One of the major characteristics of globalization was the geographic expansion of the capitalist international economic system to include the former communist countries of Europe and Asia. During the era of the Cold War from 1947 to 1991, which spanned both the Bretton Woods era and the age of interdependence, the Union of Soviet Socialist Republics (USSR) and its communist allies in Eastern Europe and China were isolated from the Western system. They created a separate, communist international economic system with its own institutions and rules based on centrally planned economies with state ownership of the means of production. Eastern Europe and the Soviet Union formed a closed economic bloc consisting of managed international trade complemented by technical assistance and joint planning. The bloc was dominated by the Soviet Union. China was linked to this economic bloc through trade, investment, and finance.

The end of the Cold War marked the beginning of the age of globalization and the collapse of the communist international economic system. In 1989, communist governments were replaced in Poland, Czechoslovakia, Bulgaria, and Romania; Germany was unified under a Western capitalist government; and Soviet troops withdrew from many parts of Eastern Europe. In 1991, the communist regime in the Soviet Union collapsed and the USSR itself broke apart.

The end of the Cold War brought about major changes in the Eastern economic system. Russia, the newly independent states (NIS) that formed after the breakup of the Soviet Union, and the former communist states of Central and Eastern Europe sought to make the transition from communism to capitalism and to more democratic forms of government. Central planning was replaced with greater emphasis on market mechanisms and many state enterprises were
privatized. Multiparty parliamentary systems with elected governments were established in most countries. Making a successful transition to democracy and capitalism simultaneously proved a major challenge.

Communist countries in Asia followed a different path, maintaining their communist regimes while attempting to transform themselves into market economies. The Communist Party remained dominant in China and Vietnam, but these countries implemented major changes in their domestic economies and their interaction with the world economy.

This chapter examines the communist international economic system, why it was formed, how it operated, and why it collapsed. This chapter then explores the efforts of the former communist states to make the transition from communist to capitalist economies and the efforts of both East and West to create one global international economic system.

**THE COLD WAR**

*The Creation of an Eastern Economic Bloc*

The British and American planners constructing the new international economic order between 1943 and 1947 (see Chapter 2) expected that the East would be part of the postwar system. Between World War I and World War II, the Soviet Union had been separated from the international economic system by the West’s opposition to the communist regime and by Stalin’s autarchic development policy. But the USSR continued to trade with the developed countries and Soviet imports of Western raw materials and technology made an important contribution to Soviet growth.2 The countries of Eastern Europe had been closely integrated with the West, especially Western Europe, in the interwar period, and Western European countries assumed “a substantial and ready resumption” of trade of principal goods with the East after the war.3

However, the outbreak of the Cold War led to an effort on both sides to separate the economies of East and West and to use that separation as a tool of political confrontation. The creation of a separate Eastern economic system was part of the Soviet Union’s postwar policy of dominance in Eastern Europe and of its international political strategy.4 Marxist ideology and concerns about postwar security provided the justification for Soviet control. According to Marxist theory, the formation of a separate Eastern economic bloc would deepen the crisis of world capitalism and speed its inevitable demise. Stalin stated that denying the Eastern markets to the West would decrease Western exports, create idle industrial capacity, and lead to the inevitable internal economic and political collapse of capitalism.5 The formation of a separate socialist bloc would insulate the East from the coming economic chaos in the West and enhance socialist economic development.6

The primary motivation, however, was political. A separate Eastern economic bloc, in the Soviet Union’s view, would provide a buffer zone of friendly,
that is, communist, states on its borders and would prevent Germany or other “hostile” Western powers from posing a threat of military invasion. Furthermore, the Soviet Union would obtain access on favorable terms to raw materials and capital equipment that could be used to rebuild the Soviet Union after the war and to advance its economic development.

Through wartime diplomacy, military occupation, and coups d’état, the Soviet Union established communist satellite regimes in all the states of Eastern Europe.7 The Soviet Union, in cooperation with national communist leaders, restructured the economies of Eastern Europe, introducing state ownership of the means of production, central planning, and the Soviet model of economic growth based on self-sufficiency and all-around industrialization.8 The Soviet Union also built a socialist international economic system centered on the Soviet Union, which had limited interaction with the West.

The Soviet Union refused to join the new international economic institutions created by the West and prevented eligible satellites from participating in Western institutions. Although the Soviet Union participated in the Bretton Woods conference, it refused to ratify the Bretton Woods agreements and become a member of the International Monetary Fund or the World Bank.9 Czechoslovakia and Poland, which initially joined the IMF and the World Bank, withdrew in 1950 and 1954, respectively, under strong Soviet pressure.10 Although invited, the Soviet Union refused to attend the preparatory meetings and international negotiations that led to the Havana Charter. Czechoslovakia and Poland participated in the Havana negotiations, but did not ratify the charter. No Eastern states were contracting parties of the GATT.11 The Soviet Union rejected the U.S. offer of aid under the Marshall Plan and refused to allow Poland and Czechoslovakia, the two Eastern states offered Marshall Plan aid, to accept U.S. aid and join the Organization for European Economic Cooperation (OEEC), the European organization established to coordinate European use of Marshall Plan funds.12

In 1949, in response to the Marshall Plan, Soviet Union and the states of Eastern Europe (except Yugoslavia) created the Council for Mutual Economic Assistance (CMEA or Comecon).13 This international economic organization pursued technical cooperation and joint planning, but its main function was to reorient trade eastward and to buttress the new political relationship between the Soviet Union and Eastern Europe.

Through Comecon and a series of bilateral trade agreements between the Soviet Union and the satellite countries, Eastern European trade was redirected from West to East. In 1938, 10 percent of Eastern exports went to Eastern countries, including the Soviet Union, 68 percent to Western Europe, 4 percent to the United States and Canada, and 5 percent to Latin America. By 1953, 64 percent of Eastern exports went to Eastern countries, 14 percent to Western Europe, and less than 1 percent to the United States, Canada, and Latin America.14 In the first post-war decade, trade tended to benefit the Soviet Union, which was able to negotiate extremely favorable prices for its imports and exports.15

The Soviet Union’s system of state ownership and central planning was imposed on Eastern Europe. In a centrally planned economy, decisions about
the allocation of resources—decisions about what to produce, how to produce it, and to whom to distribute it—are made by a central state planning organization. Eastern Europe’s economic plans were prepared with the assistance of Soviet economic advisers by handpicked economists trained in the Soviet Union. Because trade was controlled centrally, economic planners could use administrative decisions to shift trade from West to East. Under their plans, Eastern European states produced and exported those products desired by the Soviet Union.

Reparations imposed on the former Axis countries were an important element in the relationship between Eastern Europe and the Soviet Union. In East Germany, Hungary, Romania, and Bulgaria (former allies of Germany), the Soviet Union unilaterally dismantled factories and claimed goods from current production for the Soviet army and the Soviet economy. The Soviet Union acquired numerous German industrial enterprises operating in Hungary, Romania, and Bulgaria. These enterprises operated primarily as joint companies with the local national government. They enjoyed preferential taxes and access to foreign exchange and raw materials and often offered favorable prices to the Soviet Union. Because of their powerful and preferential position, these companies became a source of intrabloc conflict and were liquidated after 1954.

Financial ties were also redirected from West to East. Eastern European currencies were made inconvertible (on inconvertibility, see below). The nationalization of foreign investment disrupted private capital flows. The Soviet Union and most of the satellites were not eligible for IMF or World Bank assistance, and they rejected Marshall Plan aid. The principal source of external financing for Eastern Europe was credit from the Soviet Union for the purchase of raw materials and equipment from the Soviet Union.

Western Economic Warfare

Western economic warfare increased the East’s self-imposed isolation. The Cold War erupted following the establishment of communist regimes in the Soviet-occupied states of Eastern Europe, Soviet pressure on Iran and Turkey, the outbreak of civil war in Greece, and political instability in Western Europe. These events plus the East’s rejection of Marshall Plan assistance, the coup in Czechoslovakia, and the Berlin blockade of 1948 confirmed the U.S. view that the Soviet Union was a political and military threat to the West.

In addition to building a united and prosperous Western economy and creating a powerful Western military alliance, the aim of United States and Western policy was to deny the Soviet Union and its allies economic resources that would enhance their military capability and political power. The Western strategic embargo began in full force with the passage of the U.S. Export Control Act of 1949. This act, which remained in force for 20 years, authorized the president to “prohibit or curtail” all commercial exports and to establish a licensing system to regulate exports to communist countries. Any product that had military applicability or that would contribute to the military or economic potential of a communist state was placed on the restricted list.
The United States sought, with mixed success, to persuade other Western states to impose similar embargoes. In 1949 under U.S. pressure, the **Coordinating Committee (CoCom)** was set up to discuss and coordinate Western strategic embargo lists. Although it had no binding authority, CoCom succeeded in drawing up an international list of restricted items for its 15 members.\(^{22}\) However, the difference in views between the United States and its allies over the goals and content of the economic embargo became a source of tension throughout the postwar era. For the United States, the strategic embargo was intended to impair not only the East’s military strength but also its political and economic power. The U.S. embargo therefore was directed not only at military goods but also at nonmilitary goods that would enhance economic performance and development. The Europeans and Japanese, who had a greater economic stake in trade with the East than the United States did, felt that a broad embargo would encourage greater Eastern solidarity without hindering military and political capability. Thus, they advocated a more limited definition of strategic goods—namely, those with direct military implications.\(^{23}\) As a result of allied resistance, the international list was less comprehensive than the U.S. control list.

Another form of economic warfare was to deny the East access to Western markets. In 1951 at the height of tensions in Korea, the U.S. Congress passed the Trade Agreements Extension Act, which withdrew all trade concessions negotiated with the Soviet Union and any communist country (except Yugoslavia). As a result, products from Eastern countries remained subject to the onerous Smoot–Hawley tariffs. Many European states also adopted restrictions on imports from communist countries.\(^{24}\) Finally, the United States also used legislation to prohibit private persons or institutions from extending credit to the Soviet Union and most Eastern European governments.\(^{25}\) Other North Atlantic Treaty Organization (NATO) countries did not restrict Eastern access to credit, and an effort by the United States to impose restrictions through international agreement failed.\(^{26}\)

Thus the East and the West established separate international economic systems with separate institutions, rules, and patterns of interaction, mainly for political reasons. At the height of economic separation during the Korean War, East-West trade was actually lower in absolute terms than it had been in 1937.\(^{27}\) The policy of economic warfare continued throughout the Cold War.

Throughout the Cold War era, economic relations between East and West ebbed and flowed with political and military relations. When tensions eased, the United States and its allies sought to use promises of increased trade or investment flows in exchange for changes in the behavior of the Soviet Union and the rest of the Eastern bloc. When tensions increased, the West imposed new sanctions. Thus, following the end of the Korean conflict and the death of Stalin in 1953, the East-West political-security conflict relaxed somewhat and Western countries eased some trade restrictions. The West’s control list was shortened; Western Europe, Canada, and Japan negotiated most-favored-nation agreements with Eastern Europe and the Soviet Union and reduced trade restrictions; and East-West trade increased.\(^{28}\)
In the mid-1960s, the Johnson administration tried to expand East-West trade in order to encourage greater pluralism in Eastern Europe and greater stability in relations between the United States and the Soviet Union. Congress, however, refused to pass legislation permitting trade agreements with communist countries because of concern about Soviet involvement in the war in Vietnam. After the Soviet invasion of Czechoslovakia in 1968, President Johnson abandoned the policy.

During the period of U.S.-Soviet détente—the lessening of tensions—in the 1970s there were efforts for change in both East and West. By the early 1970s, the Soviet Union had achieved effective equality with the United States in strategic weapons. Nuclear parity enabled Soviet leaders to view the West with more confidence, to modify the fear of military invasion, and to entertain the idea of limiting expenditures on strategic weapons. The combination of Soviet nuclear parity and greater Soviet flexibility in foreign policy led the United States and its Western allies to look more favorably on easing conflict with the Soviet Union. The interest of the West in opening economic relations with the communist countries varied. Western Europeans, for both economic and political reasons, were more anxious to trade with the Soviet Union and its allies than the United States was. Japan was constrained by ongoing political disputes over the Soviet occupation of several Japanese islands. U.S. policymakers were caught between their desire to expand trade for economic and political reasons and their feeling that Western trade concessions should be linked to Eastern political concessions or to an easing in political and security relations.

In 1972, at the same time as the signing of the SALT I agreement, President Nixon and Chairman Brezhnev established a high-level, joint commercial commission that then negotiated a series of agreements designed to normalize U.S.-Soviet commercial relations and to open the way for increased trade and financial flows. Congress, however, sought to use expanded trade and access to financing as a lever to force the Soviet Union to change its internal policies on emigration. The Soviet Union refused to give any assurances regarding emigration and charged the United States with interfering in its internal affairs. In January 1975 the United States and the Soviet Union agreed to nullify the 1972 commercial agreement.

The Carter administration policy followed a similar pattern, urging Congress to repeal trade restrictions on trade and credits. The Soviet Union’s invasion of Afghanistan in 1979 ended the Carter effort to expand economic relations and terminated the 1970s era of détente. President Carter saw the invasion of Afghanistan as an indication of growing Soviet expansionism and particularly of Soviet designs on the nearby Persian Gulf oil fields. He withdrew the SALT II arms control treaty from consideration by the Senate and, in January 1980, announced new economic sanctions against the Soviet Union: an embargo on sales of wheat and other grains; an embargo on sales of high-technology goods; tightened restrictions on the sale of oil and gas exploration and production equipment; the suspension of service by the Soviet purchasing commission office in New York; and a more restrictive regime of access to U.S. ports for Soviet ships.

President Reagan adopted an even harder line with the Soviet Union, increasing military expenditures, downplaying arms control negotiations, and
providing military support to anticommunist forces such as the Contras in Nicaragua. The Reagan administration pursued a policy of economically isolating the Soviet Union. The administration maintained embargoes on the export of oil and gas exploration equipment and high-technology goods to the Soviet Union, tightened the enforcement of export controls generally, and favored more stringent export control legislation. The administration adopted a broad definition of the strategic goods that were to be denied to the Soviet Union, including not only defense or defense-related equipment but also many items that had either a limited or indirect impact on the East’s military capability. The Reagan administration also tried to use CoCom and NATO to impose this view of strategic exports on the West European allies. One such effort involved an unsuccessful U.S. attempt to stop its Western European allies from helping to build a pipeline from Siberian gas fields to customers in Western Europe.

THE COLLAPSE OF THE COMMUNIST SYSTEM

Forces of Change in the East

While the state of political-security relations was central to Western policy toward the East, internal economic problems were the major motivation of the communist countries for opening economic relations with the West. Serious economic difficulties in agriculture and the industrial sector emerged in the 1960s and reached near-crisis proportions by the 1980s, particularly in the Soviet Union.

Low agricultural productivity, a longstanding problem, had several causes: collectivization that gravely injured the peasantry; excessive interference in local farm management by the large and unwieldy Soviet agricultural bureaucracy; inadequate infrastructure in many areas ranging from roads to storage facilities; a lack of incentives given the weak links between effort and reward; and poor inputs from the industrial sector. Periodic efforts to improve agricultural productivity had been undermined by the Soviet agricultural bureaucrats for whom any change in the prevailing system was a threat to their power. Despite significant capital investment in the years after 1960, productivity of the Soviet agricultural sector in the 1980s stood at 20 to 25 percent of U.S. productivity according to Soviet statistics and at 10 percent of U.S. productivity according to Western measures. In the 1960s, the Soviet Union, once a food exporter, became a net importer of food especially grain from the West (see Figure 10.1).

Industrial growth was another problem for the Eastern system. In the 1950s and 1960s, the Soviet Union and Eastern Europe achieved high rates of industrial growth by a significant expansion in the labor force—the employment of women, the transfer of labor from agriculture to industry, and long working hours—and by the rapid increase in capital formation at the expense of agriculture and of improvement in the standard of living. By 1960, however, this type of expansion, known as extensive growth, had reached its limits. Economic growth in the Soviet Union and Eastern Europe communist bloc
fall and, at the end of the 1980s, the Soviet economy actually began to contract (see Figures 10.2, 10.3, and 10.4).

Growth slowed for a number of reasons. The Eastern states needed to shift to **intensive growth**, which is achieved by improving productivity. Intensive growth relies primarily on the application of technology: advanced machinery and production processes, modern computer and communications technology,
sophisticated management techniques, and energy. The Eastern system encountered severe difficulties in improving productivity, largely because of the central planning system that discouraged innovation, productivity improvements, and quality. Rewards for plant managers were based on fulfillment or overfulfillment of quantitative goals and not on improving the quality of the product or the production process. Indeed, there were disincentives to experiment with new methods because experiments threatened to interrupt production at least temporarily and thus to jeopardize fulfillment of the quantitative goals. Furthermore,
the absence of competition and the existence of guaranteed markets eliminated incentives for managers to cut costs or improve quality. Above all, prices did not provide a guide to help managers determine what goods consumers wanted and how to improve productivity by lowering costs.\textsuperscript{38}

Despite great emphasis on scientific research, there was little relationship between research and actual production. Unlike the West, where most industrial research is carried out by private enterprise, research in the East was generally carried on in research institutes that had few links with production facilities. Scientists and engineers were thus not positioned to respond directly to the needs of industry or to make industry responsive to scientific development.\textsuperscript{39} As a result of these systemic biases, the East fell far behind the West in the development of technology.

In the 1960s and 1970s, the Eastern countries tried to solve the problem of technology and productivity through limited national economic reforms, intra-Comecon trade, and greater trade with the West. In the mid-1960s, managers were given greater freedom to decide what to produce and how, incentives were based on profit as well as quantitative goals, and prices were made more “rational.” But the reforms did not go far enough. The reforms were strongly opposed by party conservatives and government bureaucrats who saw their power threatened by the potential new power of the plant managers and who eventually reasserted centralized control.\textsuperscript{40} Thus the Eastern economies continued to stagnate.\textsuperscript{41}

The East also attempted to solve the problem of growth through Comecon. An effort began in the late 1950s to revitalize Comecon and change it from a tool of Soviet dominance to a tool of development. Attempts were made to increase trade within the bloc, as Eastern leaders hoped that trade would lead to economies of scale, force competitiveness, and thus encourage modernization. An agreement on methods for establishing trade prices, a clearing institution (the International Bank for Economic Cooperation), and programs for national specialization in production were designed to encourage trade. Technological cooperation was also promoted.\textsuperscript{42} However, Comecon trade remained hampered by internal biases against multilateral trade, lack of complementarity with the Eastern economies, the poor quality of goods, unsatisfactory currency arrangements, and political unwillingness to delegate power to a supranational body—especially one in which the Soviet Union had a powerful voice. Trade within Comecon remained largely bilateral trade between the Soviet Union and Eastern European countries rather than multilateral integration among all Comecon nations.\textsuperscript{43}

Finally, the East sought to bridge the technology gap by acquiring foreign technology. Industrial cooperation agreements between Western firms and Eastern European enterprises became increasingly important in the early 1970s. For the East, they were intended to provide access to Western technology, improve competitiveness in the West, and reduce foreign exchange needs. The West sought greater access to Eastern markets and the opportunity to reduce costs. West Germany, which was by far the most active in seeking such agreements, entered into more than 200 agreements with Comecon nations in the 1970s.\textsuperscript{44}

Western technology, however, had little impact on Soviet and Eastern European productivity and growth. Despite the easing of CoCom controls, the
West was not willing to sell sophisticated technologies such as computer and telecommunications technologies that could contribute to the East’s military strength. Financial constraints hampered the East’s ability to purchase Western technology. Most important, foreign technology imports had little impact as long as there was no reform in the domestic economic system that would permit their effective use.

By the 1980s, the Eastern economic system was in need of drastic economic reform. Growth rates declined steadily, and investment and productivity remained low. From 1981 to 1985, growth in the Soviet Union averaged only 1.8 percent and total factor productivity declined to 0.9 percent compared with 1.9 percent from 1975 to 1980. Soviet agricultural problems were so great that some products were rationed and lines for goods became long in major Soviet cities. Between 1983 and 1985 the growth rate of agricultural production per capita actually fell 2 percent. Shortages of all consumer products caused public dissatisfaction, creating a potential political challenge to the regime. At the same time, the Soviet Union faced a number of political reversals. The war in Afghanistan had become a costly economic drain that was unpopular at home and damaged Soviet relations abroad. Eastern Europe was also restless. In Poland, for example, labor unrest arising in part from economic problems challenged the legitimacy of the communist regime in that important Soviet ally.

Gorbachev’s Economic and Political Reforms

In March 1985, Mikhail Gorbachev became General Secretary of the Communist Party and began a program to address these economic, political, and foreign policy problems. Gorbachev argued that the possibility of nuclear holocaust and the nature of contemporary world problems such as the environment made the world interdependent and called for a more cooperative foreign policy. Gorbachev adopted several key foreign policy initiatives: a defensive military strategy; an agreement with the United States on intermediate-range nuclear weapons and negotiations on strategic and short-range nuclear weapons; a unilateral reduction of conventional forces in Europe; greater autonomy in Eastern Europe and withdrawal of Soviet troops from Afghanistan; and improved relations with the People’s Republic of China.

These foreign policy initiatives not only eased political and military confrontations but also enabled the Soviet Union to focus more attention and resources on domestic economic reform. Under his domestic political policy known as glasnost, or openness, Gorbachev improved the Soviet government’s human rights policy allowing greater emigration, more freedom in public discussion and the arts, and greater democratization of the political process. In 1989, for example, he implemented a reform of the political system, creating a presidency and more open elections. Political reform was also designed to facilitate economic reform, in particular, by providing a popular check on the powerful, conservative bureaucracy.

In the economic arena, Gorbachev announced a policy known as perestroika, or restructuring of the Soviet economy. According to Gorbachev’s plan for the
industrial sector, decision making—with a number of exceptions—was to be decentralized from central planners to individual firms. Under the Law on State Enterprise adopted in June 1987, the central planning system was to be phased out by 1991 and replaced by annual plans drafted by individual firms. Central planners would develop voluntary guidelines for individual enterprises, establish long-term economic objectives, issue state orders for products of critical importance to the economy and national defense, and negotiate with firms to obtain those products. Instead of responding to obligatory targets set by central planners, firms would pursue revenue and profit. Individual enterprises would be responsible for production, sales, and investment. They would have more freedom to hire and fire workers and to set wages. Under the new law, they would also face the possibility of bankruptcy.

New markets responsive to these more autonomous enterprises were to be developed. Decisions on capital flows once made by state planners were to be made instead by newly liberalized financial markets. The existing system of centralized supply would be replaced by a wholesale distribution system that was to be responsive to the decisions of individual enterprises.

Reform of the agricultural system was also on the agenda. Gorbachev’s “new agrarian policy” in 1989 called for decentralization and a greater role for the private sector. The state bureaucracy was to be dismantled; decision making would be delegated to regional and local levels; agricultural enterprises, like industrial enterprises, were to pursue profits and to be self-financing; prices were to become more flexible; there was to be greater scope for private farming through lifetime leases of farms with the possibility of passing leases on to children.

Perestroika also had an international dimension. Part of Gorbachev’s plan, albeit a minor one, was to improve trade and financial interaction with the West in order to speed the restructuring process. In 1986, the Soviet Union announced a plan to decentralize the trade system and end the monopoly of the Ministry of Foreign Trade over trade transactions. A number of ministries, authorities, and enterprises were authorized to conduct foreign trade directly through foreign trade organizations under their control. In 1986, the Soviet Union also requested observer status in the GATT, arguing that domestic economic reforms would remove impediments to its participation in a market-oriented organization. The Western countries, fearful that Soviet involvement would politicize the GATT, suspicious of Soviet motives, and wanting to see if reform really did move the Soviet Union toward a market-oriented economy, denied the request.

The Soviet government also pursued economic cooperation with Western firms in order to promote exports and to obtain Western technology. In a major departure from previous policy, the government issued new guidelines that allowed foreign equity and management participation in joint ventures. Some Western firms responded. Western Europeans were quicker to initiate joint ventures than U.S. and Japanese firms. To finance new ventures, the Soviet Union increased its borrowing from Western financial institutions (see below on Eastern borrowing from the West). Finally, Soviet policymakers considered various schemes for making the ruble convertible, including the possibility of introducing
a convertible or “hard” ruble for international transactions that could be backed by gold, foreign exchange, or exports (see below on ruble inconvertibility).\textsuperscript{52}

Gorbachev’s foreign policy initiatives led to a thaw in East-West political-security relations. U.S.-Soviet summits were revived. Arms control talks led to agreements on medium-range nuclear weapons in Europe and conventional forces in Europe. Some U.S. officials came to believe that trade and finance could be used to support Gorbachev and his allies who favored the new thinking in foreign policy, \textit{glasnost} and \textit{perestroika}.\textsuperscript{53} U.S. allies in Western Europe, less fearful of Gorbachev’s Soviet Union and as usual interested in greater trade, urged a more moderate policy on the United States and specifically pressed for an easing of CoCom controls. Finally, the need to reduce the huge U.S. budget deficit led to pressure for reducing military expenditures, which could be justified in a more friendly East-West environment.

The Reagan administration’s steps on the economic front were cautious: reestablishment of the U.S.-USSR Joint Commercial Commission at the ministerial level to discuss improving economic relations and encouragement of “commercially viable joint ventures complying with the laws and regulations of both countries.”\textsuperscript{54} After the Soviet withdrawal from Afghanistan, the Bush administration eased export controls somewhat. Following the political revolution in Eastern Europe in the fall of 1989, U.S. policy shifted toward using trade and investment to promote change in the East. President Bush called for opening markets to the Soviet Union and endorsed observer status for the USSR in the GATT after the completion of the Uruguay Round.

Western European countries moved further and faster than the United States to increase economic flows with the East. For all the economic and political reasons discussed above, many countries of Western Europe were more interested than the United States in economic and political rapprochement with the East. Furthermore, Gorbachev deliberately courted Western Europe, publicly advocating the concept of a “common European home.”\textsuperscript{55}

As the leading trade partner of the Soviet Union and Eastern Europe and in continuing pursuit of its \textit{Ostpolitik}, West Germany took a strong interest in increasing economic relations with the East, especially since it wanted to keep alive the possibility of reuniting with East Germany. West Germany responded positively to the interest of the East in increased political ties with the European Union; and German firms, with the support of their government, aggressively pursued trade and joint-venture opportunities and signed numerous trade and joint-venture agreements with the East.

\textbf{The Failure of \textit{Perestroika}}

The policies actually implemented by the Gorbachev government differed from the plans announced in 1987. Decision-making power was transferred from the economics ministries of the government to the managers of individual enterprises, and the ministries lost their power to appoint managers of enterprises. However, many prices were still controlled centrally, and the ministries were theoretically still in control of allocating inputs to enterprises. In addition, the
ministries still controlled the research institutes, other vital sources of economic and business information, and international trade (via their power to grant export licenses). Some prices were freed selectively so that there would be room for profit-making ventures on the part of the managers, but this was done purely at the discretion of the bureaucracy.

The result was an economic crisis. The ministries could not guarantee the allocation of inputs because they could no longer insist upon fulfillment of production quotas. The managers therefore turned to a self-help system combining personal connections, barter, and bribery to obtain the necessary inputs to keep their enterprises going. The outcome was a major decline in production and general failure of the system. Real GNP declined by 4 percent in 1990 and 13 percent in 1991 (see again Figure 10.3). Since privatization efforts were still quite modest at this point, price increases for consumer goods led not to increased productive capacity but rather to inflationary pressures, massive shortages, supply bottlenecks, and higher monopoly rents for state enterprises.

Senior economic bureaucrats in the Soviet government responded to this crisis by insisting on rapid privatization of state enterprises. These ministers preferred continued state ownership, but under perestroika, privatization was the only way to retain control over their own sources of revenues, which depended mainly on the cash flows generated by the firms. The privatization the economic ministers advocated involved extensive cross-holdings of shares in firms that were already linked by vertical ties—firms that were “upstream” and “downstream” from the major producers in any given industry—in order to maintain the intra-industry relationships that had existed under the pre-perestroika system. In addition, the ministers favored transfer of ownership to the existing managers of firms rather than the sale of assets on the open market. Such an approach would enable them to preserve their own power and privileges in the new system.

In 1988, workers were given the right to strike, a right denied since the time of Stalin. As a result, wages rapidly increased. Workers in some state enterprises were also given some control over management, resulting in a low incidence of layoffs, even in severely overmanned firms. The more productive workers had to be bribed to stay on the job so as not to go to work for the “cooperatives” that sprang up everywhere between 1988 and 1991. The cooperatives were thinly disguised private operations that lived off the supposedly “redundant” but actually quite valuable assets purchased on very favorable terms from the state enterprises. Managers of the state enterprises pursued profit-making opportunities in the cooperatives rather than in their own firms, because the cooperatives were not as heavily burdened with obsolete production equipment and unproductive workers as the state enterprises.

The collapse of the central government’s control over its own revenues and its power to allocate resources made the future of state enterprises look bleak indeed. Thus, increasingly, the ministries, the managers, the more productive workers in state enterprises, and many local government officials supported a form of privatization called spontaneous privatization, which amounted to the expropriation of state-owned assets for the private benefit of those individuals.

There was renewed debate about economic reforms in 1990, with a number of new proposals for speeding up the privatization process and further liberalizing
the economy. However, Gorbachev, worried about opposition to quickening the pace of reform from conservative forces in the Communist Party, opposed further reforms at this time.\textsuperscript{57} That he was right to worry became evident in August 1991 when those forces attempted a coup d’état. When the coup failed, the conservatives were neutralized politically and pro-reform elements of the newly elected Russian government of Boris Yeltsin were able to dominate the scene. Gorbachev was forced to resign after his halfhearted attempts to salvage the leading role of the Communist Party failed, the Russian government replaced the Soviet government in Moscow, and the Soviet Union fell apart.

**FROM COMMUNISM TO CAPITALISM**

**Problems of Transition from Communism**

The transition from Communism had both political and economic dimensions. The political dimension generally involved the creation of a multiparty electoral system, the dismantling of authoritarian institutions like the secret police, and the institutionalization of the political rights and freedoms that go along with a more democratic political system. The economic dimension involved the replacement of central planning with a market system. Economic changes usually included the elimination of price controls, the privatization of state enterprises, and the creation of new economic instruments and institutions that allowed the government to extract resources from and stabilize the private economy.

The timing of these measures was critical. If one allowed prices to be determined by market forces without rapidly privatizing state enterprises, then the state enterprises, which were usually monopoly suppliers, could simply charge higher prices without increasing production. If one freed controlled prices and privatized state enterprises without creating the appropriate state and market institutions to prevent irresponsible or criminal behavior by market actors, then the country could end up with a system unable to rein in corruption. If the government failed to create market-stabilizing mechanisms, then the country might suffer from excessive inflation, rapid currency devaluations, low rates of private investment, and high rates of unemployment for prolonged periods of time.

The government of an economy in transition takes on a variety of new roles, many of them unfamiliar. It must police the marketplace to prevent gross malfeasance. The government must guarantee the property rights of private firms and individuals and adjudicate economic disputes among them. It has to ensure transparency of prices for both producers and consumers so that they can respond correctly to market signals. The central bank must concern itself with monitoring and controlling the rate of growth of the money supply in order to prevent excessive inflation. Finally, the government has to adopt and promulgate new accounting procedures so that it can collect taxes from private businesses to replace the revenues previously obtained from state enterprises.

It cannot be assumed that government officials will have the knowledge or the will to do all of the above in a timely and effective manner. Officials are sure
to meet resistance from a variety of public and private actors. Some countries will have more difficulty than others in achieving the efficiency gains that are connected with the end of central planning because of differences in their resource endowments, accumulated investments in human and physical capital, and abilities to make the required institutional changes. Therefore, the speed and consequences of economic transition will vary significantly from country to country.

In Russia and Eastern Europe, the transition to capitalism occurred at the same time as the form of government was changing. The general desire to cast off communism resulted in both political and economic reforms. Political reforms were mainly in the direction of establishing genuine representative democracies. One key question was whether to permit former communists and communist parties to participate in electoral politics. Another was how much power to grant the head of state, the legislature, and the judiciary. An area where the political and the economic overlapped was the question of how best to structure the government so that it could effectively regulate the market. A related question was whether to allow the central bank to be autonomous from political forces so that it could focus on maintaining stability in the growth of the money supply, which was necessary for stemming inflation and maintaining the value of the national currency.

**Yeltsin: Crisis and Reform**

Boris Yeltsin faced three major domestic economic challenges when he came to power in 1991. The first task was to stabilize the Russian economy in the face of hyperinflation. The drop in government revenues, but not in government spending, led to a major budget deficit in 1991 equivalent to 20 percent of GDP. The annual inflation rate for 1992 was almost 1,500 percent (see Figure 10.5).58

The Russian central bank dealt with the deficit in the worst possible manner from the standpoint of limiting inflation: it simply issued more currency. The governor of the central bank, appointed by the Parliament not the president, issued vast amounts of cheap credits to the state enterprises.59 As a result, the money supply increased by more than 700 percent in 1992. Confidence in the ruble plummeted, and many Russian enterprises insisted on payment in hard currencies instead of rubles, even for domestic transactions. Not until the late spring of 1993 did the Ministry of Finance agreed to limit state subsidies in order to reduce the budget deficit and the inflationary pressures it was causing. The rate of inflation remained between 15 and 20 percent per month through the end of 1994, finally dropping to less than 5 percent per month starting in mid-1995. During the financial crisis of 1998 (see below), the annual inflation rate soared upward again to 84.5 percent. By 1999, however, inflation was reduced to 36.7 percent. By 2000, it had declined to 20 percent.60

The second challenge was to restart the process of creating a market economy, a process that had been aborted under Gorbachev. Yeltsin first sought to privatize state enterprises through mandatory commercialization. Under commercialization, the state enterprises were to be converted into joint stock companies with shares that were to be publicly traded on stock exchanges, with boards of directors
representing the interests of shareholders. This approach, already tried in Poland, was designed to speed the process of privatization and reduce incentives for corruption.

Under the new privatization scheme, all the state enterprises were divided into three main categories according to their locus of control: federal, provincial (oblast), or municipal. The governmental responsibility for privatization was then divided according to this scheme. This approach gave the provincial and local governments—which had previously opposed privatization on the principle that it would lead to shutting down of factories in their locality—a stake in privatization. It also made it more difficult for the coalitions of managers, workers, and local governments discussed above to appropriate government assets.

Russia launched its privatization program in 1992. Tens of thousands of small- and medium-sized enterprises under the control of local authorities were sold through auctions and tender offers. The mass privatization program, directed at medium- and large-scale enterprises, utilized employee buyouts and voucher auctions to transfer ownership. Enterprises selected one of three privatization options, all of which gave enterprise insiders—workers and management—an opportunity to hold a majority of enterprise shares. To achieve fairness, the government distributed privatization vouchers free to every Russian to enable them to acquire shares in enterprises through voucher auctions. Remaining blocks of shares were reserved for the government. While some Russians traded their vouchers for cash or participated in the auctions, many more sold their vouchers to investment funds. During the first year of the program, however, investment funds were limited legally to acquiring no more that 10 percent ownership in any single enterprise.
Voucher privatization was successful in a large number of state enterprises and created a new class of property owners with a stake in the reform process. Between 1992 and mid-1994 when voucher privatization was completed, over 15,000 medium- and large-scale enterprises employing 80 percent of Russia’s industrial workforce were privatized. Over 75 percent of small enterprises were privatized by June 1994. The transfer of ownership, however, did not result in enterprise restructuring. Indeed, the prevalence of insider ownership, lack of capital, and continuing responsibility to provide social services for employees obstructed enterprise reform.

In July 1994, President Yeltsin initiated a second phase of privatization based on sale of enterprise shares for cash. The objective was to complete the privatization of larger state-owned enterprises, raise funds for federal and local government budgets, and generate investment funds for privatized firms. The government also hoped to attract investors, including foreigners, who would intensify enterprise restructuring. The program entailed sales of government-owned shares of already privatized companies as well as blocks of shares in enterprises not yet privatized. While cash privatization proceeded relatively well at the municipal and regional levels, the federal program suffered from delays due to policy struggles and the ruble crash of October 1994, which shook confidence and diverted the attention of policy makers. Ultimately, only 136 firms were put up for sale under the program, and bidding was sluggish. The Government had expected to raise some $2 billion in revenues for the budget; in the end, less than $1 billion was raised.

In September 1995, the government announced a new loans-for-shares program in an effort to raise substantial sums from the sale of shares of more than 20 of Russia’s crown jewel companies. These included the oil, metals, timber, and shipping companies. Under the program, the government would auction share-backed securities to Russian banks and other institutions. In return for these loans, the banks were to receive an immediate voice in management and a commitment to receive equity shares of the companies three years down the road when the value of the shares was expected to have increased dramatically. The program was widely criticized as nontransparent and dominated by insider deals, and was terminated after the initial transactions.

Yeltsin’s third domestic challenge was countering political resistance to economic reform. As privatization and efforts at macroeconomic stabilization proceeded, resistance to reform mounted, especially from the Duma (Parliament) that had been elected under the prior regime and was dominated by the communists. In an effort to offset continued Duma opposition to his program, Yeltsin called for a referendum on economic reform in April 1993. With 64 percent of the electorate voting, 59 percent expressed confidence in the leadership of Boris Yeltsin and 53 percent approved of the policies pursued by the government after 1992.

In October 1993, Yeltsin faced his most serious political challenge by breaking the resistance of a group of dissident members of the Russian Parliament in a quickly suppressed but bloody rebellion. The Parliament had voted to impeach Yeltsin, and he retaliated by dissolving Parliament and calling for new elections. The opposition occupied the Parliament building (the Russian “White House”).
The Russian Army backed Yeltsin against the rebels in the fighting that ensued, sending a volley of cannon fire into the Parliament building and capturing the opposition leaders.

Parliamentary elections held in December 1993 resulted in a major defeat for the reformist political party. A rapid drop in industrial production in 1992 and 1993—together with continued high inflation rates—had made economic reform very unpopular, despite progress made toward reducing hyperinflation. The liberal reformers suffered further losses in the parliamentary elections of December 1995.

Yeltsin himself had to mass a major campaign in 1996 to win a second term as Russia’s president. He decided to stand for reelection as President, despite severe health problems, the growing unpopularity of the military intervention in Chechnya, growing unrest over the failure of the Russian government to pay salaries of workers in state enterprises, and complaints about the erosion of pension benefits caused by high inflation. During the election campaign, Yeltsin promised to seek compensation for those who lost their savings due to high rates of inflation and to continue efforts to reduce inflation. He also called on the Russian legislature to pass a bill to allow the buying and selling of land and promised other agricultural reforms. Yeltsin won the July election with 53.7 percent of the vote. His closest rival, Gennady Zyuganov, a former communist, received only 40.4 percent of the vote.

**Russian Foreign Economic Policies under Yeltsin and the West’s Response**

Pursuing an aggressive foreign economic policy of integration with the Western international economy was, of necessity, part of managing the severe domestic crises that the Yeltsin government faced at the end of 1991. The ruble was not yet fully convertible and remained the main currency of most of the countries that had split off from the Soviet Union. The former Soviet republics competed with Russia to issue rubles, making the problem of reducing inflationary pressures more difficult to solve. To address this problem, in 1993 the Central Bank of Russia moved to issue a new Russian ruble to replace the Soviet ruble, asserted its right to have a monopoly over controlling the supply of rubles, and established a foreign-currency auction system making the ruble convertible inside Russia. Then, in 1994, the Central Bank of Russia severed its connections with the central banks of former Soviet republics. Although the rapid decline in the value of the ruble after 1991 contributed to inflation by raising the prices of imports, it also made Russian exports more competitive internationally. The various efforts to stabilize the Russian economy after 1992, especially efforts to reduce the budget deficit and control inflation, eventually helped to reduce the downward pressures on the ruble.

Russia also continued to face difficulties servicing its heavy burden of foreign debt. The Russian government assumed the debt of the Soviet Union in 1993, which at the time amounted to around $105 billion. Faced with economic crisis and the huge challenge of a transition to a market economy, Yeltsin turned for help to the West and to major international economic bodies like the G-7, the World Bank, and the IMF.
In May 1990, the developed countries set up a new multilateral bank, the European Bank for Reconstruction and Development (EBRD), to channel aid into Russia, the other former Soviet Republics, and Eastern Europe.70 Both aid and FDI flows to Russia were constrained, however, by worries about the commitment of the Russian government to economic reforms. In a historic development, the G-7 leaders invited President Yeltsin to the London economic summit of the G-7 in the summer of 1991. At that meeting, President Yeltsin requested increased economic assistance and political support for Russian membership in the IMF and World Bank.

Pleased by Yeltsin’s economic policies, including his efforts to privatize Russian state enterprises, the G-7 countries strongly supported Russian membership in the IMF and World Bank. Because they remained concerned about Yeltsin’s commitment to sustained reform, however, they held back on making major new commitments for economic aid. Most of the aid to Russia at this time came from Germany, as part of German payments to speed the removal of Russian troops from the former East Germany. The G-7 took a major step toward supporting economic reform in Russia in 1993, just prior to the referendum on reform called by President Yeltsin. The G-7 assistance package included approximately $34 billion in new financial flows: $13 billion in loans from the IMF, $1.5 billion in loans from the World Bank, a new G-7 Privatization Fund, an additional $10 billion in export credits from G-7 countries, and $6.5 billion in U.S. aid (which included aid to other former Soviet Republics). About $2.5 billion in loans were made available immediately.71 The new flows, plus the IMF and World Bank conditions requiring stabilization and privatization, proved to be a major economic and political boost to Russia’s reform program.

Following the 1993 program, the IMF and World Bank engaged in intensive and regular dialogue with Russia on its macroeconomic policy and structural reform program. Support and pressure from these two institutions contributed to the stabilization and reform efforts described above. In 1996, for example, the Fund and Russia concluded a new lending arrangement of $10 billion to support stabilization, which was monitored and disbursed on a monthly basis. At the same time, the developed countries supported Russian reform in other ways: ending CoCom controls on trade with Russia and the former Communist countries, beginning negotiations for Russian membership in the WTO, and rescheduling Russian debt. As a symbol of growing Russian integration into the institutions of the West, Russia became a regular participant in the discussion of political, though not economic, issues at the G-7 summits.

The Crisis of 1998

The budget deficit problem continued to plague the Russian government. Although the government stopped financing government deficits by printing money, and sought to increase revenues and reduce spending, the budget deficit remained very large. After 1992, tax revenues had declined dramatically due primarily to tax evasion in the form of officially sanctioned “tax arrears.” Economically marginal business enterprises in Russia were allowed to stay in business by not paying their taxes (they also did not pay their workers or the workers’ pensions).72
Part of the government deficit was caused by the continued need to make payments on the debt accumulated by the former Soviet Union. Between 1993 and 1996, four rescheduling agreements were signed with the Paris Club. The fourth of these, concluded in April 1996, allowed $38.5 billion of Russian debt to be repaid over 25 years with a grace period of six years. The debt owed to the 600 London Club banks was rescheduled in October 1997, greatly reducing the overall debt servicing burden. Russia became a member of the Paris Club in 1997 and, as a result, became eligible for repayment of debts to the former Soviet Union amounting to over $85 billion. Nevertheless, Russia was still unable to meet its obligations.

The Russian government tried to solve the deficit problem by attracting foreign investors. Starting in 1993, the government issued short-term bonds called GKO74 denominated in dollars and deutsche marks at high interest rates. The revenues from sales of these bonds were used to finance the deficit. By mid-1998, the value of outstanding GKO's totaled around $40 billion. However, as tax collection problems persisted, speculation grew concerning the future devaluation of the ruble. The Central Bank of Russia had to raise interest rates several times in 1997 and 1998 in order to keep investment funds flowing into GKO's and to reduce downward pressures on the ruble. Speculators believed, rightly, that the Russian government would be unable to honor its commitments to pay interest on GKO's. In addition, the Asian financial crisis of 1997 had made the global investment community unusually nervous. As a result, in the summer of 1998 foreign investors rapidly began to withdraw their funds from Russia.

Russian Prime Minister Sergei Kiriyenko announced on August 17, 1998, that the Russian government had decided to float the ruble and default on $40 billion of the bonds. The government also announced a unilateral and legally dubious 90-day moratorium on payments by Russian entities on their foreign obligations. President Boris Yeltsin fired Kiriyenko on August 23 and replaced him with former Prime Minister Victor Chernomyrdin in a move intended to calm the country and to reassure international investors. The head of the Russian Central Bank resigned three weeks later. The ruble had fallen from around 6 rubles to the dollar on August 17 to about 22 rubles to the dollar on September 20.75

The 1998 crisis had an important impact on the internal distribution of power within Russia. About one-third of the assets of the Russian banking system had been put into GKO's by mid-1998. The total amount of GKO assets was over 12 percent of GDP. The floating of the ruble and the default on GKO payments resulted not only in the flight of foreign investors but also in the ruination of many of Russia’s fledging private banks. Prior to 1998, an alliance among the private banks, the larger enterprises, and Russian underworld figures had dominated both the economy and the political system. After 1998, the power of the private banks was severely diminished.

**Domestic Economic Policies of the Putin Regime**

The Russian financial crisis of August 1998 resulted in a major drop in Yeltsin’s political popularity. Because of the political stalemate, very little reform occurred in the Russian economic system between 1996 and 1998. The Russian debt ratio
(debt/GDP) increased dramatically, mainly because of declining GDP but also because the government financed growing budget deficits by borrowing from abroad. Yeltsin selected Vladimir Putin to be prime minister of Russia in August 1999 after firing his predecessor, Sergei Stepashin.

Yeltsin resigned on December 31, 1999, and appointed Prime Minister Putin acting president. In the presidential elections held on March 26, 2000, Putin received 52.94 percent of the vote. Although he was a former KGB officer and the hand-picked successor of Yeltsin for the presidency, Putin showed soon after his election that he was committed to economic reform. Putin moved immediately to cut the budget deficit by enforcing tax laws and decreasing public spending. He reduced taxes on business activity and instituted a flat income tax for individuals. Between 1999 and 2001, Putin proposed and the Russian Duma passed a new and badly needed bankruptcy law, along with new laws regarding the hiring and firing of workers, the sale of land, pensions, and anticompetitive behavior.

One of Putin’s most important policy initiatives was to reverse some of the devolution of power from the central to the provincial governments of Russia. Devolution was used by Yeltsin to secure support from provincial politicians who could not otherwise be counted upon to support the changes taking place in Moscow. One of the results of devolution was loss of control over the levying and collection of taxes in the provinces and an inability to enforce decisions made by both the president and the Duma. By the end of the Yeltsin administration, there was broad consensus that devolution had gone too far and that there was a need for some recentralization of authority and control. The recentralization undertaken by Putin was later seen as excessive and undemocratic.

Another Putin policy objective was to take control of Russia’s fossil fuels and minerals industries out of the hands of private owners and to put it back under the control of the state. Yeltsin had permitted the so-called oligarchs to gain control over the large natural gas (Gazprom and Rosneft), petroleum (Yukos, Sibneft, Lukoil, and Tyumen Oil), and nickel (Norilsk) state-owned enterprises during the loans for shares period. Putin believed that Russia could not afford to allow these firms to be controlled by the private sector and he particularly opposed ownership by foreigners. Putin made sure that Gazprom, the world’s largest natural gas producer, became a state enterprise under the direct control of the Russian government. Only private firms that were willing to follow the directions of the Kremlin were permitted to operate unhindered.

The recovery of oil prices after 1998 helped to produce a large and sustained increase in GDP growth rates (see Figure 10.3). Higher economic growth had a direct and positive impact on poverty alleviation. The Russian public responded by giving Putin consistently high ratings in opinion polls. His party, United Russia, came to dominate the political system. The reduction in the value of the ruble after 1998 made Russian exports more competitive worldwide while also increasing the prices of imports. The Russian economy, however, remained highly dependent on the exploitation of raw materials and agriculture, and the manufacturing sector outside the energy complex had not yet benefited
from Russian integration into the world economy. One of the strategies that Putin adopted to diversify the economy and to reduce the economic and political power of the large (and often monopolistic) privatized state enterprises was to seek early entry into the WTO. More importantly, he reduced the red tape associated with the establishment of new enterprises, simplified the tax code, and reduced the level of business taxes after the successful introduction of a value-added tax (VAT).

**International Economic Relations in the Putin Era**

By the end of the Yeltsin era, Russia was on the road to becoming fully integrated into the Western system. It had obtained membership in the IMF and the World Bank in 1992 and had requested membership in the OECD in 1996. Russia applied for accession to the GATT in 1993. Its application was taken up by the WTO in 1995. Russia first attended a G-7 meeting in 1994 and was included in the G-8 in 1997.

Putin made accession to the WTO a high priority when he took office in 1999. He pushed for an agreement prior to the G-8 summit in St. Petersburg in 2006. However, bilateral negotiations between Russia and the United States at the summit were unsuccessful, so accession was delayed. The delay was due to U.S. refusal to give in to a Russian demand for the right to audit the facilities of U.S. beef and pork exporters. The Russian government (like the Chinese and Indian governments, see Chapter 7) was concerned about the impact of the WTO’s agricultural liberalization agreements on Russian farmers. Nevertheless, after the failure of the Doha Round in the summer of 2008, the Russian government expressed hopes that the talks would resume in the near future.

Russian trade grew rapidly during the Putin era from $89 billion in 2000 to $300 billion in 2007. Exports exceeded imports by $130 billion in 2007. Russia’s largest trade partner was the European Union. Over 50 percent of Russian exports went to the EU and over 50 percent of Russian imports came from the EU. Over 65 percent of EU imports from Russia consisted of energy products. Russian exports to Asia were roughly one-third exports to the EU—about 60 percent higher than exports to the Americas.

After the invasion of Georgia, there was speculation about further delays in Russia’s accession to the WTO, along with not-so-veiled threats about speeding up the expansion of NATO and expelling Russia from the G-8. Putin began to argue that Russia did not need the WTO and that the government would “abandon some of the deals it has reached to join the organization....We see virtually no advantages....”

Foreign investment inflows into Russia increased rapidly during the Putin era. During the Yeltsin presidency, the highest annual inflow of FDI was $5 billion in 1997; by 2007, inflows had increased to over $52 billion. The main sources of FDI inflows into Russia were the Western European countries and the United States. Receiving the largest inflows were the food and drink, retail, mining, timber, and automotive industries. Restrictions on foreign ownership in the energy sector remained in place, but bureaucratic administration of these...
strictions was made more predictable and less arbitrary by a new law on strategic sectors that entered into force in May 2008.87

Russia achieved many but not all of its economic policy goals by the beginning of the twenty-first century. After two major crises in the 1990s, the Russian economy was stable and growing. Increases in world oil and natural gas prices helped spur an economic recovery after 1999. The decline in the value of the ruble in 1998 encouraged exports and removed a source of instability in the economy. Economic recovery helped the government of Vladimir Putin establish its legitimacy in the wake of Yeltsin’s resignation. Russia was a member of the G-8, the IMF, and the World Bank, although it had not yet become a member of the WTO or the OECD.

The primary challenges that remained were to diversify and modernize Russian manufacturing and create a firmer foundation for democracy and economic development. The Russian economy was now capitalist, but still overly dependent on oil and natural gas exports. The Russian political system was increasingly autocratic and Russian foreign policy appeared to be headed in a dangerous direction.

**Economic Reform in Eastern Europe**

In the wake of dramatic political changes in 1989, Eastern Europe also moved toward economic reform. The pace there was sometimes quicker, sometimes slower than in Russia. Even before 1989 and the end of the Cold War, some Eastern European states had adopted extensive economic reforms. Before 1989, Hungary went furthest by allowing more competitive pricing, reducing subsidies, introducing personal income and value-added taxes, liberalizing the financial sector and foreign trade sector, and introducing a bankruptcy law.88 The impetus for Hungary’s economic reform, which had come from some sectors within the Communist Party, was poor economic performance in the 1980s and the need to service the country’s foreign debt. Political reform, aimed at allowing greater pluralism and the right of association, had gone hand in hand with economic reform and even outpaced it. Thanks to economic reforms implemented prior to 1989, liberalization of the Hungarian economy was somewhat easier than in other countries. In addition, as in Russia, a significant amount of spontaneous privatization took place in Hungary after 1989. The Hungarians were not as successful as the Russians in moving away from spontaneous privatization to a more genuine form of privatization. The electoral success of a reconstituted version of the Hungarian Communist Party in 1994 slowed the pace of reform considerably.

Things went better for the Hungarians in the first decade of the twenty-first century. Hungary joined the European Union in 2004. It had shifted most of its trade away from the former Soviet bloc countries to Western Europe after 1989. Hungary received a large share of the FDI flowing to Eastern Europe, much of it from the United States. It paid off its outstanding debts to the IMF. A new government was elected in 2006 that promised “reform without austerity,” but high deficit spending by the previous government had resulted in a need to reduce government deficits (and therefore some austerity) as part of reform.89
Poland had gone furthest in political reform before 1989 by legalizing Solidarity and other trade unions, introducing free elections, granting opposition parties seats in Parliament, and easing censorship of the press. When the coalition government with Solidarity participation took over in Poland in September 1989, it had to deal with hyperinflation, chronic shortages of goods, a large trade deficit, and a debt crisis. Tadeusz Mazowiecki, the new prime minister, implemented a rapid stabilization program that included the freeing of prices and the liberalization of domestic and international trade. This program of rapid transition to capitalism was later to be called “the big bang.” The new government supported a policy of reducing real wages to compensate for overly generous wage increases of the 1988–1989 period. Subsidies to state enterprises were cut back drastically, as were plans for new state investments. The government stabilized the złoty, Poland’s currency, and made it fully convertible into foreign currencies. Finally, in early 1990, official creditors agreed to a generous rescheduling of Poland’s official debt and in 1991 to a 50-percent reduction in that debt (see Figure 10.6).

The Polish stabilization program reduced annual inflation from 600 percent in 1990 to 42 percent in 1992. The cost of stabilization, however, was quite high. In 1990, GDP decreased by 12 percent, and real wages fell by 33 percent. Many government expenditures, even in basic areas like health and education, were cut to reduce the budgetary deficit.

The new Polish government embarked on a privatization program in July 1990. State enterprises were converted into joint stock companies (this was called “commercialization”) and the government was empowered to sell its interest in the firms after a two-year transition period or close them down. However, two years after the big bang, only 11 percent of Polish state enterprises had been privatized. The top-down approach to privatization—which had worked well in the case of East Germany because the West Germans controlled the privatization board (the Treuhandanstalt)—did not work well in Poland.
In early 2002, the government announced a new set of economic reforms, designed in many ways to complete the process launched in 1990. The package acknowledged the need to improve Poland’s investment climate, particularly the conditions for small- and medium-sized enterprises, and better prepare the economy to compete as a member of the European Union. Poland became a member of the EU in 2004. Foreign investment inflows were second only to those of Russia between 2000 and 2006 (see Figure 10.7). Foreign firms that had a major presence in Poland included Fiat, Volkswagen, Daewoo, and General Motors. The government also aimed to improve Poland’s public finances to prepare for adoption of the Euro (planned for 2012).

Czechoslovakia split into the Czech Republic and the Slovak Republic on January 1, 1993. Like Poland, the Czech Republic pursued privatization vigorously for small enterprises but more slowly for larger state enterprises. Economic results were good until 1996 when growth slowed dramatically. Part of the problem, as in Russia later, was dealing with the various stakeholders, and particularly with the managers of state enterprises and organized labor.

One could argue that the Czech and Slovak republics combined features of the Hungarian and Polish approaches to economic reform. The Czech Republic’s democratic political system functioned well in the early 1990s under the leadership of the Civic Forum, a conservative party that had few successful rivals for power. Limited party competition made it possible for the Czech government to implement economic reforms rapidly after 1993, but may have contributed to the low growth rates the country experienced in the mid 1990s. Whatever the reason, growth resumed in the late 1990s and continued on through the next decade.

No formerly communist country in Eastern Europe approached East Germany in the rapidity and depth of its transition to a market economy. East Germany had the benefit of being integrated into a larger industrialized

![Figure 10.7 FDI Inflows in Billions of Current Dollars, 1990–2006](source: World Bank, World Development Indicators 2008.)
capitalist nation in 1990, inheriting all the legal institutions (with a few notable exceptions) of West Germany, and receiving major subsidies from the German federal government, which were designed to bring its infrastructure and capital stock quickly up to the West German standards. The communists in East Germany were completely delegitimized by the acts of the regime prior to 1989, and the West German political parties quickly established a dominant role in East German politics after 1990. The transition in former East Germany was not accomplished without dislocations, however, as high levels of unemployment accompanied a general decline in living standards, especially for those on fixed incomes. As Germany recovered from the shock of unification, however, these problems began to abate.

As in Russia, the immediate impact of economic reforms in Eastern Europe was a drop in production and increased unemployment. In some cases, hyperinflation was deeply embedded and hard to eliminate. People who were used to steady jobs and stable incomes, even if low by Western standards, began to vote against the governments who had implemented economic reforms. Some voters, especially in the former Soviet Union, wanted to return to central planning. Partly to head off this opposition, governments increased social spending in the mid-1990s, with much of the new spending allocated for early-retirement plans designed to increase overall labor productivity.97 There were signs of a turnaround in the Eastern European economies in the mid 1990s (see again Figure 10.4), and prosperity under capitalism began to appear more and more likely, especially for those countries able to join the European Union.

One of the goals of the East European countries was to join the European Union. EU members were of two minds on expanding to the East. Some, especially Germany, felt it was essential for political as well as economic reasons to bring the Eastern Europeans into the union. Others felt Europe needed to be “deepened,” i.e., the Maastricht agreements needed to be implemented, before it could be “widened.” Thus, the EU negotiated association agreements providing for gradual movement toward free trade with the expectation of eventual membership (see Table 10.1).

The timing of accession of each country to the EU depended on the progress it made in preparing for membership, according to the criteria laid down by the European Council in Copenhagen in 1993. The Copenhagen criteria required (1) stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities; (2) the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union; and (3) the ability to take on the obligations of membership, including adherence to the aims of political, economic, and monetary union.98 The Czech Republic, Hungary, Poland, Slovakia, and Slovenia became EU member-states in 2004. Bulgaria and Romania became members in 2007. The integration of these countries into the EU meant that they were effectively integrated into the world economy and that their political systems would probably not revert to authoritarianism.
Table 10.1 EU Association Agreements and Partnership and Cooperation Agreements with Russia, and Central European and CIS Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of EU Association Agreement</th>
<th>Date of EU Partnership and Cooperation Agreement</th>
<th>Date of EU Membership</th>
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<td>Russia</td>
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<td>Romania</td>
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<tr>
<td>Turkmenistan</td>
<td>November 1997, currently in negotiation</td>
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<tr>
<td>Uzbekistan</td>
<td>June 1996, extended in 1999</td>
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**CHINA**

**Cold War and Isolation**

For most of the postwar period, China, like the Soviet Union and Eastern Europe, was isolated from the Western trading and financial system. China pursued a policy of independent economic development that was based not only on Marxist-Leninist theory but also on China’s historical experience with foreign occupation and exploitation beginning with the Opium Wars and unequal treaties.
of the nineteenth century and ending with the Japanese occupation in the twentieth century.

Following the victory of the Communists in 1949, Mao Zedong declared that China would “lean to one side,” that is, emphasize its relationship with the Soviet Union. A treaty of friendship, alliance, and mutual assistance against aggression by Japan or “any other state” (a veiled reference to the United States) was signed in February 1950. During the 1950s, China relied exclusively on the Soviet Union for technology transfers, capital equipment, and financial support. Originally, joint-stock companies in mining and other natural resources, like those in Eastern Europe after the war, were the preferred form of aid; these were liquidated after Stalin’s death. In addition, the Soviet Union lent China $60 million a year from 1950 to 1955 and another $26 million a year from 1954 to 1959. Thousands of Chinese went to Moscow for technical training, while thousands of Soviet technicians worked in China on over 330 industrial projects. Domestically, Mao followed the Soviet model of urban-led industrialization based on the Marxist-Leninist tenets of collectivization, state ownership of the means of production, and central planning. China’s strategy of independence was reinforced by its isolation by the West. The United States refused to recognize the People’s Republic of China and maintained diplomatic relations with Taiwan.

China’s relations with the West became particularly strained when the Korean War erupted. Following China’s attack on U.S. troops in Korea in 1950, the United States imposed a complete embargo on China. The United Nations, which continued to recognize Taiwan until 1971, also imposed an embargo on the export of strategic materials to China in 1951 in response to its “aggression” in Korea. As a result, trade with the West was minimal. China’s total trade with all noncommunist countries amounted to only $550 million in 1952.

As the fifties progressed, the Sino-Soviet alliance deteriorated. A history of border disputes and mistrust between the Soviet Union and China under girded their differences, which were exacerbated in the 1950s by ideological disputes. When Khrushchev began his de-Stalinization campaign and his policy of peaceful coexistence with the West, Mao accused him of revisionism. A struggle ensued over doctrinal purity and whether the Chinese or the Soviet Communist Party would be the rightful leader of the international communist movement. Eventually the Soviet Union retracted its offer to help China develop nuclear weapons, and in 1960 all of the Soviet Union’s technical and economic advisors were ordered to return to Moscow.

Beginning in the late 1950s, China adopted a policy of self-sufficiency and turned inward. In 1958 it embarked on the Great Leap Forward, a plan to modernize its industry and increase output by way of structural changes and greater ideological purity. Agriculture had already been collectivized, but grain production had stagnated during the 1950s. Further concentration of collectives was promoted to produce a mass mobilization of the energies of the rural laborers. The collectives were encouraged to place a priority on small-scale local industry to provide for the needs of the farmers. Economic management was decentralized and more responsibility was given to the local communist parties.
Although Mao believed that ideological incentives could unlock the potential of the workers, productivity declined as collectivization continued. This decline in productivity, combined with the withdrawal of Soviet advisors, the decentralization of the economy, and bad weather conditions, led to disaster for the Chinese economy. China’s GNP decreased by one-third in 1960 (see Figure 10.8). The poor harvest resulted in large-scale starvation and malnutrition. The decentralization of the economy led to the breakdown of industry and transportation, and eventually to wide-scale demoralization. The crisis reached such proportions that Mao was forced to step down from the chairmanship of China in April 1959 (although he remained chairman of the Communist Party). The communes were broken down, some private plots were restored, and control was returned to nonparty managers.

Although China’s domestic economy began to recover in the early 1960s, it suffered another major economic setback during the Cultural Revolution, from 1966 to 1976. In his search for ideological purity, Mao incited the public to rebel against the party, which Mao felt had lost its revolutionary fervor. Major party leaders, educators, and factory managers were purged and parts of the country fell into anarchy. The economy was crippled as basic institutions fell apart and as China deepened its isolation from world contact. Eventually the army was forced to intervene to restore order. Throughout the 1960s, China decreased its trade in real terms and repaid all of its outstanding loans in order to achieve complete self-sufficiency. It had no diplomatic and few economic ties with the United States and continued to be subject to export controls and other U.S. restrictions on trade.

As the 1960s drew to a close, pressures for change began to force China away from its isolationism. The Great Leap Forward and the Cultural Revolution left China technologically backward and politically isolated. Population growth
continued to strain China’s ability to feed its people. The most important impetus for change at the time, however, was political. Relations with the Soviet Union had continued to deteriorate, and in 1969 the two countries came close to war on the Sino-Soviet border. In 1969, China, motivated by its desire to form a tactical alliance against the Soviet Union, began sending diplomatic signals indicating its willingness to open relations with the West.

Improving relations with Beijing was an important component of President Nixon’s policy of détente. For the Nixon administration, China offered a counterbalance in the U.S. relations with the Soviet Union. Accordingly, the United States responded to China’s signals and indicated its interest in improving relations. Some of the U.S. unilateral trade barriers were removed, and the United States voted to support the entry of the PRC into the United Nations, although it voted against expelling Taiwan. In 1972, at the time of President Nixon’s dramatic visit to China, the U.S. and Chinese governments issued the Shanghai Communiqué—the first of three joint U.S.-PRC Communiqués—in which the United States established its “one China” policy by acknowledging that “all Chinese on either side of the Taiwan Strait maintain there is but one China and that Taiwan is a part of China.” At the same time, the United States and China signed a bilateral trade agreement and trade resumed after a 26-year interruption. Through the 1970s, bilateral trade grew steadily to reach $4.0 billion in 1979. However, it remained a small fraction of the overall trade of both nations.

The second joint communiqué between the U.S. and the PRC was signed in 1979 during the Carter presidency. It formally changed U.S. diplomatic recognition from Taipei to Beijing. At the same time, the U.S. and China negotiated a third joint communiqué, which resolved a number of political questions regarding U.S. unofficial relations with Taiwan, particularly U.S. arms sales.

During the 1970s Japanese-Chinese relations also improved. China’s trade with Japan grew rapidly once diplomatic relations were reestablished in 1972. Total bilateral trade between Japan and China reached $1 billion in 1972 and $4.3 billion by 1979. Growth of trade continued into the 1980s, increasing 15 times in value in 15 years. China’s main export to Japan was crude oil; Japan won contracts to build various chemical and steel plants in China. On the political side, tension remained between China and Japan due to continuing Chinese resentment over Japan’s wartime occupation.

**Deng Xiaoping’s Economic Reforms**

One of the most important events in recent Chinese history occurred in 1978, when Deng Xiaoping consolidated his power and initiated a profound reform of the Chinese economy. China’s need to embark on economic reform can be traced to many of the same inherent weaknesses of the communist system that the Soviet Union experienced. Under the socialist economic model, China’s economy suffered from inefficient allocation of resources and lack of incentives for workers, resulting in poor agricultural and industrial performance. Flexibility and technological change were discouraged, resulting in an increasing technological gap between China and the West, which adversely affected its economic and military capabilities.
Deng’s reforms affected both the domestic economy and China’s external relations, and they focused on four areas: agriculture, industry, science and technology, and defense. Beginning in the agricultural sector, China implemented a household responsibility system, which contracted work to individuals and families and gave them more power to manage their own production decisions and more latitude to engage in economic activities outside the central state economy. Peasants were allowed to lease their own farm plots from their collectives and, after producing a certain quota for the state, to sell the rest of their production on an open market. China’s 1982 constitution declared that the existence of an individual economy would complement, not threaten, the socialist economy.

Agricultural production was also encouraged through price reform. The government allowed prices for agricultural products to increase across the board and stimulated production of certain products, such as vegetables and meat, by increasing their prices even further. In 1984 farmers were allowed to contract land from the communes for 15-year periods and transfer the rights to their farmland to other people, although the state still owned the means of production. In 1988, farmers were actually allowed to buy and sell land use rights, the closest a socialist economy had come to allowing private ownership of land. The household responsibility system was extended into other sectors of the rural economy, such as light industry, fishing, and restaurants. After 1985, purchase quotas for agricultural production were replaced by open market transactions.

Reforms in the industrial sector focused on the development of light industry, to correct for previous overemphasis on heavy industry. In 1981, for the first time, production in light industries equaled that of heavy industries. The largest growth was in township and village enterprises (TVEs). Firms began to be responsible for locating their own raw materials and customers. Their profits, although taxed by the state, were theirs to keep.

The initial results of reform were strong. Agriculture improved from 4.2 percent average annual growth between 1953 and 1977 to 12.3 percent growth from 1978 to 1983. Industrial growth slowed from 10.8 percent to 6.8 percent in the respective periods, but overall national income increased from 6.1 percent average annual growth before the reforms to 8 percent growth from 1978 to 1983. Between 1978 and 2006, GDP expanded at an average annual rate of 9.5 percent (see Figure 10.8). China’s per capita income was around $4,600 in 2006 (see Figure ). The steady increase in per capita income improved the general well-being of the Chinese population, even though there continued to be major regional and urban-rural differences.

As Chinese economic reforms progressed and the government relinquished some of its central planning functions, it became evident that further price reform would also be necessary to allow the market to work. Goods, labor, and land markets were also decontrolled, although some residual controls remained on land sales and prices. The state retained control over the financial sector through continued state ownership of banks and bureaucratic allocation of credit through the banking system. After 1986, innovations occurred in the development of interbank markets in some cities and the opening of equity markets in Beijing, Shenyang, and Shanghai. New forms of financial intermediaries, such
as insurance companies and leasing operations, began to function. However, the financial system was still dominated by state-owned banks. 

In its external affairs, China adopted a new open-door policy that placed emphasis on diplomatic relations with the West and the role of international trade, finance, and foreign investment in China’s economic development. China’s trade increased rapidly after 1978, after stagnating in the 1960s (see Figure 10.9). The government’s strategy was to earn enough hard currency through its exports of textiles, petroleum, and other goods to support necessary capital and technology imports. China also depended on receipts from tourism, foreign investments, and transfers from overseas Chinese to bolster its foreign exchange reserves. The most important imports were heavy capital goods, iron and steel, oil- and gas-exploring and processing equipment, and, to a lesser extent, grain. After 1984, regulations on imports of consumer goods were relaxed, which led to occasional trade deficits.

China’s largest trading partner in the 1980s and early 1990s was Japan. Hong Kong was China’s second largest trading partner and the main source of FDI inflows, because of substantial indirect trade relations between China and other East Asian countries such as Taiwan and South Korea. Since no trade officially existed between these countries and China, the goods and money passed through Hong Kong. The EU as a whole was China’s third largest trading partner, although the United States had more trade with China than any single member state of the EU. Both Europe and the United States experienced deficits in their trade with China in the early 1990s, in marked contrast with Japan’s growing trade surplus with that country. In 2007, the U.S. trade deficit with China was approximately $266 billion, up from around $10 billion in 1990 (see Figure 10.9).

U.S.–Chinese trade relations were cemented on July 7, 1979, when the two countries signed a trade agreement that granted China most-favored-nation trading status. However, because China remained a nonmarket economy, MFN treatment was limited by a provision of the 1974 Trade Act, requiring the

![Figure 10.9 U.S. Exports to and Imports from China, 1989–2007, in Billions of Current Dollars](source: U.S. Census Bureau, Foreign Trade Statistics. Note: The trade balance is the difference between exports and imports.)
U.S. President to certify each year that China permitted citizens to leave the country. The agreement reduced U.S. tariffs on Chinese imports and made China eligible for Export-Import Bank financing. The pact also provided for the establishment of commercial trade offices in the two countries. In addition, President Reagan played the China card by encouraging trade with that country. Export controls were relaxed, allowing approximately one-third of U.S. exports to China in recent years to consist of high-technology equipment.\footnote{115} Under the Reagan administration, trade with China grew, so that by 1988, U.S. exports to China amounted to $6.6 billion, compared with $1.7 billion in 1979.\footnote{116}

To pursue a more active trade policy, China restructured its system of foreign trade. Beginning in 1988, the system was decentralized so that state-owned trade corporations and manufacturers could make their own export and import plans. In addition, factories were allowed to retain up to 80 percent of the export earnings that exceeded their export targets. On the other hand, factories were increasingly asked to become responsible for their own losses. For foreign traders, the system was more difficult. Instead of negotiating with one central trade authority, as before, they now had to court three organizations: the central trade authority, the provincial trading firms, and the manufacturers themselves. China’s desire to increase its trade also led it to apply in July 1986 to become a contracting party to the GATT.\footnote{Bringing a partially reformed, nonmarket economy with a thriving export sector into the GATT and WTO with rules designed for market economies proved difficult (see discussion below of China’s accession to the WTO).}

In the financial realm, China signaled the end of its isolationism by joining the International Monetary Fund and World Bank in 1980. China increased its borrowing from Western financial markets and international organizations, although it was wary of incurring an excessive debt burden. By 2006, China’s total long-term debt outstanding in current dollars was approximately $350 billion.\footnote{117} This figure is shown in Figure 10.10.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{long_term_debt_china.png}
\caption{Long Term Debt Outstanding in China in Billions of Current Dollars, 1979–2006}
\label{fig:long_term_debt_china}
\end{figure}

\footnotesize{\textit{SOURCE: World Bank, World Development Indicators 2008.}}
long-term debt outstanding was $323 billion (see Figure 10.10) or about 10 percent of GDP.\textsuperscript{117}

Another major change for China was its interest in encouraging foreign direct investment and joint ventures with the West. Like many developing countries, China hoped to benefit from technology transfers embodied in these investments and also to take advantage of revenues generated from the exports created by these companies. China took a number of steps to encourage foreign investment. In 1979, it established four \textit{special economic zones (SEZs)}\textsuperscript{118} to encourage inflows of foreign investment and production for export by offering favorable tax treatment, special profit repatriation agreements, and other inducements to foreign investors. In 1984, 14 other coastal cities offer similar incentives. In 1991, the entire Chinese economy was opened to foreign investment on the same terms offered in the SEZs. By 2000, there were 124 SEZs in China employing around 18 million people.\textsuperscript{119} A joint-venture law was passed in April 1988, to provide a legal framework for foreigners doing business in China. Modifications were made in labor regulations to allow foreign companies to hire and fire employees freely; in general, Chinese companies had to have permission to hire and fire workers. Although thousands of joint and cooperative ventures were created, many barriers remained.\textsuperscript{120} Primary among these was the limited convertibility of the renminbi (China’s currency). China maintained restrictive foreign exchange regulations that hindered foreign investment and profit repatriation. In addition, infrastructure problems, excessive bureaucracy, worker attitudes, and differences in management attitudes were cited as barriers to more joint ventures.

\textbf{Overcoming Opposition to Further Domestic Reforms} Despite China’s economic successes, there remained many barriers to continued change. Although the basic premise of reform was well accepted in the Communist hierarchy, there was strong conservative opposition to the speed and extent of economic reforms. High inflation rates in 1987 and 1988 resulted in fears of an overheated economy, which strengthened the position of the conservatives and allowed them to occasionally stop and even roll back the process of reform. Ongoing concerns about unemployment with its potential economic and political consequences constituted an important barrier to reform of the state enterprises.

Chinese conservatives resisted pressures for greater political reform. Indeed, thus far, China’s reform process has been notable by the absence of political reform. Student demonstrations for more democratic politics became common in the 1980s before erupting into widespread demonstrations for more political liberalization in 1989. The confrontation between the students and the army in \textbf{Tiananmen Square} in June 1989 demonstrated the strength of the desire for political participation and freedom to choose where to live and work—but it just as clearly demonstrated the government’s determination not to allow it.

China’s reform policy has thus proceeded unevenly. For example, in mid-1989, in the wake of the Tiananmen revolt, China took a major step backward
from its market-based reforms when Prime Minister Li Peng announced a return to central planning in many sectors of its economy. The new policy was presented as a temporary austerity measure to regain control of the economy, but it is a reminder that China’s road to reform will continue to be unpredictable. The main concerns of the government were the decentralization of power to the separate provinces, especially the wealthy SEZs, and the social unrest that was symptomatic of the inequalities caused by the half-reformed economy. This step backward was accompanied by the apparent victory of the more conservative element of the Chinese government. In the 1990s, as the aging Deng Xiaoping ceded control of government policy, reform momentum was again slowed by the absence of a powerful, reformist leader.

In June 1989, Deng Xiaoping selected Jiang Zemin to be leader of the Communist Party and eventually Deng’s successor as leader of the Chinese Communist hierarchy. Although Jiang became President of China in 1993, Deng remained the unquestioned leader of China until his death in 1997 at the age of 93. Zhu Rongji joined the Politburo in 1993 and in 1997 was appointed Prime Minister. Zhu was responsible for reining in inflation during the 1990s. While Jiang and Zhu were firmly committed to continuing Deng’s policies of economic reform, they, too, faced the prospect of substantial internal opposition, for example, to China’s entry into the WTO and the changes that were likely to result. In 2003, a new administration took power. Hu Jintao became the Paramount Leader of the Chinese government (he was already General Secretary of the Communist Party) and Wen Jiabao succeeded Zhu Rongji as premier. Hu and Wen made a greater commitment than previous governments to reducing the urban-rural divide and more generally to improving the lot of those who had not yet benefited from rapid economic growth.

In addition to political opposition, structural and ideological problems existed with the reform process. The riskiest part of that process, price reform, was not fully implemented. Prices of daily necessities, basic urban services, and key commodities remain controlled in an effort to curb inflation. The half-adjusted system placed strains on the economy in severe shortages in some areas. The uneven development of different regions was also unsettling, resulting in regional discontent and internal migration problems. Official corruption was a growing problem, but also a necessary way of rewarding Communist Party loyalists. Finally, reform efforts were slowed by bottlenecks in the energy and transportation sectors and by underinvestment in general infrastructure.

Despite the economic reforms, China remained a highly centralized, authoritarian system. Nevertheless, China’s reforms produced greater aggregate economic growth than those undertaken in Russia and Eastern Europe. China grew faster primarily because the Chinese prereform economy was much less developed, more heavily dependent on agriculture and, thus, benefited greatly from agricultural reforms and the movement of rural workers to the cities. Prices for state enterprises were rationalized prior to decontrol, making the transition somewhat easier for them. Much less privatization of state enterprises took place in China than in Russia or Eastern Europe. Jiang and Zhu had adopted policies
after 1993 that rapidly diminished the size and importance of the state-controlled sector of the economy, with the notable exception of the financial sector.\footnote{124} In addition, China was more careful than Russia to pursue its reforms in a context of macroeconomic stability. There were no major devaluations of the Chinese currency until 2007 and inflation remained moderate.\footnote{125} Finally, China benefited greatly from a major influx of foreign direct investment in the 1990s, whereas in Russia and Eastern Europe inflows of FDI were relatively modest.

The main questions in China were whether the very rapid growth of the past three decades would continue and whether the political system would be able to survive a future period of low growth. The growing importance of private entrepreneurs was not reflected in the Chinese political system except in growing levels of official corruption. Chinese workers had no right to bargain collectively and were not protected against exploitative labor practices. Organizations not controlled by the government or the Communist Party were not tolerated. Independent consumer rights and environmental groups did not exist. The Chinese government was intolerant of religious and ethnic minorities, especially in the case of the Tibetans but also in other parts of the country. In bad economic times, these underlying tensions would come to the fore. The Chinese leadership had to ensure high rates of economic growth to maintain the legitimacy of their autocratic regime.\footnote{126}

\textbf{China’s International Economic Relations in the Era of Globalization} China entered the WTO on December 11, 2001, after 15 years of bilateral and multilateral negotiations. Accession to the WTO obligated China to conduct a number of major reforms that would prove difficult to implement. For example, China was required to provide full trading and distribution rights to foreign firms, which would mean taking away the monopoly rights of certain state-owned enterprises to import specific products. The Chinese government would have to reduce tariffs and phase out quantitative restrictions on imports, make safety and health restrictions on imports consistent with WTO standards, and stop protecting domestic farmers from international competition by subsidizing agricultural production.\footnote{127}

Despite these difficulties, Chinese authorities went ahead with the reforms they were obligated to undertake. Exports continued to expand at a rapid pace and even accelerated as FDI inflows increased. Every large MNC had to have a China strategy to gain access to the growing domestic markets of Asia and relatively low wage rates of Chinese workers and engineers.

The rapid growth of the Chinese economy served as a major inducement for the growth of inward flows of foreign direct investment. China received over $78 billion in FDI in 2006, up from less than $4.4 billion in 1991 (see Figure 10.11). Much of this investment came from overseas Chinese investors in Hong Kong, Taiwan, and Singapore, but many U.S., European, and Japanese multinational firms also increased their presence in China during this period. Much of this investment went into export-oriented production enclaves in the southern and eastern coastal areas, Beijing, and the northeast and thus had only a limited effect on other parts of the country.\footnote{128} Foreign investment played a major role in
expanding China’s exports. One estimate is that nearly 60 percent of Chinese exports came from foreign-invested enterprises and about half from wholly foreign-owned factories.

China: Regional Power or Global Economic Superpower?

With a population of 1.3 billion people, a GDP of $3 trillion in 2007, and foreign currency reserves of over $1.5 trillion, China is a major regional power with a potential for becoming a global economic superpower. Military spending is increasing rapidly. China is a permanent member of the UN Security Council and contributes troops to numerous UN peacekeeping missions. China engages in a wide variety of infrastructure projects in Africa, with a particular focus on developing raw material and fossil fuels extraction capabilities. China played a key role in the Doha Development Round. It seeks a greater role in the IMF and the World Bank, and it wants to be the ninth member of the G-8.

China’s emergence as an economic superpower depends on its ability to maintain a high level of economic growth while simultaneously dealing with major political problems, such as high levels of official corruption, growing inequality, severe environmental degradation, and a repressive authoritarian government unable to tolerate genuinely independent private interest groups. China has come a long way, but its future is still uncertain.

CONCLUSION

The end of the Cold War presented the world economy and its system of management with an unprecedented set of challenges. The most difficult was that
faced by the new governments: how to manage the transition from planned to market economies and from authoritarian to democratic political systems. Such a transition was without historical precedent and, thus, there were few principles or theories let alone practical experience to guide the process. The transformation of national economies varied from country to country depending on the existing level of development and the characteristics of the local economy. Thus, Eastern European countries and China benefited from a shorter experience with communism while Russia’s economy suffered from the legacy of over 60 years of state management.

Political reform, the transition from authoritarian to more democratic regimes, accompanied economic reform and also varied from country to country. China, still governed by a communist party, followed a more restricted path to political liberalization while the countries of the former Soviet bloc moved more rapidly toward democracy. Scholars debated the optimum sequencing of reform—whether, for example, the Asian model of Korea and Taiwan where economic reforms preceded and led to political reforms, or the Eastern Europe and Russian model of simultaneous reforms was preferable. In the real world, however, each country followed its own path.

A second major challenge raised by the end of the Cold War was the integration of the new market economies into the international economic governance institutions developed by the West. The former communist countries sought to integrate themselves into the capitalist world economy not only to benefit from trade and investment but also as part of a larger effort to make their political and economic transitions irreversible. The rest of the world, especially the industrialized capitalist world, had to decide how and on what terms to allow the formerly communist countries to join their economic regimes. The transition economies, for their part, had to decide whether they could accept the discipline and play by the long-established rules of the multilateral system.

Another goal of the formerly communist countries was to join the existing multilateral institutions. As we have seen, the members of the former Soviet bloc joined the International Monetary Fund and the World Bank and benefited from financial support from those institutions. A new multilateral bank, the European Bank for Reconstruction and Development (EBRD), was created in 1991 to assist Eastern Europe and the Confederation of Independent States (CIS) countries in their reform. China and many of the new market economies of Eastern Europe joined the World Trade Organization while others including Russia applied for membership in the WTO. The applications of Russia and China to join the world trading regime raised important questions about their ability to achieve the domestic economic reforms which would enable them to accept the rules and disciplines of the prevailing regime.

During the Bretton Woods and interdependence periods, economic relations between the Soviet Union and its allies and the rest of the world were a function of perceptions about the degree of enmity between the Soviet bloc and the West. After the end of the Cold War and the adoption of economic reforms in China, the formerly communist countries were absorbed into the globalizing world economy at various speeds but increasingly in a way that was irreversible.
Even the largest remaining communist country, China, behaved more and more like a capitalist country with an authoritarian political system. Considerable variance existed among these countries in the degree to which the government was successful in pursuing macroeconomic stability, state enterprises were privatized, and the market was permitted to become a competitive one. These differences may have accounted for some of the variance in post-1989 economic performance. Nevertheless, one similarity is more striking than the differences. China and the formally communist countries, like the rest of the world, were all subject to the forces of globalization and were dealing with them in their own way. Whether they would be able to do so without making further and possibly radical changes in their domestic systems remained to be seen.

ENDNOTES

1. These countries are now usually referred to as the Confederation of Independent States (CIS). They include Belarus, Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan. Russia is also a member of the CIS.


22. Members were the United States, Canada, Japan, Belgium, Denmark, France, Greece, Italy, Luxembourq, the Netherlands, Norway, Portugal, Turkey, the United Kingdom, and West Germany (that is, all the NATO members except Iceland, plus Japan). Spain joined in 1985 after becoming a member of NATO; Australia joined in 1989.


25. Romania, Hungary, and Poland became eligible when they joined the International Monetary Fund and the World Bank in 1972, 1981, and 1986, respectively.

26. See Goldman, _Détente and Dollars_, 52; and Pisar, _Coexistence and Commerce_, 111–114. The Berne Union, a group of governmental and private credit insurance organizations in the developed market economies, agreed to limit commercial credits to the East to five years and to require an initial cash payment of at least 20 percent of the purchase price. The agreement was nonbinding, however, and proved ineffective.


29. U.S. Senate, 89th Cong., 2nd session, Bill 5–3363.

30. John Lewis Gaddis, _The Long Peace: Inquiries into the History of the Cold War_ (New York: Oxford University Press, 1987). It has to be noted, however, that the period of rule of Leonid Brezhnev was not one of good U.S.–Soviet relations, but rather of temporary détente, ending around 1974, followed by increasing tension and escalation of hostilities, especially with the invasion of Afghanistan in 1978 and the coming to office of Ronald Reagan in 1981.

31. P.L. 93-618, the Trade Act of 1974. Senator Henry Jackson and Representative Charles Vanik developed a proposal to link most-favored-nation treatment and Eximbank loans for the Soviet Union and Eastern Europe to freer policies of emigration in these countries. And they offered that proposal as an amendment to the U.S. trade bill that the administration needed to launch the Tokyo Round. After resisting the Jackson-Vanik amendment for two years, the Nixon administration capitulated on the assumption that the Soviet Union would change its policies in return for the inducements of credits and trade.


of the first steps taken by the Reagan administration in early 1981 was to lift the grain embargo and to announce that the administration would not use grain as a foreign policy tool. The reason for this departure from President Reagan’s hard-line policy was one of domestic politics. The highly controversial grain embargo had become an issue in the 1980 campaign, with President Carter defending the embargo and candidate Reagan insisting that it was both ineffective and economically inequitable and that, if elected, he would end it. Despite the removal of the embargo, the Soviet Union, citing U.S. unreliability, refused to increase its purchases of U.S. grain and limited its imports to the amount it was committed to purchase under the terms of the grain agreement.

36. Goodman et al., 102.
45. Joint Economic Committee Report, ix.


56. They had always used these methods but they applied them with greater urgency after the Gorbachev reforms.


64. Åslund, *How Russia Became a Market Economy*, 55.


73. Hishow, “Russia’s External Debt.” Unfortunately, most of these debts were held by countries like Cuba, Mongolia, and Iraq that were not in a position to repay them.

74. GKO stands for Gossudarstvennye kratkosrochnye obligatsii, or short-term state treasury notes. Along with GKOs, the Russian Central Bank issued long-term securities called OFZs (short for Obligatsii federal’nogo zaima). Gustafson, Capitalism Russian-Style, 92.


76. Gobbin and Merlevede, “The Russian Crisis.”


100. Ibid.


105. Ibid.


111. Ibid., 25.


118. The four initial SEZs were in Shenzhen in Zhuhai province, Shantou in Guangdong province, Xiamen in Fujian province, and the entire island province of Hainan.


122. See Barry Naughton, *The Chinese Economy*: 108 for his summary of the differences between the new and old administrations.


131. China’s IMF quota was raised from 2.98 percent to 3.72 percent in September 2006.


