of cultivated land. Private farms and small family plots[37] produced as much as one third of the nation's agricultural produce. Private farms alone, however, did not and could not have an effect on the food supply yet.

The share of private farms in Russia's gross agricultural production was 0.9 per cent in 1992 (Nefedov 1993:61).[38] The average yield of agricultural production was lower than on the collective and state farms. There are substantial losses in connection with the harvests. In the case of meat production, losses total about 0.4-0.5 million tons a year.[39]

The private farms are undercapitalized; in early 1993, there were only 68 tractors and 33 lorries per one hundred farms. Production of industrial inputs for the agricultural output is declining. The production of fertilizers fell by 2.3 million tons in 1993 compared to 1992. In 1992 alone only 60-70 per cent of the fertilizer demand could be satisfied; in 1993 this share dropped to 50 per cent. Relative prices work against agriculture: the spread between the relative prices of industry and agriculture are widening at the expense of the latter. In 1992, the prices of industrial inputs for the agriculture increased by about 17-20-times while agricultural procurement prices increased only by 10-times. In the case of animal husbandry the price increase was only 6-fold, 'creating' negative profitability in this branch of agriculture! ('Die wirtschaftliche Lage Russlands') There is hardly any investment in these farms. It is extremely difficult to obtain a loan from a commercial bank.[40] On top of all these 'objective' difficulties, 25 per cent of the private farmers surveyed do not believe in the implementation of the

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[36] This is about 5 per cent of the total number of *kolkhoz* and *sovhoz* entities. See Nefedov (1993:61).

[37] Together they worked on 8 per cent of the agricultural land.

[38] In grain this share was higher, 5.8 per cent; in sugar beets 2 per cent.

[39] This equals 3 kilograms per habitant in Russia!

[40] By July 1993, some 10,900 private farms ceased to exist due to lack of investments, high interest rates, no guarantees for the continuation of reforms, and shortage of production inputs. See Nefedov (1993:62).

agrarian reforms called for by Mr Yeltsin in early 1993.[41] The macro-economic environment is in a constant flux and gross production is on the decline. The GDP for the entire Community of Independent States (CIS) declined by 27 per cent between 1989 and 1992, 'reaching' the 1980 level at end-1992. The same indicator for the industry was -25 per cent (again the 1980 level); for the agriculture -18 per cent (reaching the 1974 level!); for gross investments -49 per cent (1974 level). The fall continued in 1993 as well.[42] The half-hearted agrarian reforms did not bring important results. There was 20 per cent less meat in 1992 than in 1989; 16 per cent less milk (compared to 1990); 17 per cent less eggs (basis year is 1988); 13 per cent less grain (compared to 1978).[43] There was a pronounced decline in the standard of living (see Table 2),[44] and income differentials increased.[45]

According to some observers, 29 per cent of the population lived under the poverty line. The quality of the food supply worsened considerably, and the share of food products in the money spent by the population increased (Volkov 1993:11).

'Where there is no market, there is bureaucracy' goes the saying. In the case of the last three years it seems to be true for Russia. There had been high expectations with regard to the 1992 shock therapy. It was assumed that the behaviour of the enterprise directors could be changed rapidly to support the market. This proved to be wrong, there was no or only minimal adjustment. In addition, enterprises did not go bankrupt, but inefficient enterprises were financing each other[46] (Ickes-Ryterman 1993:231). The economic consequences were – and still are – serious. There was a breakdown in economic stabilization; the payment arrears of enterprises worked as safety valves enabling them to postpone adjustment. Arrears arise because enterprises find the adjustment to markets costly. By this behaviour, the enterprises' own viability is obscured which undermines the commitment of the Government to policies such as bankruptcy and liquidation. The process leads to the fall of successful state enterprises as well. Because of inadequate information, liquidation and bankruptcy policies sow the seeds of coordination failure on a massive scale. Given the current state of the financial system, a precipitous effort to tighten credit could trigger widespread enterprise failures.

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[41] These reforms called for: a) landowners will have the right to buy, sell, lease or transfer land; b) workers on state-owned collective farms will be given a land-share certificate (making them quasi-owners); c) foreign owners could buy land through joint ventures.

[42] In 1993, the estimated decline of the GDP for the CIS as a whole was about 14 per cent. See *The World Economy at the end of 1993*, p. 17.

[43] The years in parenthesis are the peak years for the production of the given agricultural produce.

[44] The subsistence consumption rationing for an adult in 1993 was as follows: 6.3 grams of cold sausage; 3.1 grams of smoked sausage; 5.4 grams of cheese; 9.9 grams of butter; 11.5 grams of cream; 20 grams of noodles; 28 grams of onion; 30 grams of apple; 50 grams of millet; 82 grams of cabbage; 68 grams of sugar; 19.5 grams of oil; half of an egg; 115 grams of beef; half a litre of milk; 400 grams of potato; 238 grams of white bread; 252 grams of dark bread. See *Finansovye Izvestia* (1993).

[45] Ten per cent of the highest earners gave 19 per cent of the money incomes in 1990; in 1992 the same share was already 33 per cent. Nefedov (1993:64).

[46] The phenomenon is not new: in the first year of the shock-therapy of Poland, the same reaction could be observed.

TABLE 2
DEVELOPMENT OF SOME STANDARD OF LIVING INDICATORS IN RUSSIA
1991-1993

Months	Minimum basket (rouble/month)	Cost increase of basket	Consumer price increase, %	Average wage per month	Wage increase	Pension per month
Dec 1991	515	..	..	769	..	..
Jan 1992	1039	102	245	1438	87	342
Feb 1992	1119	7.7	38.3	2004	39	342
March 1992	1182	5.6	29.8	2726	36	342
April 1992	1214	2.7	21.6	3024	11	342
May 1992	1360	12.0	12.0	3672	21	900
June 1992	1535	12.9	18.6	5067	38	900
July 1992	1719	12.0	11.0	5452	8	900
Aug 1992	1899	10.5	9.0	5870	8	900
Sept 1992	2234	17.6	12.0	7379	26	900
Oct 1992	2757	23.4	23.0	8853	20	900
Nov 1992	3525	27.8	26.0	10576	19.5	2250
Dec 1992	4373	24.0	25.0	16071	52.0	2250
Jan 1993	5356	22.5	27.0	15690	-2.4	2250
Feb 1993	6449	20.4	26.0	18672	19.0	4275
March 1993	7478	15.9	21.0	23559	26.2	4275
April 1993	8527	14.0	14.4	30562	29.7	4275
May 1993	10850	27.2	19.0	37505	..	8112
June 1993	13102	20.7	17.4	47000	..	8112
July 1993	16469	25.7	19.3	..	..	8112
Aug 1993	18300	11.1	29.0	..	..	14620

Source: Based on various Russian economic publications.

Note: The minimum salary had been fixed at 7740 roubles on 1 July 1993, causing a big jump in the nominal value of pensions, as well.

Based on this last argument, the centralist tendencies – always present in the transition – seem to be strengthened, pushing the 'pendulum' (R. Yevstigneyev's term) to the left (Yevstigneyev 1994). According to some opinions (Anisimov 1993:3-11), the attempted shock-therapy of the Russian economy is alien to the nature of Russia. The fall of GDP deepened; the monetary approach produced only hyperinflation. Today Russian economic policy is based on two factors of self-determination: 1) the enterprises are free on the (limited) market; and 2) the state is free to do everything, to manipulate with the property, finances, without taking the market standards of the world into consideration (Anisimov 1993:11). The only possible way out is '... to launch a new stage of economic reform, a stage of stabilization during which we should provide the right conditions for producers'.[47]

[47] Prime Minister V. Chernomyrdin's speech at the opening session of the new Parliament on 11 January 1994. *Economist* (1994).

Whether this would mean more subsidies to these 'producers' and/or tighter import controls to curb the inflation which will follow remains to be seen. The new Cabinet is expected to increase subsidies to industry and agriculture, arguing that otherwise too many Russians would be without work. The reform is half-way. There is a certain level of inconsistency in policy measures; lobbying by various groups increased; budget deficit is on the rise; and inflation can become rampant. Russia might prove again – as was the case with China before 1978 – that countries falling far behind or into chaotic conditions are the ones that have failed to take strong reform measures.

In his interview with *Ekonomika,* the Prime Minister summarized the Government's opinion as follows: 'One of the characteristics of 1994 will be the realistic approach of the Government concerning promises. Now we cannot deal with everything but the decisions taken will have to be supported by finances' (*Ekonomika* 1994).

He considered the main task to be the halt of demand inflation and cost inflation which are related to the lack of real competition in production. This is a 'somewhat different task, exceeding the framework of clear monetary macro-regulation of the economy', as the Prime Minister put it. Still, the trade account of Russia is positive by a wide margin; capital flight is still substantial; the economy is more and more 'dollarized'.

The subsequent change in the Government of Russia in early 1994 with the resignation of Messrs. Gaidar and Fjodorov as the two most important representatives of radical transition, does not question the prospects of reforms in general but puts important question marks to it. There is no danger that central planning will come back. More likely, some form of autocracy and economic populism will replace the present attempts and this will delay successful transformation for many years to come. The chances of a rapid market transformation in Russia are slimmer than ever.

V SPECIAL FEATURES OF THE CHINESE ECONOMIC REFORMS

The 14th Congress of the Chinese Communist Party approved in October 1992 a resolution calling for a 'socialist market economy' as the goal of its economic policy. Accelerated reform and internationalization through bold adoption of capitalist methods[48] were the policy discussions which prepared the way for broad market-intended actions.

In 1993, China again achieved outstanding economic performance (see Table 3). GDP growth accelerated to 13 per cent, again, as in 1992, the highest in the world. This expansion was brought on largely by a 22 per cent increase in the industrial gross production. Agricultural production increased by about 4 per cent. Aggregate investments in fixed social assets increased by the phenomenal rate of 46 per cent and the total import and export volume grew by 14 per cent (*Beijing Review* 1994).

TABLE 3
CHINA – SELECTED ECONOMIC INDICATORS, 1990-1994
(Percentage change)

	1990	1991	1992	1993
Gross national product	4.1	7.7	12.8	13
Industrial output	7.8	14.5	20.2	22
Agricultural output	7.6	3.7	3.0	4
Gross fixed investments	7.5	23.8	33.0	46
Value of retail sales	2.5	13.4	15.7	15*
Retail price index	2.1	2.9	5.3	7.5*
Total exports (dollar value)	18.1	15.0	14.3	16*
Total imports (dollar value)	-10.3	19.1	22.0	19*

Source: *Statistical Yearbook of the People's Republic of China,* various years. The 1993 data (except for the figures marked with *) are from *Beijing Review,* 1994, January 3-9, p. 10.

Note: * Data are forecast based on project LINK at the United Nations.

With such economic achievements the debate seems to be over, with the group who had favoured bolder reforms and internationalization beyond the bounds of socialist ideology winning over the group who had favoured reform and limited internationalization within bounds of socialism. Economic success of China cannot be

[48] From the resolution of the 7th National People's Congress on 3 April 1992.

seriously challenged by anyone with any kind of comparative perspective. Still, it is important to have a look at the indigenous conditions of China at the start of the 1978 reform in order to single out the common and distinctive features of the Soviet/Russian and Chinese reforms.

Without a doubt, China started with certain important advantages over the kind of situation that Russia, as well as other Eastern European economies, faced later.

1. The Chinese economy was in complete disarray both politically and economically at the end of the Cultural Revolution; neighbouring countries developed at a very fast rate; cultural and social values had not been safeguarded (Åslund 1989:189); and the need for fundamental reform seemed indisputable.[49] Political and economic rationality had to be introduced immediately.

2. China's effort to increase the role of the market domestically was not connected with the break-up of the country's international trading arrangements. By the early 1970s, China had fully converted to a trading system oriented towards Japan and Western Europe.

3. In 1978, China had no foreign debt of any significant size and consequence; hence, it started its domestic reforms from a relatively strong balance-of-payments position.

4. China began the reforms without any significant degree of inflationary pressure other than what was typical in the centrally planned type economy.[50] There was no budget deficit, nor was the banking system issuing credit in an uncontrolled manner. As the reforms proceeded, this situation certainly changed but on the eve of free prices, China's consumers – unlike their counterparts in Russia – were not standing in long lines waiting for state-supplied goods which often were simply not available.

5. Therefore, unlike Russia or Eastern Europe, China did not have to begin reforms with an across-the-board stabilization effort. This is not the reason for falling GDP in the economies of Russia or Eastern Europe but it is an important factor related to it.[51]

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[49] The slumping state sector shook the foundations of the system. The share of agricultural goods sold to the Government in total food production (in volume terms) decreased from 28.3 per cent in 1953 to 20.3 per cent in 1978. Since this ratio reflects the capacity of the agricultural sector to supply food to other sectors, a low ratio indicates low productivity and a state of exhaustion in the sector. See *Japan Research Quarterly* (1992:52).

[50] The so-called 'oppressed' inflation, due to imbalances in the economy, mostly attributed to shortages. See Kornai (1980).

[51] If China had had rampant inflation, large current account deficits and large foreign debt, it would have had little choice except to start with stabilization. For historical reasons, it did not have to make that decision.

6. China witnessed the example of its Eastern Asian neighbours who had already demonstrated what resource-poor, labour- and skill-intensive people could accomplish. There was nothing else but to learn.

7. Mention must be made of Hong Kong's special importance for China. Hong Kong not only acted as the provider of foreign direct investments,[52] or supporter of infrastructure for Shenzhen Special Economic Zone, but it also was a primary trade intermediary for the People's Republic.

8. Last but not least, both the people and the Government were disillusioned after the futile attempts of the Cultural Revolution and hence they were united in the cause of reform.

9. It is well known that Chinese reforms are characterized by the lack of clear models and processes. Reforms are not being carried out by *fiat* based on clear ideas or plans but on the basis of voluntary actions taken by individuals, enterprises and local governments through a method of trial and error. These groups are the driving force behind the current reform.

[52] Mostly as a channel for Chinese businesses abroad (US and Taiwan, the Province of China).

VI PHASES OF THE CHINESE REFORMS, 1978-1993

There have been four phases of the reforms:[53]

1. 1978-1984 – the agricultural reforms;
2. 1984-1988 – adoption of market economy ('urban reforms');
3. 1988-1991 – period of retrenchment;
4. 1992- – resuscitation of reforms.

China feeds about 24 per cent of the world population with just 7 per cent of the world's arable land. The restructuring of the farm system was the most important feature of the first phase of reform. The main goal was to ease the financial burden of the farm workers. To achieve this target, there has been a substantial increase in the procurement prices and the introduction of the contract production responsibility system. These measures resulted in a pronounced surge in agricultural production. In the late 1970s, the amount of farmland per person in China was among the lowest in the world.[54] Limited arable area and the fact that high level yields had already been achieved meant that the technological constraints for increasing farm production were greater in China than in many developing countries. There had been attempts in this phase to reform the urban system as well, but these measures proved only tentative.

Two observations can be derived. First, agricultural reforms have been carried out relatively smoothly. Their great success has been referred to as a miracle and has attracted the attention of the entire world. At the same time, the determination of both the Government and the people to continue the process of reform was reinforced. Secondly, despite the tentative nature of urban reforms, the increasing autonomy of enterprises, the strengthening of fiscal authority of the provinces, and the reinstatement of entrepreneurship in the early 1980s have invigorated the Chinese economy and laid the foundation for the second phase of reform.

Summarizing the second phase of the economic reforms (Yuyan 1989:35-41), one could say that this was the phase when initial moves towards market economy ended in a deadlock. The Third Plenum of the 12th Party Congress decided on the acceleration of reforms, not for the first or the last time. The focus of the reform policy had to be on state enterprises and the price structure – the very foundations of the centrally planned model. The subsequent economic growth 'heated up' the economy.

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[53] The complete course of reforms cannot be analysed in detail here. Attention shall only be paid to issues of comparative importance. The reader is referred to Yuang (1989); Fang and Woo (1993), among others, for more detailed explanations of the reform development.

[54] It amounted to 0.34 hectares/agricultural worker, compared to 0.68 hectares in Japan; 1.03 hectares in India and 9.75 hectares (!) in the Soviet Union. See *Outline of Chinese Agriculture*, Ministry of Agriculture, Beijing (1982:12).

Investments surged and the growth, in turn, caused higher inflation and imbalances in the industrial structure.[55] The phase could only end in deadlock.

Enterprise autonomy had been extended, the introduction of taxation to replace expropriation of profits by the state (*li gai shuei*) gave greater incentives for labour and management to produce. But, retainable profit depended on consultations with relevant Government supervisory departments despite more legal clarification of their relationship. As a result, management became dependent on its bargaining power with the supervisory body. Hence, corporate autonomy became superficial; protection by the supervisory body allowed enterprises to evade responsibility and pursue only short-term gains. For authorities on the macro level, the goal was to separate ownership and management rights by introducing a number of novel methods including a tentative bankruptcy system,[56] a contract management responsibility system and a system of share holding.[57] At this time, however, this latter attempt also failed.

Price reforms started with 'deregulation' in 1985, when all agricultural prices had been deregulated. In 1988 seven consumer prices (durables such as refrigerators) and 13 different brands of tobacco and liquors were freed. For certain specific goods, a two-tiered system combining Government-set and market prices was introduced. Enterprises, local governments and banks became more autonomous in investment decisions, profit utilization and fixing salaries. Change was not always for the better, however, the result being a weakening of macro-economic control. Nonetheless, these reforms paved the way for market-related incentives and, as such, are of great significance.

Part of price reforms and related to enterprise reforms was the special method of purchases for enterprises. The law required enterprises to buy raw materials and sell products for the state quota at official prices but allowed them to buy and sell raw materials and products beyond the agriculture at market prices. Illegal behaviour was encouraged. Quota-bound goods were sold on the black market or diverted to other productive units. Discrepancy between official and market prices became a major issue.

By mid-1988 structural imbalances, precarious balance-of-payments position, bottlenecks in manufacturing became increasingly conspicuous and hindered the progress of reform measures. Retrenchment seemed the only alternative, which is the central issue of the third phase of reforms. As in the 'overheated' phases of earlier reforms – and in other planned economies – all prices were frozen and capital spending plans were slashed. As a result, inflation abated but caused severe recession and related problems, including low consumption, increased unemployment and deterioration of

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[55] According to some observers, the acceleration of inflation after 1984 was caused by the decentralization in the state sector, allowing state enterprises to realize their innate tendencies to over-consume and over-invest. See Fan and Woo (1993).

[56] By end-1987 it became a standard policy instrument.

[57] A good summary of these intentions and policy measures could be found in Russian by Onikienko (1992). There were various forms, the most standard was the 'management responsibility', whereby an enterprise enters into agreement with its Government supervisor specifying the amount of profit to be handed over, the amount of salaries to be paid, and productivity levels. Managers are fully responsible for the operations of the enterprise while the agreement is in place.

Government finances. The central authorities resorted to the traditional command-model remedies such as priority allocation of funds and raw materials. Yes, this alleviated pressures in the economy stemming from overheating but economic restructuring, the original idea behind these moves, did not come about. The December 1990 Plenum (7th) of the 13th Party Congress was compelled to reconsider and to give higher priority to the tightening of ideological control. Despite ideological tightening, economic reform proceeded without too much fanfare. Unlike in other centrally planned economies, the setback did not cause serious damage to the prospects of economic reforms; it merely postponed them for a while. In the agricultural sector in 1991, tight political control, increased familiarity with price increases and a large rise in real income enabled a big step to be taken without major protest toward free market prices for farm produce. China's planners can look with satisfaction at the extraordinarily complex step-by-step move towards market-determined farm product prices which have been accomplished with much less social upheaval than might have been the case with a sudden 'single cut' price liberalization in the early 1980s. This caution has become a trade mark of Chinese reforms. Between 1980 and 1990, the per person output of meat, of aquatic products, and of fruits rose inexorably. Increased incomes of the population enabled the people of China to improve their diet, which was reflected through the market mechanism in the changed relative profitability of different products (Nolan 1992:26). Believing in the necessity of enterprise restructuring, enterprise reform was continued at a slower pace.[58]

Foreign trade reforms were also continued. The most important policy measure to be mentioned was the granting of autonomy in external trade to 100 large enterprise groups. By the end of 1990, the combined GNP of the five south-eastern provinces reached approximately $83.4 billion. Although small compared to South Korea ($210.1 bn), Taiwan, Province of China ($150.4 bn), GNP has surpassed that of Singapore, Thailand and Malaysia. In fact, these zones may well become the newly-industrialized economies (NIEs) of the next generation. Effective from January 1991, export subsidies were abolished. In price policy, the two-tiered system for cement was abolished; prices for steel, crude oil, coal and rail transport were raised. Some foodstuff prices were increased, including cooking oil, the politically sensitive item. In finance, the groundwork for the establishment of a stock market was completed.

The fourth phase of economic reforms started with Party Document Number 2 for 1992 and new rounds of bold reforms were decided at the 14th Congress of the Chinese Communist Party. Consumer goods market developed into a network; capital goods market witnessed active progress and step by step standardization. Financial and stock markets experienced brisk development. Macro-economic control achieved tangible results. As part of its effort to solve the contradictions and problems resulting from rapid economic growth in the first half of 1993, the central Government adopted various economic, legal and administrative measures necessary to achieve order in the banking system (*Beijing Review* 1994). The importance of finances in general and that of the banking system is further emphasized by the fact that private savings have

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[58] The basic document for this was the '*Eleven proposals regarding the revival of medium and large enterprises*'. In September 1991 one more proposal was added at the Central Government Activities meeting. Thus, there were twelve proposals in all.

become the main source of capital accumulation. The development of the national economy is dependent today on the efficiency of the financial sector in its transmission role and function. Furthermore, efficiency of the finances and monetary policies in general is of vital importance.

The reform of the financial system aims at strengthening the Renminbi (yuan) and at enhancing economic development through financial means. So far, however, Chinese banks do not operate as independent banks; they do not function according their own risk-taking activity (Tálas 1993:736). Management and bookkeeping system of finances with political and economic character should be separated. Planned macro reforms cover additional reform on finance, taxation, banking and investment system. One of the reform programmes is the tax-assignment system which has been a hot topic among economists. Replacing the local financial contracting system with the proposed system, although not exactly Western-type, would surely meet with resistance from coastal areas where it would be hard to continue preferential treatment (*China Economic News* 1993). Planned for 1994, the proposed tax reform[59] covers the following issues: all enterprises to be included in the same income tax bracket;[60] new turnover system based on value added to be introduced; the levying of individual income taxes to be unified; introduction of taxes on new sources of income, such as stock exchange and real estate to be implemented; the local tax system to be consummated, extending the scale of local taxes; and a tax-sharing system and appropriate delegation of power to lower levels in enacting local tax laws to be proposed.

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[59] Individual Income Tax Law of the People's Republic of China can be found in *China Economic News*, for Provisional regulations of the PRC on land value-added taxes (pp. 7-8); Interim regulations of the PRC on consumption taxes (pp. 8-10); and Interim regulations of the PRC on business taxes (pp. 10-12) in *China Economic News*.

[60] State, cooperative and private enterprises alike. Distinction between domestic and foreign-funded enterprises to be eliminated later.

VII THE EFFECTS OF CHINESE REFORMS, 1978-1993

Let us summarize some of the most important economic development indicators for China in the given period:

TABLE 4
ECONOMIC PERFORMANCE OF CHINA, 1978-1993
(Percentage change)

	1979	1981	1983	1985	1987	1989	1990	1991	1992	1993
Real GNP	7.6	4.4	10.4	12.8	10.9	4.0	5.2	7.0	12.8	13
National income (real)	7.0	4.9	10.1	13.5	10.2	3.7	4.8	6.5	11.7	12.7
Industrial growth (real)	8.8	4.3	11.2	21.4	17.7	8.5	7.8	14.2	20.2	22
Agricultural growth (real)	7.5	5.8	7.8	3.4	5.8	3.1	7.6	3.0	3.0	4
Fixed assets investments, growth, %	-	-	16.2	38.8	20.6	-6.9	7.6	23.8	32.7	46
Consumer price index, %	2.0	2.4	2.0	11.9	8.8	16.3	1.3	3.9	5.3	7.5

Source: People's Republic of China, Bureau of Statistics, *Statistical Yearbook of China*, various years. For 1993 see *Beijing Review*, 1994, p. 10.

These data speak for themselves. Without a doubt, the series of reforms manifested in higher consumption and standard of living for the general benefit of the Chinese people and central authorities. How can these reforms be summarized?

Mandatory planning decreased drastically. Guided planning allowed enterprises freedom in executing Government sanctioned targets. This type of enterprise management expanded in the reforms. There were concerted efforts to develop a commodities market, capital market and labour market. Existing financial structures were overhauled, many new institutions created. Long-term capital market for the sale of Government bonds and financial debt, a foreign exchange market and a stock exchange were formed.

Diversification in the ownership of production, especially the rapid growth of the non-state sector (see below), is the first indication of the development of a market economy. Non-state enterprises increased their share in production from nil in 1978 to about 30 per cent in 1990. Since collectively owned enterprises fall outside mandatory planning, a market economy is in fact a reality in China.

The course of reforms has been followed by some, not always unexpected, problems. Decentralization, for example, led to weaker macro-economic control; the price reform to higher inflation; and the agricultural reform to 'de-monopolization'. The introduction of market economy led to widening income gaps and widespread social dissatisfaction at certain times of the reforms. Given the enormous structural adjustment these contradictions were almost inevitable.

There has been a close relation between inflation and economic reforms, shown by demand-pull analysis. Rapid growth of disposable income and a corresponding jump in consumption demand reveal some of the inadequacies of economic reforms in the 1980s. Until then, the reforms had focused on giving more autonomy. Nothing (or little) was done, for example, to erect an infrastructure or a social welfare system. The make-up of consumption remained with low salaries and high subsidies. Disposable income grew, production (and imports!) of consumer products increased, which led to more investments in these sectors. This almost uncontrollable investment rise, in turn, caused total demand to soar, further widening the gap with the supply capacity of basic industries and adding to price increase pressures. Increased investment demand went hand in hand with increased bank loans. Deficit spending led to a rapid increase in the money supply. Banks, state enterprises and local governments were equally to blame for this. The central Government was not totally blameless either, as it failed to provide an effective control mechanism to stem this proliferation. As a matter of fact, the central Government quite often ordered national and regional banks to lend to ailing factories so that they could, in turn, mollify the workers with one-time payments. With these 'stability and unity loans' (*Wall Street Journal* 1994:A9), the Government acknowledged the importance of maintaining social order, even if that meant reversing economic reform. Given the shortcomings in the reform measures, high inflation is inevitable.

There is perhaps a paradoxical advantage of this cyclical development. With fast economic growth there is increased demand for investments; the economy becomes 'overheated', leading to higher inflation; and central authorities step on the brakes which pushes the economy into recession. Old remedies are not working well for invigorating the economy and new, qualitatively different reform measures are needed. Decentralization and the inability of the central Government to exert proper macro-economic control necessitate the creation of a system which can properly manage the economy. However, a consensus regarding the control of inflation must be reached with the people. A new round of economic reform is needed.

A group of economists, mostly from Shanghai, worked out a new economic strategy for the enhancement of the economic reforms. The draft aims for a similar economic system for China that has already proved to be efficient in other Asian economies. The Japanese model is taken as the basis with certain elements from the heavily regulated Singapore model as well. In the future, economy will be regulated by an efficient apparatus and, as in Singapore, the key industries will remain in state ownership. Economic regions will also be reorganized – heavy industry will be concentrated in the northern regions; high technology centres will be established, and the southern regions will keep their export orientation. Financial independence of the provinces will be limited and the central government will again directly take part in issuance and collection of taxes.[61] If so, investment will be effected, too. A unified 33 per cent tax rate for enterprises is suggested, once again following the example of Singapore and not Hong Kong. The idea is to enhance the competitive position of the enterprises. Bankrupt state enterprises can be sold or closed down. Ownership and use of real estate and land will be newly regulated. The state social insurance system will be substantially modified.

Perhaps the most astounding experiments and results relate to the property issues in China. Let us summarize them in the next section.

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[61] The share of the state in the total amount of national taxes between 1978 and 1992 declined from 37 per cent to 17 per cent. See *Statistical Yearbook of China* (1992).

VIII PROPERTY ISSUES IN THE CHINESE ECONOMIC REFORMS

The answer to the property issue and to the related questions can be a decisive factor in the future of the 'Chinese economic model'.

In China, the privatization of state-owned enterprises is not even considered for the time being. Although during the almost two decades of economic reforms, macro-level policy makers confronted quite often the shortcomings of central planning and management, the remedy suggested and accepted was always an improvement in the functioning of state property but never any change in it (Stepanek 1991). State ownership remained intact for a long period of time. Instead of privatization of large state-owned economic units, China opted for the promotion of the rapidly growing non-state sector (*World Economic Survey* 1993). This way of approaching the market economy, '... referred to as marketization, focuses on subjecting all production units regardless of ownership to market forces rather than to privatization of production' (*World Economic Survey*). Before analysing the actual Chinese policy steps, an explanation is needed.

Property rights do not simply provide an alternative between 'state' and 'private' ownership. Instead, there is a whole gradation of property rights from comprehensively unrestrained individual property rights through a wide gradation of controls on the rights to sell assets, produce and market output, employ labour and dispose of the income from assets. State ownership can be restructured in two ways. First, there is a direct method whereby state-owned enterprises (SOEs) are incorporated and become eligible to issue stock. Capital is injected from non-state organizations. Second, expansion of the non-state sector accelerated and the splitting up of state enterprises continued.

Even within the texture of apparently unchanged 'state' ownership, important changes did in fact occur in the 1980s in China. First, the profit retention system introduced in the early 1980s should be mentioned. Direct state grants in the form of investments have been decreasing while the share of bank loans in the total of investment, on the contrary, increased.[62] Secondly, take-overs, mergers, and joint ventures began to develop widely both within the 'state' and the 'collective' sector and between the two. Large groups of industrial enterprises began to emerge. Thus the Chinese state was actively pushing Chinese business organizations along the lines of Japan and South Korea. Furthermore, as mentioned above, a revenue sharing system had been introduced; state enterprise managers have been selected for their skills and not for their political loyalty.

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[62] Between 1984 and 1988 the index of bank borrowing (true banking loans, not including state grants in the form of loans) for investment increased five-fold (from 100 to 501.3 per cent); the share of bank borrowing as a percentage of total investment was 25 per cent in 1984, 38.9 per cent in 1988. Fan and Woo (1993:20), Table 6.

Reforms improved certain facets of economic development but at the same time existing structural problems had been exacerbated. Almost 40 per cent of state-owned enterprises (SOE) are recording operating losses, and 'triangular debt'[63] or 'debt-chains' are on the rise. Poor economic performance and frequent stagnation of large, mostly state-owned, enterprises have become major contributing factors to the deterioration of Government finances.

What are the forms of non-state property?

1. **Urban collectives**: established by municipalities, counties, and districts. In 1991 there were about 190,000 such units which produced about 5 per cent of total industrial output for that year. Characteristic for all, they tend to have a bureaucratic inertia, there is interference from state authorities, and inefficiencies and lack of clear autonomy distinguish them from other non-state property forms.

2. **Township and rural enterprises:**[64] belong to a town or village government, include rural cooperatives. In 1991 their number was about 1.6 million, over 1.39 million were township and rural enterprises accounting for 24 per cent of total industrial output.

3. **Individual businesses**: allowed since 1978, these include families and individuals with a maximum of 7 employees. These businesses accounted for 5 per cent of industrial output in 1991.[65] In the same year, 92 per cent of the 6.3 million individual businesses were in rural areas.[66]

4. **'Other' types**: private enterprises hiring more than 7 employees, foreign enterprises, joint ventures with foreigners, other types of joint ventures (i.e. between state and non-state entities; between state/non-state and foreign partners).

Individual businesses and 'other' types of economic units give about 12.5 per cent of total industrial gross production.[67] Share of state sector fell from 75 per cent to close to 50 per cent in just about 13 years (see Table 5).

Throughout the years of non-state sector reforms, small, collective-owned enterprises came much closer than the large economic units to operating according to the rules of the market (Perkins 1992:20). This statement is not surprising at all. Through the rural reform policy, the successive changes in financial policy favouring

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[63] Enterprises financing each other, thereby increasing public debt and postponing adjustment to market conditions.

[64] In certain economic reports and analyses the term 'village enterprises' is used intermittently. See Singh and Jefferson (1993:9).

[65] Same as for urban collectives (cooperatives).

[66] The number is around 17 million if one includes household and private ventures in agriculture and tertiary sectors.

[67] In 1985 this share amounted to 5 per cent.

small-scale enterprises as well as tax and technology policies, the Central Government authorities achieved substantial entrepreneurial activity on the part of the non-state sector.[68] These enterprises were not only allowed but willing to take on the risks involved in various business deals. Central and, more importantly, local governments – exerting still substantial influence over the management of these enterprises – would ensure for the managers a wage with incentives linked to performance.

The opportunity for reward and the risk of failure were always present. Seeing the economic results of this type of property policy one can agree with the statement that 'the entrepreneur can be committed to the success of the endeavour and risk professional and financial loss from its failure as long as there are sufficiently strong incentives for financial, professional and other gains' (*World Economic Survey* 1993).

TABLE 5
SHARE OF GROSS INDUSTRIAL OUTPUT BY TYPE OF ENTERPRISE, 1980-1991[69]

(Percentage)

	1980	1983	1984	1985	1988	1989	1990	1991
State-owned	76.0	73.0	69.0	65.0	57.0	56.0	55.0	53.0
Non-state-owned	24.0	27.0	31.0	35.0	43.0	44.0	45.0	47.0
Collective-owned	24.0	26.0	30.0	32.0	36.0	36.0	36.0	36.0
Urban	..	..	..	15.0	15.0	14.0	14.0	13.0
Rural (township and rural)	..	..	..	15.0	19.0	20.0	20.0	21.0
Joint urban-rural	..	..	..	2.0	2.0	2.0	2.0	2.0
Individual (private)	0.0	0.1	0.2	1.8	4.4	4.8	5.3	5.7
Urban	..	..	..	0.3	0.4	0.4	0.4	0.5
Rural	..	..	..	1.5	4.0	4.4	4.9	5.2
Foreign-owned	0.5	0.8	1.0	1.2	2.7	3.4	4.4	5.7

Source: *World Economic Survey*, 1993, United Nations publication (New York, 1993), p. 192, citing *Statistical Yearbook of China*, 1992 (Beijing, 1992), pp. 403 and 406.

What is so special about these collective-owned enterprises that their behaviour is markedly different from that of the state enterprises? First of all, these enterprises are not cooperatives in the normal sense of the word. Instead, they resemble national state-owned enterprises, with the 'state' being the local community. The local government's 'rural enterprise department' monitors the operations of the enterprises. The relationship between the enterprises and their 'state/local government' is much more direct, closer than in the case of enterprises belonging to the central government. According to our view, village and rural enterprises behave differently as far as the 'soft budget constraint'

[68] An excellent discussion of the issue of entrepreneurship in China can be found in *World Economic Survey* (1993).

[69] Based on output in current prices.

is concerned (Kornai 1980). Basically, this meant the assurance for state enterprises that they would not be closed even if an imprudent investment were to result in bankruptcy. Soft budget constraint, however, is not the same for the state and non-state enterprises.[70] The reason is quite simple. County and township governments do not have the resources to bail out chronic money losers for long. While banks are not always repaid by these administrative centres, a losing county or township enterprise ultimately must be founded out of the profits of another enterprise in the area. Probably having more similar enterprises, the local officials would soon be forced to decide on jettisoning the losing firm through reorganization or putting it out of business. In effect, the local government entity, dependent on local enterprises for much of its revenue, behaves more like a mini-conglomerate than a government bureaucracy.[71] Thus, the rules of the market, with many deviations, of course, are observed.

If one adds up all of the small-scale producing units in agriculture, industry and services, they account for nearly 75 per cent of total GNP in China. To put it differently, three-quarters of Chinese output is produced by units oriented primarily towards the market. Only 25 per cent is closely tied to the central government bureaucracy. Increasing factor inputs still accounted for over two third of industrial growth, but productivity increase gave already one third of gross production. Productivity growth in collective-owned industries was substantially higher than that in state-owned industries in the 1980s.[72] Increasing marketization may also have made it easier to mobilize factor inputs, the reverse of what one would expect since the strength of centrally planned economy lies in its capacity to mobilize inputs. Some of the inputs into collective industries may have been diverted from large SOEs, but some were in the form of local labour and capital that the state system may not have been able to mobilize.

By end-1991, the share of the rural collective sector was 21 per cent (see Table 5), exceeding the urban collective sector by a wide margin. The individual, privately-owned sector is still insignificant with 6 per cent share in total industrial production.[73] It is important to note here, however, that the share of foreign-owned businesses in industrial output equals that of private production.

Policy changes with regard to the private sector introduced some fluctuations and decline in the number of private units between 1988 and 1990. With the decisive change in favour of these economic units since 1991, the size of the sector has recovered

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[70] The best studies on micro-economic behaviour of township and village enterprises are summarized in Byrd and Qingsong (1990).

[71] Once again a parallel feature with the Japanese and South Korean system.

[72] Average productivity of labour in the collective sector increased by 12 per cent annually while productivity of capital grew by 4.5 per cent annually between 1980 and 1988. Total factor productivity of collective industries grew at the rate of 4.6 per cent annually in the period with a higher growth rate, of 5.9 per cent, in the period's latter part. Jefferson, Rawski and Zheng (1992:253), cited by *World Economic Survey* (1993:197).

[73] By the end of 1988, there were 14.5 million self-employed units with employment of 23 million. In contrast, there were only 225 thousand private enterprises, with 3.6 million employed. Private enterprises were overwhelmingly small-scale units, having in 1992 on the average 16.7 employees. See *World Economic Survey* (1993:195), Table VII. 6.

substantially. But the size of the private enterprise sector remained substantially below the 1988 level. The pace and scope of development of private enterprises have been more rapid in rural than in urban areas, mainly owing to differences in policy implementation and availability of land and labour and entrepreneurs. Interestingly enough, the share of investment in fixed capital by enterprises of different forms of ownership remained largely unchanged in the 1980s. State enterprises continued to account for the majority share, 75-76 per cent of total productive investment, while the rural collective sector accounted for about 10-11 per cent and the private sector for 8-9 per cent (*Statistical Yearbook of China* 1992:32, 281 and 641). On the contrary, share of foreign direct investments in the total value of fixed investments increased from 3 per cent in 1985 to almost 7 per cent in 1991.

An important indicator for the success of any sector is its contribution to overall export performance. In the case of China, exports of the non-state sector have become the source of the very rapid growth of exports. Exports of rural enterprises increased at an average annual rate of 40 per cent between 1985 and 1992. By the end of 1992, their exports constituted 23 per cent of the country's total exports, compared with only 4 per cent in 1985. Geographically these exports are concentrated in the coastal regions. About 4 per cent of these enterprises are behind the majority of these exports sales, hence the concentration is rather high. Contribution of the foreign investment sector to exports is even more pronounced. By the end of 1992, exports of this sector accounted for 20 per cent of total exports compared with a negligible share in 1984 (*World Economic Survey* 1993:196). Exports of rural and foreign-owned enterprises constituted 43 per cent of China's exports in 1992. A substantial share, indeed.

The non-state sector is an important employer, as well. Employment generation of this sector has been rapid throughout the 1980s.[74] Urban private and foreign-owned enterprises accounted for 4 and 2 per cent of the growth, respectively. State enterprises generated 20 per cent of employment growth. The combined share of employment in urban collective, urban private, foreign-owned and rural collective and private enterprises was larger in 1991 (24 per cent) than that of employment in state sector (18 per cent).

The domestic dynamism of the non-state sector is continuing. Between 1980-1990 the employment of this sector increased by 3.2 times, production by 17.7 times, productivity 5.5 times, albeit in nominal terms (*Japan Center for Economic Research Report* 1994:8). In 1993 China received more than $20 billion in foreign direct investments;[75] its exports increased by 8 per cent and imports by 29 per cents, respectively. China became the 11th most important trader in the world in 1993, after having been in the 32nd place in 1978. Policy steps announced for 1994 have affirmed the continued importance and development of this sector. The aim, together with enhancing economic efficiency, is the optimization of industrial structure. The former

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[74] Growth in employment in rural collective and private enterprises accounted for 43 per cent of total employment growth between 1985-1991. See *Statistical Yearbook of China* (1992:97 and 389).

[75] All together China negotiated about $110 billion in foreign direct investments; and has actually received $33 billion since 1978. See *Beijing Review* (1994).

dual exchange rates will be unified, a unitary and manageable floating exchange rate system based on market supply and demand will be implemented. The foreign exchange retention system – remitting a part of the received foreign exchange to the state – will be abolished (*Beijing Review* 1994:8). The implementation of this task would require several devaluations of the yuan – about 50 per cent in *toto* – with negative effects on the economy. Import liberalization is slated for further progress, foreign investments are going to be concentrated on technology-intensive projects and infrastructure. Thus, these policies should be supportive of the non-state sector as well.

IX CHINESE STEPS IN DIRECTION OF A FINANCIAL AREA

In the last quarter of 1993, Moody's agency upgraded China's long-term bonds[76] and it is expected that Chinese financial institutions will receive the same treatment. Moody's agency expects the Chinese Government to implement a complete change in market economy, even though this process will be accompanied by sharp domestic political conflicts and economic fluctuations. A better 'report card' for China's external finances was possible due to its low level of international indebtedness.[77] Debt amortization is about 10 per cent of the foreign exchange income of the country.

China's fast economic growth contributed to the high level of economic development in the Asian continent which is about 7 per cent (excluding Japan), compared to the 0.5 per cent growth rate of the world economy. The area, often called 'Great China' – China, Hong Kong, Taiwan, Province of China – became the fourth growth pole of the world economy after Europe, North America and Japan. China is still at the beginning of its development, hence economic growth can be expected for a considerable time period. Due to the rather high growth rate, the economy became overheated. Reflecting the high level of fixed capital investments, raw material prices skyrocketed (+40 per cent and up), bond and real estate prices increased, and a high demand for transportation and electricity caused some shortages in these fields. With coordinated policy actions, an annual GDP growth of 8-9 per cent is not only feasible but necessary, as already planned for 1994.[78]

The central problem of China can be described as the inability of the central bank to control monetary policies. It was barely able to limit the expansive credit activity of Chinese commercial banks; credits and loans of non-bank institutions have not been regulated; interest rate development played a rather limited role, import and abundance of foreign exchange on Chinese territory has not been met with appropriate measures. The People's Bank of China dealt with issues typical for commercial banks. In the first 6 months of 1993, the money supply increased by 52.8 million yuan reaching 486.3 billion yuan – an increase of 50 per cent on an annual basis. Personal consequences could not be left out: the Governor[79] and two deputy-Governors of the central bank were dismissed, and a new Governor, Mr Chu Zhungchi, and three new deputy-Governors were appointed. The central bank will be independent from the state by the end of 1994. It will be responsible for the stability of the yuan and for the control of monetary development.

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[76] A bond issue of 30 billion yuan, terminating in 1998, now received grade A3. Until November 1993 the issue was graded as Baa1.

[77] It is now $66 billion, 15.8 per cent of the GNP.

[78] See the interview with Prime Minister Li Peng in *Beijing Review* (1994).

[79] Li Guixian.

In its 16-point programme, the central bank suggested measures to cool off the 18-month-old high economic growth. The Government approved the programme and started to implement it. The measures are especially tough for the financial sector. State banks, having been involved in extended speculative deals in the coastal regions and big cities, are no longer allowed to establish commercial and real estate subsidiaries. Due to the large amounts of capital tied to these speculative deals, the banks were unable to finance important infrastructural investments and to pay for the procurement of agricultural products. Beijing ordered the withdrawal of illegally extended credits amounting to 220 billion yuan but only one third of this amount has been received at the central bank. This outcome confirms the fact that individual sectors of the vast, complex Chinese economy cannot even in periods of crisis be ruled and controlled from Beijing.

In order to stimulate private savings and limit speculation and consumption, certain interest rates have been raised. The interest rate of three-year state bond has been increased from 12.52 per cent to 13.96 per cent, thus giving positive real interest. Short-term real interests are still negative in China. Irregular inter-bank loans have been banned, banks cannot compete with each other for savings by independently increasing their interest rates. Bank employees cannot accept a fee for granting a loan and cannot be connected with deals financed by their employer banks.

As a consequence of the measures to cool the economy, the volume of bank loans decreased by 76.2 billion yuan in July and August 1993; 28 billion yuan less money had been printed in the period from 1 July to 22 September 1993 than in the corresponding period of 1992. The central bank introduced the Western-type regulation of money supply.[80] The Chinese currency was successfully stabilized.

China is planning the most radical financial reforms since 1949 in six fields: bank issues, finances, taxes, investments, and foreign trade and enterprise management. Regulatory and policy-forming functions of the central bank will be strengthened. According to a joint decision of the Ministry of Finance and the Central Bank, the central bank will have to eliminate all its ties to firms which were formed and financed by the bank. Profits resulting from this action will be paid into the central budget.

As a clear sign of Hong Kong joining China, the People's Bank of China is considering opening a branch in order to manage its international reserves better. The newly established Hong Kong Monetary Authority was assured that only investment purposes motivated this move and not the undermining of this new institution.[81]

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[80] In July 1993 the central bank pumped quietly 20 billion yuan into the Shanghai swap centre in order to shore up the value of the yuan.

[81] The establishment of the Hong Kong Monetary Authority can be taken as a step furthering unification of China and Hong Kong in 1997, and also enhancing financial independence. For 50 years after unification, there shall be two financial systems with two exchanges in one country.

1. Bank system in China

In China all banks are state property. Until the mid-1980s the central bank handled all commercial activities. Later four specialized banks were established, currently there are eight with 85 per cent of the bank assets. In reality, however, these specialized banks act for the government ministries and their loans are politically motivated.

In March 1993, the Government decided to transform the Chinese banks into commercial financial institutions. New financial institutions will be established for issuing such economic policy loans as transport, infrastructure, and for the search for new energy resources. An important part of the bank reform is the establishment of a contemporary payment system and an international inter-bank money market. Deregulation of the Chinese bank sector proceeded relatively fast as state banks, in many cases, established non-bank financial institutions. According to some observers, 30 per cent of the bank sector is already deregulated.

As discussed in Chapter VIII, financing in the case of non-state collective enterprises is done from financial resources of the owners and from retained income, i.e., the market regulates them. The financing of reformed – even state-owned – and non-reformed enterprises should be separated. The latter would receive loans but the financial institutions would strictly control their cash-inflow balances and investment decisions, thus squeezing out non-profitable enterprises step by step. Reformed enterprises could use their incomes freely .

A Long Term Development and Credit Bank, together with an Eximbank and another Agricultural Bank, is expected to be established in early 1994. Thus specialized banks could be freed from financing large-scale investment projects.[82]

In the integration of the bank sectors of China and Hong Kong, an important role is played by the fact that banks from the People's Republic participate in the privatization of certain banks in Hong Kong.[83] The Bank of China group also promotes cohesion between the mother country and Hong Kong.[84] Hong Kong banks strive for a strong presentation in the Chinese financial markets.[85]

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[82] The four largest specialized banks – Industrial and Commercial Bank, Bank of China, Construction Bank and Agricultural Bank – hold a large portfolio of 'dead-loans', credits extended to inefficient state-owned enterprises.

[83] The fifth largest Hong Kong bank, the 100 per cent state-owned Overseas Trust Bank will be privatized this way.

[84] The group consists of 14 members, 13 from these in Hong Kong. Only 4 of these branches in Hong Kong are registered in Hong Kong, the rest in China. Main task is enhancing Hong Kong's stability, supporting Chinese economic development and construction projects in Hong Kong. The group has been in Hong Kong for 75 years and is an important part of business relations between various businesses. The group does not wish to monopolize the Hong Kong financial market after 1997 either.

[85] The greatest profit from the liberalization of the Chinese banking system could be enjoyed by the Hong Kong bank. This bank is ready to consult Chinese state-owned enterprises, it participates in their

Chinese banks are in the leading ranks among the two hundred largest Asian banks. In 1992, the largest Asian bank with regard to first-rate capital was the Industrial and Commercial Bank of China, bypassing the previously leading Bank of China. The People's Construction Bank of China was third, and the Agricultural Bank of China is number four. Chinese banks hold 27.3 per cent of the combined capital of the two hundred Asian banks, and 33.4 per cent of all assets belong to the Chinese.[86]

The present state of the dual exchange rate system has contributed to the fact that capital flight out of China has increased. Chinese citizens are allowed to take 6000 yuan out of the country. There are free yuan markets in Hong Kong and New York City. It is estimated that the capital flight through Hong Kong may have reached about $18 billion. The errors and omissions part of the official balance of payments of China in 1992 showed $8 billion,[87] and capital flight was very likely to be a large part of it. In addition to the import increase, capital flight also contributed to the decrease of Chinese international reserves. After four years of substantial surplus, the balance of trade showed a deficit in 1993 ($12.2 billion). During the first half of 1993, international reserves decreased by 14 per cent reaching $38.4 billion. The reserves cover four months of imports only. In September 1993, after six years of negligence, China re-entered the international private capital markets.[88]

In 1992 the combined exports of China, Hong Kong, Taiwan, Province of China and Singapore totalled $350 billion, equalling Japan's exports and not being very far from the exports of the USA. Thirty per cent of the Japanese exports are directed toward South-East Asia. According to some opinions, the most important external impulse for the Japanese economic growth can be expected from this region. Between 1990 and 1992, the share of this combined region in the Japanese foreign direct investment increased from 12 per cent to 15 per cent.

In summary it can be stated that the steps in direction of a greater financial region enhance the chances of market economy in the mother country as well. A world power is in the making which could turn into a dominant economic and political factor of the Asian region. No wonder that smaller nations of Asia follow these developments with certain apprehension. But even for these countries, it is of utmost importance that China grows in strength as a trustworthy partner whose decisions are based on economic – not chauvinistic – considerations.

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modernization and advises them on their assets and portfolios. A substantial part of its deals are indirect deals through its partners. The bank operates 14 bureaux in China.

[86] Data are from various issues of the *Far Eastern Economic Review* in 1992 and 1993.

[87] In 1991 it was $6.8 billion.

[88] China floated a 300 million DM bond in Germany, orchestrated by the Dresdner Bank in 1987. The 1993 bond is 30 billion euroyen, in China's own name.

X SIMILARITIES AND DIVERGENCES BETWEEN THE CHINESE AND RUSSIAN REFORM\TRANSITION APPROACHES

A clear perception of the initial situation(s) matters a lot. The starting political and economic conditions in the Soviet Union (later Russia) and China must be stated clearly and firmly in order to be precise on the comparativeness of the two ways of economic changes.

The comparison between the Soviet Union (Russia) and China should not be overstretched, because of the special problems facing the Russian state. First of all, the starting point of transformation in Russia was completely different from that in China in 1978. China, after the decade-long Cultural Revolution, was in political, economic and social chaos, there was a complete loss of confidence in the state and Government, and in their services. The need for fundamental reform was indisputable in 1978. Market, as a basic means of social order was accepted both by the hierarchy and the population. There was no other way than to start bold, daring reforms anew.

At the time of the start of transformation, the Russian economy was still functioning, although economic growth had declined. State and government services were supplied, the attempted transformation measures were more 'designed' than 'pushed' by the prevailing social and economic conditions in the country. Unlike in China, however, there has been heavy resistance against the attempted reforms both by the general public and by leading political circles. The military sector of the economy was rather lukewarm in its support for a general overhaul of the Soviet system. Last but not least, the Soviet Union has never really experienced economic decentralization.

China entered the reform process intact, as a state, its population being more homogenous than that of the multi-national Russian state. The Soviet Union, due to political and economic developments not detailed here, has disintegrated into several independent states. In the long term, a series of separate, but more cohesive nations, may make economic reconstruction easier, but in the short to medium term, the nationalist struggle creates instability which hinders economic progress (Nolan 1992:3). Naturally, political and military stabilization efforts had to be mixed with economic stabilization issues, most of the time to the disadvantage of the economy. Political efforts to keep the economic entity of the previous Soviet Union or at least part of it intact, modified the applied economic transformation policy. More precisely, transformation has been implemented according to the political hopes of the 'rouble zone'.

In contrast to the Russian case, the Chinese centrally planned economy was already much more decentralized in 1978 as various provinces and regions had a fairly high level of autonomy in terms of a command economy. Central organs and authorities did not interfere much with their affairs once the central directives had been fulfilled.

Reforms have been more easily accepted on lower levels then in Russia where a complete overhaul of the central system had to be put on the agenda with the concomitant resistance by the bureaucracy on all levels.

As mentioned before, there were hardly any expectations by the Chinese population concerning the central way of economic improvement. In Russia, however, there were high – and we can now state, unrealistic – expectations regarding the possibility of fast, efficient transformation of the stagnant Russian economy into a market economy. Almost all citizens had some experience of markets in China during the last 15 years of reforms, but unlike in Russia, the concept of a large state working in the national interest to harness the market for common goals, remains a respected concept in the popular mind.

A clear target system is also necessary for an economic policy, otherwise it will be indecisive. In China, there was simply no other way than the commitment of the Government (and the Party, of course) to force former centrally planned economic institutions to operate differently in a different environment. Perhaps in a paradoxical way, this negative target system was more than sufficient to push for a modified centrally planned system, with important market elements. Central planning institutions in Russia had not been discredited yet at the time of transformation. Partial reforms were only discussed, not implemented.

In both cases, however, the executive power was behind the reform/transformation efforts with different results. Teng Xiaoping, having defeated not only the Gang of Four but also the radical reform wing of the Communist Party, managed to pave a cautious, continuous way for reforms. Gaining the support of the nation's basic group or class was a precondition to the success of reform. In the Soviet Union, Mr M. Gorbachev failed to unite the proponents of substantial economic reforms. The evolving clash between the executive and the legislative power could not but limit the prospects for successful economic reforms.

It can be stated that in both countries there was a lack of clear models and ideas on the practical reforms. In China, reforms have been based on voluntary actions taken by individuals, enterprises, and local governments through trial and error. These groups are the driving force behind the reform. Central authorities follow their activities with great attention. With a bit of exaggeration, reform attempts are destined for success in the Chinese case because there are strong local interests in pursuing them. Even if it meant opposing central intentions, the lower-level decision makers ensured that the continuity of reforms would not be broken. Under decades of reform, a transmission belt between the Center and myriad of micro-economic organs – provinces, local authorities – had been established. Further, it seems apparent that as China realized the danger of persisting with any specific doctrine or blueprint, it opted several times for changes in the way of thinking on economic reforms. In Russia the preponderance of the central, omnipotent state and authorities is still prevalent. Decentralization of power to the local level is only haphazard and its results are very fragile. The transmission belt between the centre and 'periphery' is either non-existent or is not working properly. Once a reform or transformation idea is conceptualized, it is treated as if it were 'written in stone' with no deviation possible. Changes required by practical implementation need an arduous legal process thereby further neutralizing any effects of transformation.

In this regard, it is important to emphasize that in China local governments behave more like a mini-conglomerate of enterprises than government bureaucracy. The local governments are very much interested – not only politically! – in the successful management of these entities, because their financial success is dependent on it. This is way they operate more or less according to the rules of market by jettisoning inefficient, non-delivering enterprises and by enhancing the prospects of successful endeavours. These local authorities have strong interest in using the market in overcoming market failures. In Russia, local levels are nothing more than imitations of central bureaucracy. There is almost no economic incentives for the local authorities. Their rewards and punishment are decided at the central level. In the Chinese case, it had been realized quite early in the reform process that because of their large number and scattered location around the whole country, the economic levers of tax, price, profit and credit policies rather than administrative direction to achieve the macro-economic targets in rural areas should be used. This deliberate choice is a very important step in the process of introducing market mechanism in China (Yuyan 1989:11).

The increased autonomy, the strengthening of fiscal authority of the provinces, and the reinstatement of entrepreneurship in the 1980s in China invigorated the economy, several factors in the economy already behaving according to the rules of the market. Thus, overall economic growth had been enhanced. To the contrary, the need for far-reaching decentralization together with economic stabilization and transformation put Russia on a path of secular recession. Attempts to free the lower-level economic units from the bondage of central tutelage proved rather costly and inefficient because the necessary institutional set-up was still missing. In other words, the long-term effects of decentralization may be quite substantial, but with regard to the success of the reform in the short-term, it proved confrontational.

As far as the implementation of reforms in the two economies is concerned, China's approach is economic incrementalism with limited political change, unlike Russia where all facets of the political and economic system have been tampered with. Slow, cautious policy steps proved to be lasting in the Chinese case and not just under political pressures. Russian transformation measures, however, were taken under great political pressure in order to produce tangible results. However, a great majority of these measures proved to be only transitory: changes in political perceptions and strategy modified the economic policy rather swiftly.

In China, the increase in the role of the market was not tied to the break-up of the country's international trading arrangements, as in the case of the Soviet Union. The demise of the Council for Mutual Economic Assistance (CMEA) as the most important trading partner for the Soviet economy would have been devastating even without economic transformation. Linked together, it made stabilization and transformation at the same time a necessity. Unlike in China, where there was a gradual opening in foreign trade as reforms enfolded, foreign trade opening in Russia was partial and controversial. The role of foreign trade in economic transformation has not properly been analysed. Opening – rather, not closing – towards the former republics of the Soviet Union as a political requirement was mixed with macro-economic necessity of proper export prices. The role of foreign direct investments was emphasized in words but real actions came rather late.

The Chinese economic reform concentrated on agriculture in its first phase. The reasons for this are fairly well researched, so there is no need to repeat them here. It is important to emphasize here, however, that the small-scale, intensive farming has not been lost even in times of great political turmoil. Agricultural collectivization, unlike in Russia, has never been fulfilled in its entirety. Family production as a side-activity was continued and was an important place for absorption of marginal workforce. Introducing the contract production responsibility system, resources of volume which so far had been hidden or not completely utilized and efficiency increases have been realized. Individual farms became the predominant type of rural economic units in agriculture, producing the largest part of food supply for the country. Farmers, realizing the advantages of free choice and decision, trusted the central authorities to design further reforms. Local authorities became stronger, their interest in furthering economic reforms more intense and more decisive. The most important innovation in the 1980s, however, was not the re-organization of agricultural production from collective to family units but the spread of rural industries (Osterhammel 1993:322). In Russia, where there were no prior 'memories' of private farming and skills had to be reborn. Private farming traditions and entrepreneurial spirit in agriculture had always been missing, hesitant privatization in agriculture could be nothing but half-hearted. First of all, farmers did not – and still do not – believe in the implementation of the agrarian reforms; continuation of centralist tendencies is expected; and, finally, private farms do not have an effect on the food supply yet. Agriculture also had to struggle with the effects of deep recession at a time when the size advantages of the *kolkhoz* and *sovhoz* system had already been lost but when the positive elements of private farming had not yet been realized.

The Chinese reform process produced positive results in industry, as well. Accumulation and allocation of capital is central for any restructuring. The reconstruction of the manufacturing sector into an internationally competitive sector, which eventually becomes profitable is exactly where capitalist markets fail. Private investors are cautious; they prefer 'clear and fast deals', where there is hope for short-term profits. These issues are likely to dominate the investment calculation. Under these circumstances there is a strong case for Government intervention to raise savings and channel them into reconstruction projects aimed at regenerating the manufacturing sector. That is exactly what the Chinese Government, through trial and error, is practising. There has been a substantial shift in the regional pattern of industrial growth, namely the Eastern coastal region's share in overall output has increased. This is a region where the return on investment is higher than in other parts of the country. This way, China modifies its industrial structure by relocating large investments to the coastal regions, thus indirectly decreasing the share of inefficient investments in other regions. The rationality of the size structure of SOEs improved; the rapid growth of the collective sector's share in industrial output was largely at the expense of the small state sector. The reforms reversed the sectoral pattern of industrial growth as well: light industry grew faster than heavy industrial branches. In the Russian transition process, stabilization issues have priority in the overall macro-economic policy. Sectoral issues of industry have been and perhaps had to be neglected in the short term. The enfolding recession hit industry the most, both in absolute and relative terms. Political break-up of the Soviet Union meant collapse of the supply system of industry as well. It will take some time to re-establish normal, economic relations between industrial systems and industries which were once unified but are presently in other independent republics of the Community of Independent States.

Privatization, namely the direct change in state property, has not played an important part in the Chinese reform process. Instead, China opted for the creation of a non-state sector, combining urban cooperatives, rural township and village enterprises, individual (private) enterprises, and foreign enterprises. The strong interest of local governments in using markets and in overcoming market failure to promote the local economy assured the interests necessary for a thriving local industrial activity. This, in turn, led to competitive thinking by enterprise managers, even to the extent that they had strong incentives to improve labour discipline in the workplace. The productivity gains, export successes, employment absorption results of the non-state sector convinced central authorities that further advances in this field are not only feasible but necessary. Russian privatization, on the other hand, started as one of the main elements of the transition process. Great importance and expectations have been attached to the expanding private sector. Newly established or privatized businesses were to benefit more from the accelerated reforms. The proposed so-called *voucher* privatization was started with great expectations but the internal contradictions of the macro-economic policy soon put this endeavour on ice. As newer and newer legislation followed, the process became entangled in ever worsening bureaucracy and the absence of a national market for equity, the normal starting point for a massive privatization scheme, became a political problem. As the speed of privatization slowed down, the gist of the whole process has again been changed. It seems inevitable first to implement macro-economic stabilization in earnest and there and then to start/continue privatization in Russia.

There were other factors for which the slow, gradual improvement in China's development was an advantage. Unlike in Russia, where gradual deterioration created major imbalances in the complex production system of the country, China started the improvement process based on a simpler production system. China's production has a rather simple inter-sectoral relation; the role of services is still limited in the whole economy.

The way domestic markets have developed in China was another contributing factor. Regional markets were developed to meet regional needs and thereby were able to heal regional inequalities. This process led to increasing industrialization in the countryside, not so much by the design of the planners as according to the local (regional) needs. In Russia, the omnipotent planning system had already been abandoned but the new institutions for a national and regional markets were not in place. Hence, further increase in state involvement is inevitable to pave the way for market reforms, but this can prolong genuine market responses.

There is a major difference concerning Western assistance to the transformation of these economies. Basically, the West has left China alone in its reforms and international multilateral institutions became a part of this process only later. The reforms have been based almost exclusively on domestic resources and foreign direct investment. Quite early, foreign private capital recognized the huge possibilities of the vast Chinese market and flooded China with capital. Efficient enterprises were built, the country's technological level improved, China's foreign economic performance enhanced. In clear contrast to this, Russia's transformation could not but start with a major role played by the international multilateral institutions. Committed assistance flows, however, either did not arrive or were not in the amounts requested. As the political scene changed drastically within the country, so did the response of external supporters. The international financial assistance, although important, came too late to stem the radically deteriorating economic situation. In these turbulent political and economic circumstances, only a trickle of foreign direct investment was received by the country in the last two years.

EPILOGUE

China's approach – economic incrementalism and limited political change – has produced an outstanding economic advance over the course of a decade and a half. The transition in Russia has so far brought about desperately poor short-term economic results. It is possible that, due to the differences in starting positions of the two giants, the comparability between the two can only be done with certain limitations. Still, one cannot forgo the conclusion that a gradual path of economic reform/transition may be much more difficult to bring about in countries lacking the strong political leadership China possessed during the course of economic reform (Nolan 1992:2). To put it differently, '... countries such as China have problems of the sort that need to be dealt with by some authoritarian regime'.[89] China's experience has demonstrated the feasibility of gradual transformation under socialism as well as the possibility of severing economic reform from political developments. The lessons of China in this respect should provide a valuable working model for Viet Nam and other socialist nations in Asia contemplating reform. The presence of a strong central leadership or a committed authoritarian regime might warrant that economic progress may for some time be greater in the 'market CPEs' (Nolan 1992:19), like Viet Nam and China, than in those former centrally planned economies which overthrew their communist parties.

With its successful economic development, it is simply inconceivable that widespread popular pressure in China would not in time push the system towards a wider and a firmly rooted democracy based upon high levels of income and all the associated cultural attributes. The continuation of the reform path, with the openly targeted state of middle-income, and the similar task of reconstruction and modernization in other fields of economic life so far left untouched or not properly modernized, requires strong, purposive state action, harnessing the power of market forces rather than obliterating it.[90]

China's practical economic success and the confrontational results of the Russian transition both make it necessary to re-examine the economic functions of the state and to understand those policies which release the creative power of the markets but also shape and guide the setting within which market forces operate. The post-war enthusiastic confidence in the capacity of Governments to achieve planned national goals has become severe criticism of the role of the state. Equally naive confidence in the market ensued. With the domestic and external proposals for the economic adjustment or transformation programmes, it was assumed that, after an initial fall in output, the stabilization and structural adjustment programme could lead to rapid growth

[89] In the quotation, Professor M. Shinohara compares the necessity of a strong, authoritarian regime in China in times of the reforms to that of Japan, before the second World War. See *JCER Report* (1994:8).

[90] A somewhat similar way of argumentation on this line is found in Nolan (1992).

of output.[91] Experience in both countries proves the fact that there is an important function for government planning in a time of such uncertainty. This function should focus on assisting the restructuring of SOEs by analysing the probable pattern of (domestic and external) demand as the economic structure alters. Seemingly 'dormant' economic units can make profits as demand begins to grow. It may turn out to be extremely wasteful to allow this sector, based on short-sighted decisions, to be closed down. Establishing an effective state administration out of the confusion of present day Russia is extremely difficult. But it is precisely during the turbulent times that the state, albeit in new ways and in a country-specific manner, needs to intervene strongly in the workings of the market if socially desirable outcomes are to be achieved.

At this point the comparison of the two transformations should be briefly assessed. The specifics of the traditional and contemporary Chinese economic development seem to be quite influential in explaining several results of the after-1978 reform process. Hence, comparison with the Russian transformation can be done with several restrictions to give proper weight and care to the different starting position, conditions, socio-economic structures, culture and other issues. It is evident that the infrastructure necessary for a market-type economic development in Russia is not yet in place. The question, however, is: Will it – or can it – come into being naturally, without any special measures? If not, to what extent is the right historical and cultural background necessary for a successful market system? In case this infrastructure is country-specific, with important elements of general nature, it seems evident that different types of markets will evolve in Russia and in China.

As far as China is concerned, two conclusions seem to be warranted. First, both economic reform and internationalization will proceed rapidly even though structural problems remain. The reform process is at a critical junction but will, eventually, prevail. Second, though separation of politics and economic reform will continue to be the working principle, China will eventually evolve into a unseen political and economic entity. However, the changes will not be as drastic or as radical as those seen in the former Soviet Union or Eastern Europe.

Successful market economy has been closely linked to democracy. Market economy cannot function without democratic institutions. The reverse is also true: democracy can only mature when a market economy exists. Neither a democratic political system nor a market economy can be established overnight. Both are closely related to the level of a country's economic and social development. In this respect, the Chinese and Russian way of experimenting with economic transformation should be both instructive and beneficial for other transformation economies. Further in-depth studies are needed on the particular issues of the two countries to enhance our understanding concerning general and particular issues of economic transformation.

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91 'A recovery from the reduced level of output should be able to get under way within two years or so ... Further strong growth of output and rising living standards could be expected for the remainder of the decade and beyond.' IMF, World Bank (1990:18-19).

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