Real Live Transitions from Socialism to Capitalism: Russia
Review from Tues.

• Why the transition from Socialism to Capitalism?
  – Liberal arguments
    • Inability for socialist economies to grow and modernize
    • Inability to compete in the global economy
  – Economic Nationalist arguments
    • For Russia, elites saw that their country was becoming less powerful as it was becoming less wealthy
Economic Nationalists want Growth which leads to wealth which leads to power...

- Soviet Union: The inefficiencies of Autarky
- Soviet Growth rates fall
- Technology gaps widened and multiplied
- Soviet elites: “Yikes! We are no longer a Great Power!”
The Soviet Union under Gorbachev: tinkering with Socialism

- Perestroika
- Glasnost
- Led to.....
  - Econ. Crisis
  - Weakening of Communist party’s hold on the state
  - Declarations of independence
- Which meant the death of the Soviet Union
A complete system change is necessary (Kornai) but which path to capitalism?

OR
Russia chooses Shock Therapy....

• Large cluster of simultaneous changes needed
  – Price liberalization + privatization + elimination of subsidies for industry + anti-monopoly policies + enforcement
Russia: Shock Therapy in action

- Privatization + Price controls and subsidies are removed
- Led to inflation...Prices rose for necessities
- So govt. printed money....But that didn’t help...obligations to do everything too great
- So factories reverted to barter, didn’t pay workers
- Govt. gets IMF loan
- IMF imposes “Washington Consensus
- Ensured no turning back to Communism
- Inflation drops
- Macroeconomic stabilization
- Unemployment and inequality
- More Privatization
So market institutions were in place but they were weak.....

- Crony Capitalism
- Emergence of oligarchs
- Asset stripping
- Job losses
- Capital flight
- Bandit Capitalism
- Protest
- Longing for a return to Communism
Results....Unemployment
Privatization benefitted the Rich and Powerful....and the corrupt

• Crony Capitalism
• Emergency of oligarchs
• Asset stripping
• Capital flight
• Bandit Capitalism
• Protest
• Longing for a return to Communism
Inequality

Figure 2: Russian Growth and Inequality

Brain Drain
Repression
Russia.... A “One Trick Pony” or a new world economic Power?
China chooses Gradualism

• The Chinese got “shock therapy” out of their system
• They learned the hard way
• They chose the path of gradualism
• Ideological pragmatism
• Stiglitz believes they had the wisdom to “know what they didn’t know”
Abandoning Protectionism

- China started entering the international economy after 1978
- Foreign trade decisions were decentralized
- Special economic zones were created
- Volume of foreign trade rose
- And foreign investment flowed in......
The China Price

• Low wage “industrial reserve army”
• Joint ventures
• Technology transfer
• Competition
• Remember the “product cycle?”
Influx of Capital: FDI

China’s Reserves Outgrow China’s Trade Surplus & FDI Inflows

How could China save so much more US$ than it earned?

Annual Increase in FDI + Trade Surplus
Annual Increase in Reserves

Source: Reuters, Feb 2006
China’s growth
Equality and Inequality in China

Figure 1 – Income inequality in China

- urban to rural income ratio
- coastal to inland GDP per capita ratio
- Gini (unadjusted)
Economic growth substitutes for political reform?

• Economic reform as a substitute for political reform?
• Institutional reforms limit the power of the one-party state
• Some of the reforms were......
What did we learn from the Transition experience?

• Both Liberals and Economic Nationalists agree that....

• Growth is ultimately more important than equality.
What about the relationship between markets and democracy?

• The Lesson from Russia
  – Simultaneous introduction of markets and democracy backfired
  – Democracy was weak and illiberal
  – The weak state could not regulate the market
  – Market undermined democracy
  – It takes a strong state to introduce the market

• But why did it work in Poland?
The relationship between markets and democracy

• The Lesson from China
  – Gradual introduction of markets without democracy
  – China followed Gerschenkron: strong state led development
China: State-led development

– Moved from focus on equality to focus on growth
– Started with agriculture
– Lifted rural population out of poverty
– Mandatory planning gradually replaced by markets
– developed without inequality
Shifting World Power

The rise of New Powers and the end of American hegemony?

The world is changing rapidly

• The international order is obsolete
  – Shaped by US during the cold war
  – Institutions based on rules of capitalism and democracy

• Powerful, wealthy, often non-democratic countries with state-run economies are challengers
  – The BRICs

• But they have little power in international institutions like the IMF, World Bank, G-8

• And why should they care about the current international order?
Why should we care?

• The Liberal Would dismiss this question. Why?

• U.S. economic nationalists would be worried. Why?
The BRICs
Simultaneous “Take-offs”

- China and India: 1/3 of world’s population
- High growth rates
- Likely to keep growing
- And shifting the technological balance of power
- India will vault over Germany in our lifetimes
For the economic nationalist: Economic power means military power

• China has the world’s largest foreign exchange reserves
• Uses it for access to raw materials
• Large foreign aid programs
  – Nigeria
  – Sudan
  – Indonesia
• Can military power be far behind?
And Russia....

- Nuclear petro-state?
- Growth without development?
- Failure to modernize +
- Global Ambitions......
There are now more non-democracies than democracies in the world

• They are powerful
  – They include two nuclear powers
  – Half the global population
  – Oil producers

• Their Economic policies have not followed western liberal model
  – They pursue “state capitalism”
  – Blurring distinction between public and private
And they are changing the game

• They are already shaping world politics
  – Russia exerts influence in areas vital to U.S. security
  – India is dethroning US high tech industry
  – India and China are settling their differences and cooperating

• They are proving to be resilient in economic crisis
  – They have amassed sovereign wealth funds
  – That buffer their economies

• And they don’t have a place at the table
The G-20
Meanwhile....U.S. Hegemony is declining

- US Growth rate has fallen by \( \frac{1}{2} \) since the beginning of the century
  - Debt and deficit
  - Energy dependent
- China’s share of global product has grown by 144 percent
- India is growing at 5% per year
- Russia is flush is oil and gas revenues, paying off debts while the US sinks deeper into debt
And is being challenged in international institutions

• Old arrangements are relics
  – In IMF and World Bank, Benelux has a larger quota than China

• China challenges the “Washington Consensus”
  – Why should it be the premise for economic development
  – And a condition for loans?
Why is this happening?

Theories of Political Economy have an answer
Theories of Dynamic Markets

• The Business Cycle
• Product Cycle Theory
• Marxist Analysis
• All of “Development” Theory
• Weber’s “open source” theory
• “Creative Destruction”
Creative Destruction

- Joe Schumpeter, *Capitalism, Socialism, and Democracy*
- Creative Destruction: innovators destroy established businesses
- Source of market power
- Ensures against monopoly power
- It hurts
Creative destruction historically: Schumpeter’s “waves”
Econ. Nationalist View: Nations that produce high technology are most powerful

- Britain rose to Hegemony on the invention of the steam engine
- Germany rose to power because of its revolutionary technological contribution to heavy industry
- During its hegemonic period, the United States was the most innovative
Waltz: international political economy ruled by a hegemon is unstable

• Dominant powers expand too much
  – “Imperial decay is . . . primarily a result of the misuse of power which follows inevitably from its concentration.”

• And even if they don’t, others worry that they are too powerful
  • Their preferences might not be the preferences of others

• But isn’t America different?
  – Arthur Schlesinger thinks so.......
Solution? Bring these challengers into international institutions

• Elevate the G-20