



## Background

As stated previously almost all countries with transitional economies are countries that were once communist (except in the case of China which still considers itself a communist state). Most of these countries traded very little with capitalist economies and only traded with other communist nations. Under communist rule, all industries and enterprises were state owned and therefore faced little competition domestically or internationally. The government determined the prices of goods and the quantity produced hence the term *centralized planning*. The merits and shortcomings of communism is a debate by itself and certainly goes beyond the scope of this guide. A few of the problems with this system will be discussed only because they are relevant to the problems facing such countries that are now transitioning to free market systems.

During the 1980s, several communist countries began small measures towards liberalizing and opening up their economies. Reform in the Soviet Union began in the mid 1980s under the leadership of Mikhail Gorbachev. His name is synonymous with the term *perestroika* which was the term given to the economic reforms that he began. As the Soviet Union began opening up the economy, it also began to loosen its grip on the economies of other Soviet satellite states in Eastern Europe. Nations such as Czechoslovakia allowed private ownership in certain industries and for the first time consumers were given more choices in the goods they could purchase. Many socialist and non-aligned economies also depended heavily on favorable trade arrangements and subsidies from the Soviet Union. When these sources of support were removed, these economies found themselves in “disarray, having lost the support of Moscow in confrontations with the richer industrialized countries.”<sup>2</sup> While many of these nations eventually successfully implemented free market reforms and are well on their way to becoming part of the global market, there are several that have blundered and are in need of solutions.

## The Russian Path

Russia’s transition from a command economy to a market based economy is a classic example of the pitfalls of rapid liberalization. It highlights both the economic and social costs involved with reform. Other countries on the path to reform have taken important lessons from this case study.

During the mid 1980s the Soviet economy was under enormous strains. There were several state owned enterprises (SOE’s) that were losing vast sums of money due to inefficient and antiquated operations. However, the state was unable to shut these firms down even though they were running at a loss for a variety of reasons such as the potential unemployment, corruption and deals made with other state owned firms. Faced with rising deficits and a stagnating economy, Gorbachev began allowing the state owned firms to have more decisionmaking authority. Foreigners were allowed to invest in joint ventures with state run companies and international trade was permitted. Originally all

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<sup>2</sup> Barbara Crossette, “After half a century, the UN tries to redefine itself for a new world” *The New York Times* September 18, 1994.

trade was controlled by the Ministry of Foreign Trade, but now companies were allowed more autonomy in foreign trade. These gradual changes did have a small effect on the economy however, much of the old Soviet system remained in place. The ruble remained inconvertible and this limited the amount of direct foreign investment. Firms were still state owned, and private ownership of firms by Soviet citizens was still very limited.

Unfortunately, the reforms did not go far enough to aid the Soviet economy and by 1991, the Soviet economy was in deep trouble. Decentralization severed the traditional links between suppliers and retailers and many industries went into decline instead of becoming more profitable. By 1991 the Soviet GDP was down 17% from the previous year, and that year the union dissolved into 15 different republics.<sup>3</sup>

## **Privatization**

Russia's new president Boris Yeltsin felt that the failures were because the reforms had not gone far enough. In the early 1990s, the Russian government embarked on a massive privatization effort in order to sell off industries that were both profitable and unprofitable in order to pay off massive government debts. During this period, many academics and economists from the West traveled to Russia as economic consultants. The idea behind selling off these companies was that private entrepreneurs would manage these companies far more effectively than the state. With profit being their main motive they would devise the best ways to turn the companies around and in turn stimulate the Russian company. Everything from steel mills to oil wells to car manufacturers were sold off (often for very little money). Further complicating the situation was the massive corruption in Yeltsin's cabinet and government.<sup>4</sup> Rather than public auctions, many state owned companies were sold to citizens with political contacts. The experiment in privatization was very much a failure for the Russian people. The businessmen who bought these companies through bribes and other corrupt means often either quickly sold the companies to foreigners for a handsome profit, or sold off all the assets of the company (which was often worth more than the purchase price). Instead of stimulating the economy, the privatization led to massive unemployment and an economic recession.

## **Currency**

One of the market reforms was making the ruble a convertible currency. For the first time people could convert their Russian rubles into U.S dollars. The Russian government set a target exchange rate, but the exchange rate that had been set was higher than the realities of the market. The high interest rate made it attractive for foreign companies to sell their goods in Russia because the goods were affordable. In order to support this exchange rate the Russian government had to borrow huge sums of U.S dollars to exchange for rubles when Russians wanted to convert their currency. By 1998

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<sup>3</sup> Trade Finance Infrastructure Development Handbook for Economies in Transition  
[http://www.unescap.org/tid/projects/globalize\\_wgtfbk.pdf](http://www.unescap.org/tid/projects/globalize_wgtfbk.pdf)

<sup>4</sup> *BBC News*, "Yeltsin linked to bribes scandal" September 8, 1999.

Russia owed the rest of the world roughly 150 billion dollars<sup>5</sup>. Unable to make payments, on these loans and against the advice of the IMF, the government defaulted on loan payments to creditors triggering an international financial crisis. The ruble plunged in value and Russia's credit rating fell to the equivalent of *junk bond* status.<sup>6</sup>

## Social Consequences

The painful economic reforms of the 1990s took a hard toll on the Russian people as well. The privatization efforts led to massive unemployment since many of the underperforming industries were sold off and then closed or scaled back. This combined with massive government corruption caused a drastic rise in the crime rate and organized crime. In the mid 1990s, Russia experienced double digit inflation which decreased the purchasing power of the average citizen. Under the Soviet system, the state was the main employer of workers, and was also responsible for the feeding, and housing of the population. Almost all housing was state owned as were the grocery stores where people purchased food. With the rising costs for everything from food to gas, many were unable to purchase basic items they could easily afford in the past. The removal of all government subsidies only made matters worse. Inflation especially hurts senior citizens and pensioners who are on fixed incomes. Workers who had spent decades working for the state found they could not longer afford to live on the meager pensions they received. In many instances, the state was so short on funds they were unable to pay employees, including soldiers. Economist Jeffrey Sachs writes that "the West's failure to help had very high costs. The Russian people were optimistic at the beginning. They had become deeply cynical, and deeply demoralized, by the end of the 1990's....By the end of the decade, the optimism had vanished, and Russians were again searching for a strong leader with centralized power. When the reformers did not get the help they needed, they were replaced by gray apparatchiks and corrupt wealth seekers."<sup>7</sup>

The rapid privatization also generated large wealth disparities in the population that didn't exist previously. Businessman and politicians who benefited from the reforms made millions and billions of dollars and with the favorable exchange rate they converted most of the currency to U.S dollars and invested it outside Russia. This concept known as *capital flight* essentially transferred wealth out of Russia. The low wages and the lowering of the standard of living lead to another flight known as the *brain drain*. Educated Russians realized that their education and talent could fetch them much higher salaries and standards of living outside of Russia, which led to increased immigration. Those who stayed behind were now poorer than before and in turn had fewer children.

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<sup>5</sup> <http://www.eastwest.be/russia.html>

<sup>6</sup> Jeffrey J. Frankel and Andrew K. Rose., 1996. "[Currency Crashes in Emerging Markets: Empirical Indicators](#)," [Center for International and Development Economics Research \(CIDER\) Working Papers C96-062](#), University of California at Berkeley.

<sup>7</sup> Jeffrey D. Sachs, *The End of Poverty: Economic Possibilities for Our Time* Penguin Press New York 2005 p. 143.

Lower birth rates and higher death rates have contributed to a steady population decline<sup>8</sup>. The U.N has warned that the Russia's 2005 population of 140million could fall by a third by 2050.

## **Current State**

After the 1998 crisis, Russia's economy has gradually recovered and is currently experiencing 8 to 9% annual growth. The government under the leadership of Vladimir Putin instituted a number of reforms for the state to re-purchase several failed industries. This is somewhat of a reversal of the earlier privatization efforts, but there have been successes. Yeltsin's government has been plagued by accusations of corruption and intimidation, especially in regards to Yeltsin's political rivals, including Mikhail Khodorkovsky, the former head of Yukos.<sup>9</sup> The main engine for economic growth has been the current high oil prices. At 122 billion barrels of proven oil reserves, Russia has the second largest oil reserves in the world and large natural gas reserves as well. The government has been able to pay off all outstanding debt and currently enjoys a sizable foreign currency reserve of some \$500 billion USD.<sup>10</sup>

## **The Chinese Example**

In sharp contrast to Russia, China embarked on a very different route towards a market economy. While China still maintains it is a communist state, its economy more closely resembles that of a capitalist one. China's reforms began in the early 1980s under Premier Deng Xiao Ping. China's first steps towards reforms didn't involve industrial privatization (although that would come later) or a freely exchangeable currency. Instead it began with agricultural land reform.

## **Agricultural Reform**

The pre-reform Chinese economy was a centrally planned economy. All enterprises were state owned, and agriculture was grouped into *collective farms*. Like the Soviets, the Chinese dictated economic blueprints through a series of 5 year plans. Learning from the Soviets, the Chinese government set their sights on expanding heavy industry. In order to do this, they needed to import equipment from the outside and this required large sums of foreign exchange. To facilitate this, the government instituted a policy of low interest rates and overvalued exchange rates to make the cost of imports cheaper. The government also set wages low for workers employed in heavy industries and mines. The idea was that by reducing the costs for these enterprises, the state-owned industries could make a higher profit and begin paying back the loans they had taken out to purchase the equipment. These heavy industries were often located in big towns or cities so they would be close to distribution centers and harbors. Therefore, more people began moving to the cities and with the low wages they were earning, the government realized it had to ensure food was affordable. Therefore the government instituted price

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<sup>8</sup> ^ [a](#) [b](#) CIA World factbook, [Russia](#)

<sup>9</sup> *BBC News*, "New fraud charges in Yukos case" February 5, 2007.

<sup>10</sup> *BBC News*, "Auditor withdraws Yukos reports" June 25, 2007.

controls on food items and peasants were obligated to sell fixed quantities of produce for government determined prices. Agricultural output was also the main source of foreign exchange earnings. Even in the 1970s, agricultural output accounted for 60% of all exports. Industrial growth depended on strong agricultural performance. Since the government couldn't allocate scarce resources and funds to agriculture, productivity increases had to come in other ways. At the time all farms were run as collectives. The state owned the land, and peasants in a town worked on the land as a collective. In theory each farmer's wage was determined by his or her individual effort but because of the difficulty in monitoring, essentially all the farmers in the collective received the same wage.

By 1978, the government had realized that collective farming didn't result in the most efficient farming. It therefore slowly began allowing collective farms to adopt what it termed the household responsibility system. In this system the collective would lease the land from the government for a fixed term. The collective would divide the production quota (set by the government) to individual households. Each household now had an incentive to work to meet the quota and whatever extra it made could be sold at a profit. Production yields on collectives with the household system were far greater than on other farms and the government began allowing more farms to adopt the new system. By 1983, 98% of agricultural collectives in China had adopted the new system.<sup>11</sup> Leases were extended from 5 years to 30 years so that farmers would have an incentive to invest more money and resources toward the farm and further increase its productivity. The agricultural reforms showed that the profit incentive was a key to improving efficiency.

## **Privatization**

Privatization began in its first stage (1979-1983) by allowing state owned enterprises (SOE's) more autonomy in making decisions and giving them financial incentives. Industries that produced over the quota allotted to them were either allowed to sell the surplus for a profit or were given a performance related bonus for the increased productivity. Enterprises that exported goods were allowed to retain part of the foreign exchange earnings for their own use. In the next stage between 1984 and 1986, enterprises were responsible for their own financial obligations and were gradually introduced to market forces. Now instead of taking part of the profit, the government charged a profit tax (similar to a corporate income tax on capitalist systems). In the last stage (1987-present), state owned enterprises adopted several corporate standards such as a board of directors, and annual financial statements.

Rural industries were privatized through TVEs (town or village owned enterprise). Initially TVEs suffered due to lack of access to credit, raw materials and market. With the reforms of the 1980s TVEs began to take off and by 1993 TVEs accounted for 38% of total industrial output. These TVEs were owned by cooperatives and were responsive to the market. They had many of the advantages of privately owned

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<sup>11</sup> Lin, J.Y. (1988) "The Household Responsibility System Reform in China's Agricultural Reform: A Theoretical and Empirical Study." *Economic Development and Cultural Change* 36(3, supplement) (April): S199-S224.

industries in the west. They had to obtain raw materials and energy from the market and were not entitled to state subsidies. Their employees could be fired and wages were set to market conditions. These enterprises quickly became far more profitable than their state owned counterparts. In fact the growth of TVEs served a dual purpose of forcing the state owned industries to become more competitive or face closure by the government. The TVEs also brought the prices of raw materials and energy back into line with their actual market prices.

Beginning in the 1990s several foreign companies were allowed to set up joint venture partner ships with state owned enterprises. Through this method, the government was able to stabilize several money losing industries without selling them outright. The requirement of a joint venture before a foreign company can enter the market has many special benefits for the economy. It forces the foreign company to transfer some technology and managerial control to the domestic partner. It also prevents the foreign company from completely extracting all the profits it makes out of the country.

### **Special Economic Zones**

In conjunction with the reforms, the government of China began allocating certain cities and special economic zones. These zones were free of all government restrictions on economic and business transactions. Corporate profit taxes were very low in these zones, and profits were fully convertible to other currencies. These zones quickly attracted large foreign investments and multinational corporations began seriously looking at setting up plants in these zones. In these zones, private businesses were allowed to set up shop and export the good produced there free of Chinese tariffs and taxes.

### **Currency**

In the years 1979-1980, the exchange rate was roughly 1.5 yuan to 1 US dollar. This artificially low rate could not cover the cost of exports. Therefore a dual rate system was created where commodity trade was settled at a rate of 2.87yuan while all other transactions still occurred at the lower rate. In the mid 1980s the government allowed the value of the yuan to fall and introduced centers at which enterprises could exchange yuan for dollars to purchase imports. Allowing the exchange rate has a number of effects. While it makes imports more expensive for the Chinese it makes exports very competitive. By allowing the value of the yuan to fall against the dollar, China began its road to becoming the manufacturer for the world. The words "Made in China" owe a great deal to foreign exchange rate reform. In 1994 the dual system was combined and a managed floating exchange rate came into being. Today there is in fact much pressure in the U.S congress on the Chinese government to allow the yuan to appreciate in value.<sup>12</sup>

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<sup>12</sup> *Cato Journal*, Vol. 16, No. 2 (Fall 1996).

## **Current Status**

China has enjoyed double digit economic growth for over a decade now. They have one of the largest amounts of foreign currency reserves in the world and have begun to invest it in a multitude of places. While China hasn't fully transitioned into a capitalist free market economy, it is very close. Prices of most goods and services, with a few exceptions, are market driven. The growth in the manufacturing industry has led to large influxes of people moving from rural areas to the cities and this of course has led to a host of issues. Income disparities have also increased dramatically, and the government faces mounting pressure to ensure that rural populations are not left behind. Within socialist or communist societies, inequalities become especially glaring as these societies are supposed to eliminate these inequalities.

## **Integration into the World Economy**

The paths to reform by China and Russia show the different issues that must be considered both at a micro and macro level. Liberalizing too quickly without the proper social safety nets and legal framework can have disastrous consequences. At the same time, liberalizing too slowly can cause a nation to lose foreign investment to other countries that are opening up faster. We have seen that forcing foreign firms to set up joint ventures can have beneficial results but, in order for this to succeed, domestic firms must be given an opportunity to catch up to international standards. The same dilemma is faced when it comes to taxes and tariffs. If taxes and tariffs are set too low, foreign firms can flood the economy in transition and domestic industries will be forced out of business. If on the other hand tariffs are set too high, foreign companies will not enter the market, and uncompetitive state owned and privately owned enterprises will continue to fail to reach maximum productivity.

As stated above, government planners must put in place measures to ensure that increased economic growth is more evenly distributed. If agricultural and rural industrial wages do not keep pace with urban wages, it can lead to civil unrest and political instability. Both China and India exemplify this current predicament. In India, the Bharatiya Janata Party (BJP) lost power after a decade of controlling the government largely because the economic progress brought on through reforms did not reach the large rural populations. Like many economies in transition, a majority of India's population still lives and depends on agriculture. This is why land reform is so important.

Any discussion about the world economy would be incomplete without discussing trade barriers. Economies in transition often have domestic industries that are not yet ready to compete in global markets. Reasons for this include lack of technology, high costs of natural resources and lack of capital for modernization. However, governments in these countries may have interests in keeping these industries running despite lower cost imports. Agriculture is a sector that falls in this category. Many economies in transition as well as developing economies produce agricultural goods at much lower costs than developed economies, yet developed nations will continue to subsidize farms or put in place import tariffs to prevent foreign goods from supplanting domestic

agricultural output. Farm subsidies in developed nations, highlights the point that economies in transition are not the only economies that suffer from industries that cannot compete in global markets.

## **Conclusion**

It is vital for nations with economies in transition to integrate into the large global economy. This opens up global markets for exports, reduces the cost of imports and attracts foreign investment and new technology. Aiding economies in transition is mentioned in the U.N Millennium Declaration<sup>13</sup>. It can be asserted that most economists have come to accept that global trade results in more winners than losers. The question is how to bridge the transition? In this paper, the contrasting approaches of China and Russia have been discussed to highlight the pitfalls that come with integration. These nations and others are transitioning from one in which the state is responsible for jobs, health and food to one in which the individual is responsible for all these. A particularly vivid illustration of this dilemma comes from a political cartoon in which the first two boxes show a Russian rejoicing at the prospect of living in a capitalist society. He no longer has the government telling him what he can buy, where he can live and where he has to work. In the final box, however, he is crying because he has no idea how to make such decisions on his own and how to fend for himself in such a world. It is ultimately the government's job to bridge this gap, but other nations and the U.N can help. In 1993, the General Assembly passed a resolution (G.A. res. 48/181)<sup>14</sup> to reaffirm a commitment to aid economies in transition toward market-oriented policies that will result in a positive impact on world trade and global economic growth. It was only after the fall of the Soviet Union could a body such as the U.N actually endorsed one economic system (capitalism) over another (communism). The resolution also calls on the International Monetary Fund (IMF) and World Bank in addition to the U.N to provide policy advice and technical assistance to countries with economies in transition. While the IMF and World Bank play a large role in such activities, it is important to note that their advice is not always sagacious and has led to economic crises in numerous economies including Russia (as discussed earlier) as well as Argentina. The rapid economic liberalization in Russia occurred largely through the advice of the IMF and the lessons from it should not be forgotten.

Another area that needs to be addressed is government corruption. While there is no doubt that corruption in some form exists in all economies including capitalist ones, economies in transition often suffer from such severe corruption that it impacts the overall economy significantly. In Russia, China and much of Europe, all business transactions are hampered by the need to bribe government officials in order to gain various permits. Transparency International, a well-known non-governmental organization (NGO) that is committed to spotlighting and combating corruption

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<sup>13</sup> <http://www.un.org/millennium/declaration/ares552e.pdf>

<sup>14</sup> <http://www1.umn.edu/humanrts/resolutions/48/181GA1993.html> A/RES/48/181. Delegates should also examine the latest resolution on this topic: A/RES/61/210 December 20, 2006.

worldwide, ranked China and India tied for 72<sup>nd</sup> in the world, along with Mexico, Morocco, Peru, and Suriname, and Russia tied for 143<sup>rd</sup> in the world (with Gambia and Indonesia) of 179 countries surveyed.<sup>15</sup> The U.N Convention against Corruption<sup>16</sup> asks member states to aid in efforts to fight corruption both within their borders and outside. Battling corruption also requires a legal framework to do so. GA-2 Resolution 59/243 calls upon the U.N and Bretton Woods institutions (i.e. the IMF and World Bank) to aid in “strengthening the legal and political framework for completing market-oriented reforms.”

A successful transition to a market-based economy must be accompanied by vigorous and sustained oversight as well as a real commitment to protecting the most vulnerable segments of society during these transition periods. Furthermore, the new wealth that is created must be distributed in a fair and transparent manner so that all people feel that they have a realistic chance to benefit from new economic freedoms being introduced. Referring to the incredible concentration of wealth in Mexico, specifically, and many economies in general, Brian Winter writes “This kind of enrichment was not what made people tear down the Berlin Wall. Countries from Eastern Europe to Latin America did not undergo painful reforms during the 1990s just so a handful of people could get very wealthy. Study after study has shown that the concentration of economic power in so few hands leads to a slower pace of technological innovation, unequal lending practices, and the stunted development of capital markets....”<sup>17</sup> The General Assembly Second Committee and interested stakeholders must commit themselves to establishing freer and fairer markets in the economies undergoing transitions without blindly binding themselves to unfettered and unregulated market capitalism.

### **Guiding Questions**

If the nation you represent has an economy in transition, what kind of path has it embarked on to integrate into the global economy? If you don't represent such a nation, does your nation have major trading partners with such economies? What kind of bilateral trade agreements are there with such a nation and are they mutually beneficial?

Many of the U.N resolutions passed on this topic are vague and simply affirm a pledge to aid economies in transition. What forms of technical or financial assistance can the U.N provide these countries? Are they looking for loans, better trade agreements, and larger foreign investment?

What role should NGOs and institutions such as the IMF play in aiding economic liberalization?

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<sup>15</sup> Transparency International, “Corruption Perceptions Index 2007”.

Found at: [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/2007](http://www.transparency.org/policy_research/surveys_indices/cpi/2007) Delegates should note that the lower the ranking for the country, the more widespread corruption is believed to be.

<sup>16</sup> GA-2 Resolution 58/4

<sup>17</sup> Brian Winter, “How Slim Got Huge” *Foreign Policy* November/December 2007.

