



# UNIVERSITY OF LEEDS

**Gradualist Transition vs. Shock Therapy:  
The Case of China and Russia**

**MA South East Asian Studies**

***China's Development***

***EAST5015M***

***Dr Heather Zhang***

**Academic Year 2010/11**

**Term 1**

**Essay**

**Timotheus J. Krahl**

**Word Count: 3246**

## **Table of Contents**

1	Introduction.....	1
2	Shock therapy vs. Gradualism .....	1
2.1	Gradualism .....	1
2.2	Shock Therapy .....	2
3	The Development in two countries.....	2
3.1	Economic transition in China since the 1970 .....	2
3.2	Economic transition in Russia from the mid 1980s on.....	4
4	Comparing China and Russia .....	6
5	Conclusion .....	7
6	Bibliography.....	8

# **1 Introduction**

Even if the great change in world politics took place in the beginnings of the 1990s, the question of an economic transition is still vital in our days. Vietnam, just to mention one country, undergoes this process these days. Prime examples of transition are China and the former Soviet Union, both countries stand for two different approaches. The following will present the theories, explain transition in the mentioned countries, analyse it and try to value both theories.

## **2 Shock therapy vs. Gradualism**

With the fall of the Berlin Wall in 1989 and the surrounding development, we could assume that communism might be dead. Overall the number of communist states (quoted by the CIA World Factbook) has reduced to five: the People's Republic of China, Cuba, North Korea, Laos and Vietnam (CIA, 2010). Economies on their way from a centrally planned economy towards a market driven economy, are generally known as transition economies. Some of the above quoted states are currently undergoing a process of transition. The approach towards transition is broadly discussed, and we could separate the theories in two different camps, the Shock Therapy, adapted by the former USSR and most of the East Europe and the Gradualist Approach currently adopted by the People's Republic of China. The following will briefly describe both of them to get a better understanding of the development which took place in both countries.

### **2.1 Gradualism**

In contrast to the Shock Therapy the gradualist approach is incremental. It is a slow process in cooperation with the society to transform countries' political and economic structure. Murrell (1993, p. 119f) mentions the evolutionary economic perspective. He emphasizes the contribution of history and society to the economic system and therefore their need of involvement during a period of change.

In general it is to say that supporters of the gradualist transition prefer a longer lasting state intervention. The way of dealing with it by the state could be different but e.g. fixed exchange rates, delayed privatization, wage controls etc. are means of it (Hall & Elliott, 1999, p. 307). In reference to the authors mentioned before, the gradualist transition needs the involvement of the public and active participation of state institutions.

Scholars, who criticise the gradualist approach, mention that it would represent a society which is unsecure about the way it prefers to develop (Woo, 1994, p. 280f). Within these circumstances, the

gradualist transition seems to be “political more sustainable” (Wei, 1997, p. 1245), in a contrary case the Shock Therapy would be more favourable (1997, p. 1245f).

## **2.2 Shock Therapy**

As the term indicates, the so-called Shock Therapy must be a process, which has an immediate impact on the state, society and economy. Therefore it must bring tremendous change on various levels within a very short amount of time, and as a result it creates a negative economic shock. David Lipton and Jeffrey D. Sachs formulated some of the core arguments for the shock therapy at the beginning of the 1990s. A central contribution to this transformation theory was the paper called “Creating a Market Economy in Eastern Europe: The Case of Poland” (Lipton & Sachs, 1990).

The driving idea behind Shock Therapy is to implement liberal government structures and economic policies, to create a fully functional market within a short amount of time. Through the quick application of new policies the cost of transition should be minimized. The idea in general is fuelled by neoliberal scholars, such as James Buchanan, Milton Friedman, and Friedrich Hayek (Hall & Elliott, 1999, p. 306). It is expected, that through the absence of the state, the market driven allocation of resources will create economic growth. Mechanisms to reach those goals include, the deregulation of prices and the exchange rate, free trade, privatisation and macroeconomic stabilisation (Hall & Elliott, 1999, p. 306; Lipton & Sachs, 1990, p. 100). Coming from that point of view, it is obvious, that one of the core assumptions is that the communist party has been already overthrown (Nolan, 1996, p. 239).

A main critic regarding shock therapy is that a functional bureaucracy with its existing networks will be thrown over. Moreover, the applied reforms implicate to reconfigure or create new institutions (e.g. Central Banks) which pose a strong challenge to the bureaucracy (Murrell, 1993, p. 114). Another burden to society is the downturn of the economy in the first moment of the new agenda in place.

## **3 The Development in two countries**

After taking a brief look on the systematic application for economic transition in (post)-communist countries, the next step will examine two of the biggest countries, which have undergone or still undergo the process of transformation, China and Russia.

### **3.1 Economic transition in China since the 1970**

The decision the Chinese leaders made in the 1950s determined the country’s economic policy for the next 20 to 30 years. During the 1950s agriculture was still the major contributor to the Chinese

GDP with 56.9%, followed by the Light Industry with 27.8% and the Heavy Industry 15.3% (Lin, Cai, & Li, 1994, p. 15). The communist party aimed to develop the countries heavy industry and subordinated all other political decision to it. Looking back on the decades before 1978 it is generally recognized, that it was one of the worst periods in Chinese history, which had limited contribution to the countries development.

Even if the country made progress, rebounded from the Great Famine and the GDP (constant 2000 US\$) exceeded 100 billion USD in 1970 (World dataBank, 2011), the rulers, namely Deng Xiaoping, recognised that change has to take place. The milestone of China's transition was the Third Plenum of the Eleventh Congress of the Chinese Communist Party (CCP) in December 1978. It was there where Deng announced China's return on the global stage, its opening towards the West and the introduction of capitalist measures (Knight, 2003, p. 318).

A core to the process of China's transition is to understand that change was a process of adaption, each step of it triggered the following one. Looking at the process, we have to distinguish between two major periods of reform, the first from 1979 to 1993, which Qian (1999, p. 6) entitles "Reforming the System" and from 1994 on, which he names "Replacing the System". At the heart of the reforms, are four areas, the agriculture, state-owned enterprises (SOE), township-and-village enterprises (TVE) and the macro-policy.

In 1978 the government detained the system of collective farming, but later that year a collective gave secretly trial to a new system of leasing out the land to the farmers, and therefore shifting the responsibility from the cooperative to the private household (Lin J. , 2004). As the new model outperformed the collectivised farming, more and more regions adapted to it. Finally the "household responsibility system" was most likely official recognised at the end of 1981 (Lin, Cai, & Li, 1994, p. 21). Qian (1999, p. 7f) credits the success of it to the process of decentralization, which started off in 1979. A successful transformation of China would not have been able, without delegating power from the central to local governments. With the new gained authority, regional leaders were able to adapt the household responsibility system without Beijing's recognition.

Another important field is the transformation of SOE, Lin (Lin J. , 2004, p. 13) works out four stages of reform. During first period from 1979 to 1983 authorities tried out several policies to widen the scope of autonomy and financial incentives. Even at that stage, the companies still operated within the socialist economic framework, but partially adoption of modern business practices took place. The second stage was scheduled from 1984 to 1986, during that period the profit transfer was converted from remittances to profit tax, and the companies were allowed to sell the above State plan produced goods at market prices. The following period from (1987 – 1992) was employed to

clarify the role between state and business managers, before finally from 1993 on modern business practices were fully applied for SOE.

The main engine for China's success, have not been the SOEs but the private companies, or in China's case TVEs. Lin et al. (1994, p. 15) mention as one weakness of the pre-reform China the low allocation efficiency. With the new autonomy for SOEs, their demand set the central plan under pressure and therefore the authorities reduced the number of centrally allocated and price controlled goods (Lin J. , 2004, p. 14). Benefactors were the TVEs, which did not only profit from a better access to resources, but also from the effects of the household responsibility system, which created surplus income to reinvest (Lin J. , 2004, p. 14). In combination with the authority of regional governments, the TVEs were in a better position than privately owned companies. Quian (1999, p. 12) mentions, that in a weak institutional environment, with insecure property rights and imperfect capital markets, regional governments had a positive impact to protect and finance TVEs. Finally the competition between SOEs and TVEs, fuelled the government's desire to enhance the business environment for the underperforming SOEs and therefore it implemented further reforms (Lin J. , 2004, p. 15).

On the field of the macro-policy it is to distinguish between three areas, the price system, foreign exchange and interest rates. The central government gave the country round about 15 years to liberalize most of the prices (Qian, 1999, p. 17), until then it followed the dual-track price system (Lin J. , 2004, p. 16). SOEs were allowed to sell their over plan production for market prices. Over time the number of goods with set prices was reduced, and by 1996 with the exception of some goods completely liberalised (Lin J. , 2004, p. 16). The exchange rate during 1979/80 averaged around 1.5 Yuan per US Dollar (Lin J. , 2004, p. 16), in the long run the government aimed for a floated exchange rate, in favour of China. To achieve it, a dual exchange rate was implemented, with an internal rate of 2.8 Yuan per US Dollar for commodity trade. From 1985 the Yuan was gradually devalued, currency trade was relaxed and as of the 1<sup>st</sup> January 1994 the managed float was established and the internal and external rates were united. In the aftermath of the 1978 reforms, the government had to increase the interest rate several times; nevertheless it was still kept below market rates.

### **3.2 Economic transition in Russia from the mid 1980s on**

During the 1980s the Russian economy was stagnating, but stable, with low inflation, zero unemployment and an established and solid political environment. Nevertheless, Russia was lacking behind its Western competitors, and reforms were desperately needed. In March 1985, Mikhail Gorbachev became General Secretary of the Communist Part of the Soviet Union, the man to whom the terms *perestroika* and *glasnost* are linked and who brought freedom to the world but left a

devastated country (Åslund, 1995, p. 26f). At the beginning of his rule, Gorbachev intended to transform Russia from the inside, starting a similar process as China did in 1978.

The reforms of the Gorbachev administration missed out to have a thought through structure and as he stuck to the communist doctrine the implementation of market force never fully came true. Early on, in February 1986 Gorbachev already announced radical reforms, but during these days the General Secretary did not much then working on his international recognition (Hedlund, 1999, p. 84). The policies implement during 1986 did not contribute to advancement of liberal structures of the USSR economy. One example is a decree regarding “non-labour incomes” (Hedlund, 1999, p. 85) aimed to diminish informal sector activities, but in the end it hit the peasantry, who sold their foodstuff on local markets. In February 1987 Gorbachev announced a new and from his perception more radical reform with the support of leading scholars. The reform suggested giving more freedom to SOEs and the end of central planning, but finally it turned out to be only a reformulation, moving from *plan targets* to *state orders* (Hedlund, 1999, p. 86). Even if the discussion since Gorbachev’s election was vital, the reforms were half-hearted, and finally they have been lost years (Hedlund, 1999, p. 88). The years till the end of Gorbachev’s governance were characterised by his aim for political reform rather than economic change. Thereby he made use a mixture of authoritarian and soviet style politics: manipulated elections, caring on the idea of a socialist economic system and his enthronement as general secretary and president. In the end, Gorbachev’s did not contribute to an economic renewing of the USSR and lost his power struggle against Boris Yeltsin in December 1991. The new President inherited a politically, socially and economically collapsed country had another 6 years of economic crisis ahead (Androshchuk, 2006, p. 5; Hedlund, 1999, p. 88f). Finally it is to mention, that there would have been the chance for real economic change during the years of Gorbachev’s office, in the summer of 1990 Stanislav Shatalin presented a reform plan, which would have been a radical turnaround towards market economy.

In 1992, the new Russian government adopted a radical reform plan. The basic structure was coherent to Shatalins plan and included five major fields of action in coherence with the implementation of a market economy: macroeconomic stabilization, price liberalisation, a convertible currency, privatisation of SOE and the creation of a social safety net (Fischer, Summers, & Nordhaus, 1992, p. 83). The effects of Shock Therapy was tremendous, through the immediate price liberalisation the country experienced a hyperinflation of 1,353 percent in 1992 and the continuous economic slowdown from 1992 till the end of 1996. Negative GDP growth hit its high in 1992 with 14.5 percent. Within two years, by 1994, most of the companies were privatised. Ownership was given to the employees and managers through “ownership vouchers” (Androshchuk, 2006, p. 5), a scheme which created more confusion than a functional market. The problem of Russia’s

transformation at the beginning of the 1990s was the absence of law and order and a strong government administration. The main target for the government was not to minimise the cost for society whilst transition, but to create capitalist institution as quick as possible. The result was the “creation of markets in circumstances of total chaos (Financial Times, 23. Aug., 1994)”, as Nolan (1996, p. 266) quotes the Russian deputy Prime Minister Mr. Soskovets.

The transition of the Russian economy at end of the 1980s and the beginning of the 1990s failed because of Gorbachev’s incapability to lead the country through one of its most critical periods in modern history. The economic crisis and the end of the Soviet system, called for a strong and visionary leader who would have guided his country through this turbulent period. Finally the winner of the Peace Noble Price surrendered his successor a domestically shaken country and left him no other option then a Shock Therapy, which was poorly accomplished.

#### **4 Comparing China and Russia**

It is important to recognize that the process of economic transition did not stop at the beginning of the 1990s, but the above present the most critical periods in time for both countries, it was then where the right- and wrongdoings took place. With the given foundation, the following will analyse the both concepts applied for each country: Gradualism and Shock Therapy, before the final question will be answered why the Chinese transition seems to be more successful and smother. But beforehand a short snapshot of the current state of the economies of both countries.

As it is generally known, China is a prime example for economic growth within the last 15 years. The average growth in Russia for the years 2001 to 2010 was 5.3%, China in comparison grew on average 11.4% in the same time. The International Financial Crisis of 2008/2009 hit the Russian economy hard, the GDP in 2009 declined by 9% (YoY) whereas China only experience lower growth rates (IMF, 2010). Both countries belong to the so-called BRIC states, a group of leading emergent economies. Furthermore the CIA World Factbook ranks the countries among the Top 10 economies in regard of GDP (PPP) size, China with \$ 8,818 billion (ranked 3<sup>rd</sup>) and Russia with \$ 2,116 billion (ranked 8<sup>th</sup>, after the UK and followed by France).

In general the assumption could be made; that both countries did not chose *their path of transformation* build upon a theoretical framework. In the case of China, it is to assess the political leaders wanted to safeguard the communist system and with it the power of Communist Party. Nolan (1996, p. 244) argues that the Chinese leaders, thoughtfully maintained the social and political structures. From his perspective a change on the whole bandwidth of state organisation, would finally created a collapse the Soviet Union experienced. Furthermore from an evolutionary

perspective, as described above, a strong state is the guarantor of successful change. Woo (Woo, 1994, p. 279f) on the other side, blames the Chinese of not knowing what they really wanted. From his perspective, gradualism is the result of the absence of social consensus about the future development of a country. The case for Russia seems to be slightly more complicated; the Shock Therapy was applied only in the 1990s after the transition was already triggered off. Gradualist moves could have been possible at the very beginning if the leaders would have made whole hearted decisions on the field they targeted. But the country which Yeltsin inherited did not have the capacities to fully take the challenges of a transformation. The Russian leaders have been aware of the consequences coming along with a Shock Therapy, but they did not pay enough attention to it and kept rushing.

The last question to answer, and it is impossible to do this in detail, is why China has been more successful with its process of transformation and if the gradualist approach is superior. For the Chinese case, the gradualist approach was and is the better option, it guaranteed stable society and institutions whilst economic change accurse. And as it is known countries like, South Korea and Taiwan went from an authoritarian regime with high state intervention to a full democracy with a market economy. The failures of the Russian transition have been mentioned above. From that point, a superior transformation process could not be chosen, much more history teaches that each country has to opt for the applicable way and be aware of possible mistakes, which create failure.

## **5 Conclusion**

In the end, it is to asses, that economic transition has to be answered on a country specific basis, and that there is no model to be favoured. The above teaches that the process of economic transition is highly critical; leaders have to be aware of the risks for their country and carefully plan the steps ahead. It is at that stage where failure takes place, and a country possibly will be direct into chaos, anarchy and economic crisis. The public opinion is maybe more supportive of the Chinese way, as it is the smoother path and did not put a high economic burden on the society, but actually Easter Europe present several examples of successful Shock Therapy transitions. Finally, it might be useful to take a brief look on our days Vietnam: For the moment, a gradualist transition seems to be the right path, but as soon as the political system would be overthrown by internal forces, the new leaders might over think the current agenda.

## 6 Bibliography

Androshchuk, A. (2006). *Transition Economies: A Look at Russia, Ukraine and Poland*. Retrieved from Honors College Theses. Paper 32: [http://digitalcommons.pace.edu/honorscollege\\_theses/32](http://digitalcommons.pace.edu/honorscollege_theses/32)

Åslund, A. (1995). *How Russia became a market economy*. Washington, D.C: Brookings Institution.

CIA. (2010). *The World Factbook*. Retrieved 12 30, 2010, from <https://www.cia.gov/library/publications/the-world-factbook/index.html>

Fischer, S., Summers, L., & Nordhaus, W. (1992). Stabilization and Economic Reform in Russia. *Brookings Papers on Economic Activity, Vol. 1992, No. 1* , pp. 77-126.

Hall, T. W., & Elliott, J. E. (1999, Jun.). Poland and Russia One Decade after Shock Therapy. *Journal of Economic Issues, Vol. 33, No. 2* , pp. 305-314.

Hedlund, S. (1999). *Russia's "market" economy : a bad case of predatory capitalism*. London: UCL Press.

IMF. (2010). *World Economic Outlook Database, October 2010*. Retrieved 01 07, 2011, from <http://www.imf.org/external/pubs/ft/weo/2010/02/weodata/index.aspx>

Knight, N. (2003). Imagining globalisation: The world and nation in Chinese communist. *Journal of Contemporary Asia, 33: 3* , pp. 318-337.

Lin, J. (2004). *Lessons of China's transition from a planned economy to a market economy*. (P. U. Technology, Ed.) Retrieved 01 03, 2011, from <http://info.worldbank.org/>

Lin, J., Cai, F., & Li, Z. (1994). China's economic reforms: pointers for other economies in transition? *Policy Research Working Paper Series* .

Lipton, D., & Sachs, J. (1990). Creating a Market Economy in Eastern Europe: The Case of Poland. *Brookings Papers on Economic Activity, Vol. 1990, No. 1 (1990)* , pp. 75-147.

Murrell, P. (1993). What is Shock Therapy? What Did it Do in Poland and Russia? *Post-Soviet Affairs, 9, 2* , pp. 111-140.

Nolan, P. (1996). China's rise, Russia's fall. *Journal of Peasant Studies, 24* , pp. 226 - 250.

Qian, Y. (1999). *The Institutional Foundations of China's Market Transition*. (S. Stanford University, Ed.) Retrieved 01 03, 2011, from <http://web.cenet.org.cn/upfile/30210.pdf>

Wei, S.-J. (1997). Gradualism versus Big Bang: Speed and Sustainability of Reforms. *The Canadian Journal of Economics / Revue canadienne d'Économique, Vol. 30, No. 4b* , pp. 1234-1247.

Woo, W. (1994). The art of reforming centrally planned economies: comparing China, Poland, and Russia. *Journal of Comparative Economics (18)*, pp. 276-308.

World dataBank. (2011). *World Development Indicators (WDI) & Global Development Finance (GDF)*. Retrieved 01 05, 2011, from <http://databank.worldbank.org/>