Iikka Korhonen

Differences in Transition Paths: Russia versus China

Iikka Korhonen
Bank of Finland
Institute for Economies
in Transition.

INTRODUCTION AND MOTIVATION

The past four decades have seen the global economy transformed in many ways, but there was no event as large and significant as the liberalization and opening up of the formerly centrally planned economies. To illustrate this change, Figure 1 shows nominal gross domestic product in a number of countries in 1992 and 2018. China's emergence is obvious.

In this article, I shall assess the transition paths for two of the largest such economies, namely China and Russia. While there are some similarities in their transformation, the processes can be more properly described in terms of their differences: different starting points, very different political developments as well as constraints before and during the transition, different approaches to financial market and capital flow liberalization, different privatization strategies, etc.

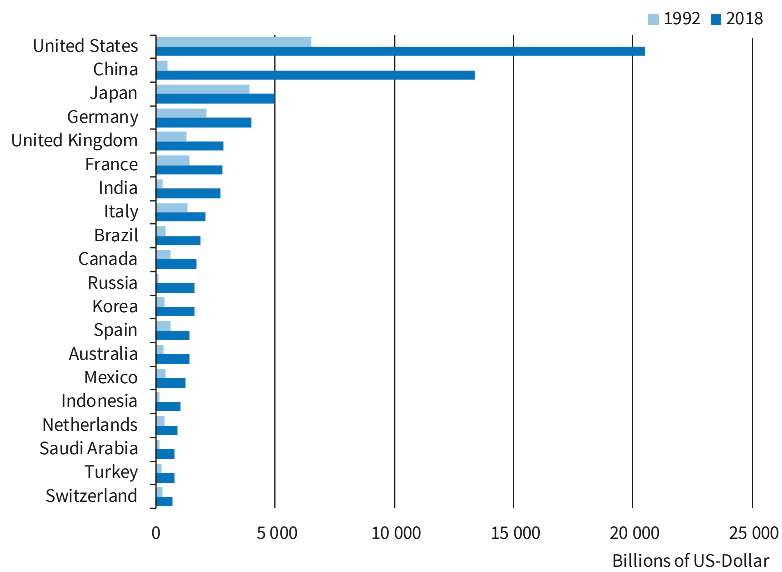
When China's first tentative reforms started in the late 1970s, China was extremely poor. Agriculture was by far the most important sector both in terms of output and employment, while Russia was heavily industrialized and much richer when its economic reforms started in the late 1980s. According to most traditional metrics, China's human capital was at a much lower level than Russia's. Nevertheless, China has been able to constantly maintain rapid growth in the per capita GDP, while Russia experienced a very large output drop at the outset of the transition in the early 1990s. Also, Russia's experience during the global financial crisis in 2008 and 2009 was much more unfortunate than China's.

What factors account for these differences? It is likely that China's gradual growth strategy has been mostly successful so far, as many of the distortions corrected by the reforms have been quite evident. Also, comparing their political systems in the late 1980s and most of the 1990s, China was much better able to maintain control over the state apparatus and various regions, while in Russia the first years of transition were very much marked by the breakup of the Soviet Union and dissolution of the traditional trade ties. In addition, the simple fact that poorer countries, ceteris paribus, tend to grow faster than richer ones, has favored China (for a recent survey concerning the evidence of this income convergence, see e.g. Roy et al. 2016). It is quite possible that in the coming years, China's growth dividend from this source will be much smaller, and achieving relatively fast economic growth will be that much more difficult. The structure of China's economy already corresponds to most other middle-income countries, and services are the largest part of the economy, both in terms of output and employment. Also, urbanization is already at a high level, so shifting the labor force from the countryside to the cities can't be a further engine of growth.

At the same time, Russia has also changed considerably from the Soviet times. Its economic structure is in many ways very similar to that of other middle-income countries as well; for example, services provide the bulk of employment. The notable exception is Russia's energy sector, which remains very important in terms of value-added and export revenue, but not in terms of employment (less than 2 percent of the labor force is employed in the energy sector).

Figure 1

Nominal GDP



Source: IMF World Economic Outlook Database.

© ifo Institute

DIFFERENT INITIAL CONDITIONS AND THE TRANSITION PROCESS

When China began its first tentative economic reforms in 1978, it was a poor, predominantly agrarian economy. Almost 70 percent of the labor force worked in agriculture, and per capita GDP at purchasing power parity was less than 3 percent of the US level. This means that agriculture was the natural place to start reforms, and also that the potential for catching up was extremely large, given the distance to the advanced countries. China had succeeded in detonating a nuclear bomb in 1964 (partially with the help of the Soviet Union), so obviously in some areas, the country had moved beyond a simple agrarian society. Nevertheless, overall Chinese society and economy were still dominated by agriculture, and the vast majority of people lived in the countryside.

In the late 1980s the Soviet Union was a heavily industrialized and largely urban society. Less than 20 percent of the labor force worked in agriculture (Central Intelligence Agency 1992). This meant that opportunities for increasing efficiency by shifting labor from agriculture to industries and services was much more limited than in China at the outset of the transition.

After the tumultuous and disastrous Cultural Revolution, the Chinese society and economy were in many ways in disarray. Hence there was a clear need for economic reforms that could help to improve the welfare of its citizens and also provide the government with more resources to carry out its duties. It was clear that the command economy as it had been practiced before had not been successful in its stated aims. Naughton (2018) provides a useful discussion on the reasons for going forward with reforms and also why reforms related to agriculture were the first ones to be implemented.

Lau, Qian, and Roland (2000) provide a theoretical framework to assess the initial agricultural reforms and to discuss their real-world effects. In simple terms, Chinese farmers were required to sell only a certain, ex ante announced portion of their output to the state at a fixed, low price, while being allowed to sell the rest at market prices to the market. This means that the producers' marginal revenue would be equal to the market price. This move towards a more market-oriented way of organizing production proved to be both very popular and very successful. The initiative soon spread to industrial goods as well. Lau, Qian, and Roland (2000) report that in 1978, at the beginning of the reforms, some 6 percent of output was sold at market prices, but by 1985 this share had already risen to 63 percent. In industrial production, the shift towards more market-priced transactions was not as marked, but it can certainly be observed as well.

China was able to embark on a gradual reform path, as it maintained control over various parts of the state apparatus. In addition, the central government was always ready to allow some regional initiative, as long as these were intended to increase production and/or efficiency. Regional leaders' career prospects were also tied to the economic success of their regions, which gave them an incentive to prioritize efficiency enhancing reforms (Xu, 2011).[1] Yet, China's initial reforms during the 1980s left many areas untouched, including much of the labor market (internal migration is still regulated via hukou system) and foreign trade.

In contrast, Russia was much more industrialized and urbanized when it's economic and political reforms started. While some tentative reforms were tried during the latter half of the 1980s, there was not a corresponding potential to increase efficiency from liberalizing some parts of agriculture and services, such as retail trade. Most of the economic activity simply took place elsewhere.

More importantly, Russia's economic reforms were undertaken during a period of political instability, which at times was *extreme*. Dissolution of the Soviet Union did not end the period of instability, and between 1992 and 1995 there were serious doubts concerning even the territorial integrity of the Russian Federation. Gaidar (2007) provides an insider's account of how various reform plans in 1991 and 1992 were blocked by vested interests, either at the line ministries and large state-owned enterprises, or by regional politicians who were trying to improve their bargaining power vis-à-vis the federal level. Reformists' position was made much more difficult by the very weak public finances and decline in foreign currency holdings: a drop in the price of oil had led to much weaker public revenue, and impending dissolution of the Soviet Union disrupted intricate production networks even further.

In this situation, the government of the newly independent Russian Federation had only a very limited set of options. For example, it chose to liberalize consumer prices in the beginning of 1992. This led to an immediate and very large increase in Russian price levels, caused by the very large monetary overhang from Soviet times (as prices had not been allowed to adjust to higher monetary incomes, rationing – both formal and informal – became a way to allocate goods). The Russian government also moved relatively rapidly forward in some aspects of privatization. In most instances, households were given the apartments they lived in, which gave people at least some form of property. Obviously, there was a large element of luck in all of this, and people were treated very differently depending on where they happened to live. Another Russian privatization element was the use of vouchers. Citizens were given vouchers that could be used to purchase shares in privatized companies. Even though these vouchers were often bought up by those with access to finance and managers of the affected companies, this approach ensured a relatively quick privatization, especially of small and medium-sized state-owned companies.

In China, privatization of the state-owned companies proceeded at a much more cautious and slower pace, if at all. Initially China only allowed private (or semi-private) companies to emerge, and most state-owned or state-controlled companies were not subjected to genuine market competition until the early 1990s. In 1993, local authorities were given much more freedom to restructure state-owned companies in their regions. These measures quickly caused the number of employees in the state-owned companies to rapidly decline, as companies were sold, merged, or liquidated. However, there was never a goal of privatizing some of the most important and largest companies in strategic sectors such as energy and telecommunications.

[1] Obviously, this has also increased incentives for falsifying local economic statistics.

FORUM

FURTHER REFORMS

The approach towards the financial sector was very different in Russia and China. As a part of the initial liberalization drive of the early 1990s, Russia allowed a very large number of private banks to be established. At the same time, state-owned Sberbank remained (and remains) the dominant player, especially in the retail sector. Liberal policies led to an explosion in the number of banks (reaching even over 2,000 in 1995), but also in the number of bank failures. Banking supervisors struggled to keep up with the proliferation of new banks and banking business. The number of banks started to really decline with the financial crisis of 1998, and in recent years this trend has continued. At the same time, the share of state-owned banks has increased, and they now control more than two thirds of the retail market. Concurrently with the liberalization of banking operations, many capital flows were liberalized as well. This was partly an attempt to attract foreign funding (whether in the form of foreign direct investment or portfolio flows), which was especially important in financing the public sector deficit in the early and mid-1990s.

China chose a very different approach to financial sector liberalization (see for example Fungáčová and Korhonen 2011). While smaller private banks were allowed to operate locally and regionally, the largest banks remained majority state-owned (even if they also attracted foreign strategic investors). Also, the state maintained control over lending and deposit rates. As capital account restrictions limited Chinese access to foreign assets and markets, China was – and is – able to maintain a system where high domestic savings were mobilized by domestic banks to finance investment activities of both private and public sectors, often without much attention paid to the profitability of various projects. Over time, and especially after the global financial crisis, this has led to a situation where efficiency of investments is already quite low (see e.g. Dieppe et al. 2018). Going forward this will limit China's growth potential, unless financial intermediation starts to operate on a more commercial basis.

One reform area where China clearly moved with more determination was foreign trade. China joined the World Trade Organization in 2001. While there were several transition periods for many goods, this event clearly increased China's links to and integration with the rest of the global economy. Many foreign companies had taken advantage of China's low labor costs already before the WTO membership, but especially after the accession China truly became the "factory of the world," or at least "assembly plant of the world." Lower tariffs and lower transportation costs led to much more complex production chains where a single component could cross national borders several times before the final product was shipped to consumers. While domestic value-added of a single good assembled in China could have been relatively low, manufacturing activity provided employment and also opportunities for learning and adaptation. (For a survey of global production networks and China's processing trade, see Ma et al. 2009.) Liberalization of foreign trade also increased domestic competition, which led to higher productivity growth.

In Russia, the issue of WTO membership was never as pertinent. As most of Russia's exports were – and are – raw materials, their market access is simpler than that of manufactured goods. Moreover, there were very few domestic stakeholders speaking for trade liberalization, as more competition would have been disadvantageous for many well-connected businesses. In the end Russia joined the WTO in 2012, after almost twenty years of negotiations.

OUTCOMES OF THE REFORMS

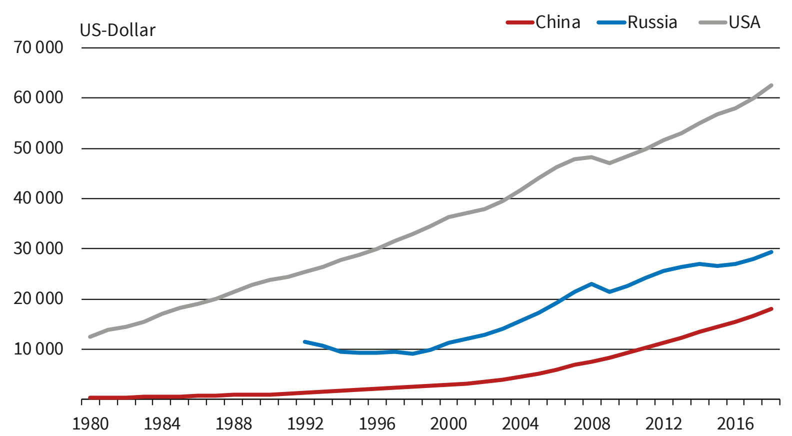
How have the different reform policies served the populations of both China and Russia? Clearly, the average Chinese person is now much more affluent than at the outset of the reforms in 1978, (Figure 2). Also, several hundreds of millions of Chinese have been lifted out of extreme poverty. In this sense, the Chinese transition can be viewed as a resounding success.

At the same time, the transitional recession in Russia was very deep, and average welfare levels declined

Figure 2

GDP per Capita

Current purchasing-power corrected US-Dollar



Source: IMF World Economic Outlook Database.

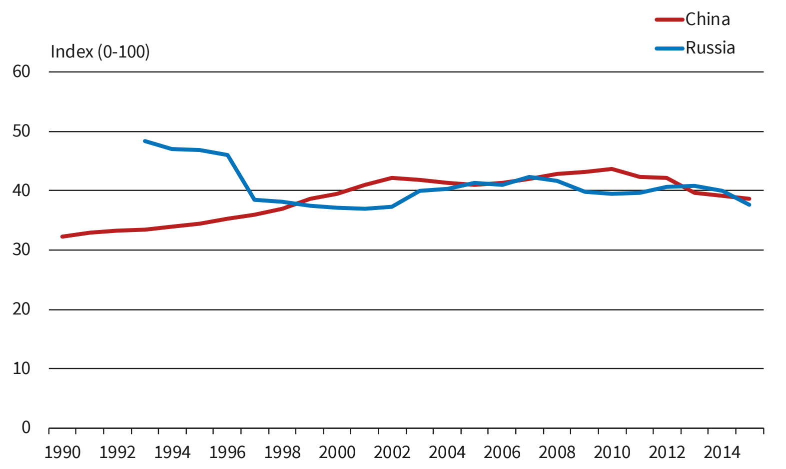
© ifo Institute

for much of the 1990s. Nevertheless, after the financial crisis of 1998 Russia's GDP started to increase, and this trend was further strengthened by rising oil prices as well as by the global economic boom in the first half of the 2000s. This was also the period when Russia's economic structure came to resemble most other countries at its income level.

At the same time as Russia's economic system started to resemble that of many other middle-income countries, its political system also became much more open, and civil liberties were broadened. This is in stark contrast with China's approach to political liberties. In Russia, citizens still enjoy unfettered access to international media, and also the local media is much more likely to pose uncomfortable questions to those in power. It should also be noted that internal migration is clearly easier in Russia than in China. So, in this aspect Russia and China have truly diverged. In the long run, this may have a larger effect also on economic outcomes.

Figure 3

Gini Coefficient



Source: World Bank. © ifo Institute

China proved to be remarkably resilient to the effects of the global financial crisis of 2008 and 2009, while Russia's GDP declined markedly with the price of oil. After the initial recovery in 2011 and 2012 Russia's growth has been quite lackluster. However, China has propped up its domestic demand by ever-higher levels of debt, which has clearly increased risks in the economy.

While it is true that in Russia, at least the vast majority of population now enjoys a higher level of material welfare than during the final years of the Soviet Union, it should be noted that China has been able to catch up with Russian income levels during the past three decades. In the mid-1990s, after Russia's transformational recession had bottomed out, China's per capita GDP (at purchasing power parity) was slightly more than 20 percent of Russian levels. In 2018, it had reached more than 60 percent. Also, Russia's catching up with e.g. the US income level seems to have stalled in recent years, while China continues to converge. It remains to be seen whether China's convergence also stalls when it reaches somewhat higher income levels.

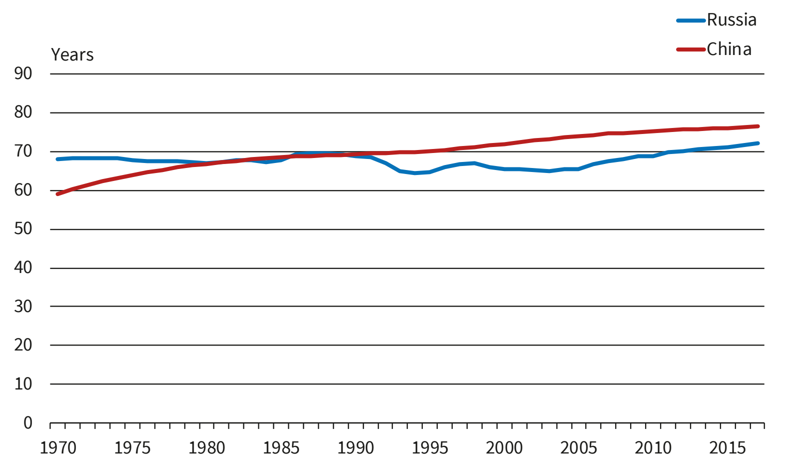
Another facet of the transition experience has been a clear increase in income inequality in both countries. In this regard both countries show a clear increase in the Gini coefficient following the start of the reforms. Especially in Russia the increase was very drastic in the early 1990s (Figure 3), but in China income inequality most probably trended upwards all through the 1980s and 1990s. After the global financial crisis, the measured income inequality seems to have declined somewhat, but both countries remain more unequal than most European OECD countries, including those that were centrally planned until the early 1990s. In both countries, income and wealth inequality also have a strong regional element. In Russia, especially the largest cities and regions with significant raw material production generally have the highest income levels. In China, southern and western provinces were generally the first ones to industrialize and integrate with the global economy, which has helped their inhabitants to achieve higher income levels. Meanwhile many provinces in the north and south have been left behind. The problem is aggravated by the fact that internal movement is still limited by the hukou system, i.e., workers are not free to move permanently to areas with the highest wages. In terms of income inequality, the two countries' different transition paths have produced quite similar outcomes.

Another facet in assessing the outcomes of the two countries' transition paths is the population's health. While there are obviously several potential indicators for this, life expectancy is often used as a summary measure for general health outcomes. In this sense, the early 1990s in Russia were a clear disaster (see Figure 4). Life expectancy declined by approximately four years in less than a decade. This was caused both by a decline in health expenditures and increase in, for example, alcohol consumption. The drop was especially steep for males. Life expectancy started to increase sustainably only in the mid-2000s, even though the economy had bottomed out already several years before. This warns us against simplistic and mechanical conclusions regarding the effects of economic conditions on health outcomes. For example, decisions to limit the availability of alcohol have certainly played a role in increasing life expectancy in Russia.

In China, the evolution of life expectancy has been very different. There has been a steady increase in life expectancy at birth throughout the past four decades,

Figure4

Life Expectancy at Birth



Source: World Bank. © ifo Institute

and in 2017 it was already over 76 years. In this sense, the Chinese model of transition has been much more successful than the Russian model. At the same time, it should be noted that many countries in Central Europe, such as Poland, were able to enact relatively radical economic reforms without a similar drop in life expectancy as in Russia.

In the end, transition paths in Russia and China were chosen under several sets of constraints. Furthermore, political constraints continue to exert influence on economic policies also today. It is clear that Russia did not have many options in 1991 as the Soviet Union and the whole state apparatus were imploding. Also, China's inability to meaningfully restructure and reform its remaining and large state-owned enterprise sector is due to political economy considerations. The Chinese Communist Party is unwilling to cede control of the strategic sectors of the economy, as they are deemed essential for the ultimate control of the society. In Russia the dominance of energy sector continues, even though the government pays lip service to the idea of diversification of the economy. Diversification away from extractive industries has proven to be difficult in many other countries as well, as so many vested interests benefit from the status quo. It remains to be seen whether sustainable economic convergence with high-income countries in either of the two countries is possible with the current set of policies.

REFERENCES

Central Intelligence Agency (1992), *Soviet Union Economy 1991*, Washington, D.C.

Dieppe, A., R. Gilhooly, J. Han, I. Korhonen, and D. Lodge (2018), *The Transition of China to Sustainable Growth – Implications for the Global Economy and the Euro Area*, European Central Bank Occasional Paper no. 206.

Fungáčová, Z. and I. Korhonen (2011), *Like China, the Chinese Banking Sector Is in a Class of Its Own*, BOFIT Discussion Paper no. 32/2011.

Gaidar, Y. (2007), *Collapse of an Empire: Lessons for Modern Russia*, *Brookings Institution Press*, Washington, D.C.

Lau, L. J., Y. Qian, and G. Roland (2000), "Reform without Losers: An Interpretation of China's Dual-Track Approach to Transition", *Journal of Political Economy* 108 (1), 120-43.

Ma, A. C., A. V. Assche, and C. Hong (2009), "Global Production Networks and the People's Republic of China's Processing Trade", *Asian Development Bank Institute Working Paper* no. 175.

Naughton, B. (2018), *The Chinese Economy: Adaptation and Growth*. The MIT Press, Cambridge, Massachusetts.

Roy, S., M. Kessler, and A. Subramanian (2016), "Glimpsing the End of Economic History? Unconditional Convergence and the Missing Middle Income Trap", *Center for Global Development Working Paper* no. 438.

Xu, C. (2011), "The Fundamental Institutions of China's Reforms and Development", *Journal of Economic Literature* 49 (4), 1076-151.