



# The Illusion of Westernisation in Russia and China

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Russia and China have similar heritages. They were and remain authoritarian martial police states, deviating substantially from the cultural, institutional, and behavioural requirements of efficient democratic free enterprise. Both modernised without westernising (preserving their authoritarian martial police states), but with conspicuously different results. These disparities are catalogued, analysed and attributed to cultural factors inclining Beijing to pursue a disciplined, value-adding development strategy that is nearly the antithesis of Moscow's reliance on natural resource extraction and rent-seeking. China's relative authoritarian success, and its stellar growth performance *vis-à-vis* western democracies leave open the question of comparative systems merit. Could some authoritarian martial police states be superior to democratic free enterprise as some scholars are beginning to suggest? Close scrutiny indicates that they cannot; that authoritarian systems are crisis prone, dynamically inferior and welfare diminishing after the advantages of relative backwardness have been exhausted in the long run.

*Comparative Economic Studies* (2007) 0, 000-000. doi:10.1057/palgrave.ces.8100232

**Keywords:** Russian economy, Chinese economy, growth, democracy, westernisation

**JEL Classifications:** D60, D90, FO2, F21, P51, P52

## INTRODUCTION

The economic performance of Russia and China during the last quarter century could hardly have been more disparate for nations which claimed to have been twin planned communist systems in 1980, and had behaved similarly during the preceding 30 years. What explains the disjuncture? And what does it imply about the competitive viability of authoritarian societies in



the future? This essay argues that Russian and Chinese behaviour is best explained by common features of their core systems that were momentarily aligned during the postwar Soviet era, and latent cultural propensities that emerged later. It also contends that while authoritarian systems can survive, modernise, mimic aspects of advanced societies, and sometimes briefly rival western democratic free enterprise, the 'idea of the west,' remains best (Huntington, 1996).<sup>1</sup>

The communist paradigm which forced the core Russian and Chinese systems 1949–1991 to perform in tandem was based on the principle of physical systems management, or natural economy where the state criminalised private ownership of the means of production, business and entrepreneurship (Soviet War Communism 1917–1921), and as a consequence was drawn to fill the vacuum by requisitioning and rationing. Ownership, business and entrepreneurship in these regimes were state monopolies, precluding private profit-seeking, which allegedly exploits the masses. Likewise democracy was proscribed because it was equated with exploitation by the ballot, making Chinese and Russian communism 'beneficently' authoritarian.

Communist leaders were taught early by the Soviet economic collapse 1917–1921 that requisitioning and rationing were not efficient enough to assure national survival. Planning was needed to allocate resources to better use, and where this did not suffice individual self-seeking had to be enlisted into state service. Rulers found that plan constrained individual utility seeking by state enterprise managers, supervisors, and collective farmers could be tolerated, and informal second economy activities overlooked, but open markets threatened their regimes' power. (Rosefielde, 2007). Both Russia and China adhered to this paradigm throughout the Maoist (1949–1976) and early Deng Xiaoping (1978–1992) eras. They tolerated intra-state negotiated haggling and supply contracting, peasant communal agriculture and some informal activities without permitting consumer demand to govern the provision of public and household goods. The state was in command. It claimed to embody the people's will, promoting and protecting social welfare, and eclipsing western challengers.

But the face behind the congenial socialist mask was a grim. Russia and China were authoritarian martial police states. This term is descriptive, not polemic. It means that sovereignty (the power to determine supply) over

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<sup>1</sup>The counterview that democracy is an impediment to economic growth has many not-so-closeted proponents. See Varshney (2007). It is assumed throughout that no system performs perfectly, and for convenience that all diverge proportionally from their ideals. Merit is assessed from the standpoint of the Pareto–Arrow–Bergson norm. See Rosefielde (2007).



public goods was the right of the Communist Party, not the people's democratic will, expressed through fair, multi-party electoral representation. The leadership in this authoritarian capacity chose to maintain immense military establishments supported by martial attitudes, and preserved its stranglehold on intra-party political, administrative, military, economic and civic power through omnipresent secret police. The KGB (*Komitet gosudarstvennoy bezopasnosti*) and NSCC (National Security Council of China) were the swords and shields of communist autocracy.

These characteristics distinguished the Communist east from American democratic free enterprise or European social democracy (Linz and Stepan, 1996). In the west, individuals not autocrats are the sovereigns of their welfare achieved through private ownership, legitimate business, entrepreneurship, markets, democratic participation, civic freedom and responsible electoral representation. The idea of the west is self-regulating in both private and public spheres, not imposed from above by 'progressive autocracies'. Although experts understand that neither the east nor the west is inherently superior judged in terms of social welfare (Bergson, 1965), the self-destruction of the Soviet Union has persuaded many that democracy and competitive markets are better than authoritarian martial police states on technical and ethical grounds.

Russian and Chinese leaders in the 1980s grudgingly conceded that communist physical systems management, intra-state enterprise haggling, collectivist agriculture, and the shadow economy were inferior as the west claimed, but were not convinced about the necessity of democracy, popular limitations on secret police, and military power. They were prepared to experiment with private ownership, business and entrepreneurship; mixed with state markets partially responsive to consumer demand, and residual aspects of planning, physical systems management and state ownership. But the Chinese Communist party and post-communist Russian leaders refused to relinquish their autocratic rule (Rosefielde and Hlouskova, 2007),<sup>2</sup> both believing like Hitler before them that democracy and self-regulating free enterprise under the rule of contract law were not essential for prosperity.

OECD statistics reported in Tables 1 and 2 support Chinese communist leaders on this important point, but not the Russians. Chinese gross domestic product and living standard growth 1973–2000 surpassed democratic norms by a wide margin, while Russian performance was manifestly inferior. It improved during the recovery phase of the Putin years (although inflation and unemployment remain high), but the jury still is out on whether Moscow can



**Table 1:** Comparative size estimates per capita GDP 1973–2000 (America=100; per cent)

	Russia	China
1973	36.3	5
1980	34.6	5.7
1990	29.6	8
2000	18.3	12.2

Source: Angus Maddison, *The World Economy: Historical Statistics*, OECD, Paris, 2003, pp. 69, 89, 101, 184, 234, and 262.

Note: The figures for Russia 1973, 1980, 1990 pertain to the USSR. This does not distort the trend because per capita income in the RSFSR was close to the Soviet mean.

**Table 2:** Comparative GDP size estimates 1973–2000 (America=100; per cent)

	Russia	China
1973	42.8	20.9
1980	40.4	24.7
1990	34.3	36.3
2000	10.0	54.5

Source: Angus Maddison, *The World Economy: Historical Statistics*, OECD, Paris, 2003, pp. 55-7, 85-6, 98-9, 170, 174, 176.

Note: The figures for Russia 1973, 1980, 1990 pertain to the USSR. Approximately 30% of the relative decline in Russia's GDP 1990–2000 is attributable to territorial downsizing.

achieve robust sustained growth after the petro-boom has run its course (Table 3). Why did the Chinese succeed, where the Russians failed?

## MUSCOVY

Some of the blame for Russia's catastrophic performance lies with Mikhail Gorbachev's and Boris Yeltsin's bluster, and the G-7's misguided advocacy of shock therapy (shock without therapy), but the deeper problem was Muscovite culture, especially its peculiar brand of repressive authoritarian rent-granting that elevates power relationships above utility and profit maximising. From the rise of the Grand Duchy of Muscovy under Ivan the Great, and Ivan the Terrible's subsequent ascension to the title of Tsar, Russia has been governed as a rent-granting autocracy where all the nation's assets belonged to the ruler *de facto* or *de jure*, managed by a small coterie in return for fealty and tax, without the rule of civil and contract law (Rosefield, 2007; Hedlund, 2005). Sovereign grants were discretionary and revokable without cause or compensation. The status of those subservient to rent-grantees, whether agents, serfs, slaves or hired workers were similarly insecure.

**Table 3:** Recent Russian macroeconomic performance (per cent, unless designated otherwise)

	2001	2002	2003	2004	2005
CPI inflation	18.6	15.1	12.0	11.7	10.9
Real wage growth	19.9	16.2	10.9	10.6	12.6
Real GDP growth	5.1	4.7	7.3	7.2	6.4
Real manufacturing growth	—	—	10.3	10.5	5.7
Food	—	—	6.9	4.4	4.4
Textiles	—	—	1.2	-4.0	-1.5
Wood and wood products	—	—	9.7	8.7	4.5
Chemicals	—	—	5.4	6.6	2.6
Basic metals	—	—	7.2	3.9	5.7
Machinery and equipment	—	—	19.0	21.1	-0.1
Electrical equipment	—	—	43.2	34.5	20.7
Transport equipment	—	—	14.0	11.5	6.0
Gross fixed capital formation	10.2	2.8	13.8	11.3	10.5
Unemployment (ILO_type)	8.8	8.5	7.8	7.9	7.5

Source: Federal Service for State Statistics, Central Bank of Russia, Ministry of Finance, IMF Expert Group, OECD calculations. OECD Economic Surveys, *Russian Federation 2006*, OECD, Paris, 2006, Table 1.1, p. 23; Table 1.2, p. 24; Table 2.2, p. 80

Production was organised on the basis of command, assignment and coercion with subjects lacking rights, or enforceable legal protections. Rudimentary market transactions in kind or coin were pervasive, but always subordinate to physical power. As a consequence, the majority was dis-empowered, and even the position of insiders was weak. Consumer sovereignty in employment and production was negligible. The preferences of the powerful counted, but were restricted by the system's intrinsic anti-competitiveness, and the precariousness of income and wealth throughout the hierarchy. The virtues of thrift, value-added profit-seeking, productive investment and even lifetime utility maximisation were severely debased, encouraging a here-today-gone-tomorrow mentality that diminished economic potential. These defects were partially compensated by acquired skills allowing transactors to negotiate fluid environments, and admirable resilience to adversity, but Muscovy whether in Tsarist, Soviet or post-communist guise remained fragmented, inefficient and crisis prone. It displayed a preference for autarky and satisficing, giving 'fortress Russia' a ramshackled look (Rosefield, 2006a, b; Trenin, 2006), and an aversion to globalising westernisation.

Q1

Moreover, experience has shown that while copycat modernising reforms are possible, none were satisfactory substitutes for self-regulating democratic free enterprise, or EU social democracy. Russia's Tsars tried slave-serfdom, hereditary nobility, emancipation, direct foreign investment and technology transfer, advisory parliamentarianism, and Pyotr Stolypin's proprietary peasantry (Gerschenkron, 1961). The Soviets criminalised private property,



business and entrepreneurship, dabbled with leasing (market socialism) during NEP (New Economic Policy) and under Gorbachev after 1987, experimented with planning incentives, price-fixing, *tolkachi*, enterprise lobbying, inter-firm contracting, the shadow economy, spontaneous privatisation and discretionary managerial revenue expenditure. Boris Yeltsin licensed looting (asset-seizing), insider rent-seeking, oligarchy, price decontrol, state and private Ponzi schemes, hyperinflation, and diversion of natural resources from the VPK (military industrial complex) to civilian cronies. Putin reimposed autocratic discipline by re-empowering the secret police, VPK and civilian bureaucracy, collared oligarchy, reduced capital flight and dismantled much of the Soviet welfare apparatus in kind (Rosefielde and Hedlund, 2008; Rosefielde and Hlouskova 2007).

Each order altered the mechanisms of power, the status of players and distribution of benefits. But throughout rent-granting and resistance to the rule of contract law persistently served as the foundation for the Kremlin's authoritarian martial police state, and as primary causes for Russia's inferior economic performance and potential (Rosefielde, 2007; Ledeneva, 2006).

This said, the catastrophic behaviour of Gorbachev's Market Communism 1987–1991, and Yeltsin's post-Communist Market Muscovy (1992–2000) deviated so far from the Soviet Command Muscovite norm that it begs for further elaboration. Was Russia's 17-year hyperdepression (1989–2006) caused by accumulative disequilibrium diagnosed by Igor Birman before the deluge in 1986 (Birman, 1983, 1986; Rosefielde, 1988),<sup>3</sup> or does the blame rest primarily with Gorbachev and Yeltsin? Many interpretations are possible, but the evidence points a finger at both, while illuminating the inherent convulsion prone nature of the Muscovite system. Birman characterised Command Communism (1929–1953) and Reform Communism (1954–1986) as economies of perpetual shortage reflecting the fundamental disequilibrium of what Fredrich von Hayek called planned chaos (Hayek, 1935), including the second economy, epitomised by empty retail shelves, and unspendable excess cash balances (forced savings). This consumer goods famine did not mean that Soviet investment durables, weapons and hence GDP were stagnant or declining. There was growth, and living standards were probably rising gradually, but this was not good enough for powerful strata of society (Rosefielde, 2003). Three years after coming to power, prodded by disgruntled

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<sup>3</sup> 'In my opinion, the negative growth of productivity starting only at the end of the 1970s marks the end of the Soviet economic system. Together with Professor Marshall Goldman, I think that the economy is in a crisis, and, perhaps without him, think that it will continue to deteriorate. Summarizing, the Soviet economy will not muddle through; it will deteriorate further' (Birman, 1986, pp. 69–71).



insiders, Gorbachev launched *perestroika* (radical economic reform) to rescind Reform Communism, substituting Market Communism that he promised would usher in an era of socialist consumer prosperity. Had Gorbachev been competent and committed to his rhetorical agenda, he should have constructed Langan market communism, retaining the criminalisation of private ownership, business and entrepreneurship, but did not. Instead, he opted for a new Muscovite model that best served insiders who spontaneously privatised state property, and diverted enterprise revenue to themselves. They had Gorbachev's ear after 1986, coopting his rhetoric and goading him to destroy Market Communism by adopting policies that disrupted established inter-industrial supply linkages, causing production to contract in civilian industry outside the reach of the VPK. Yeltsin then completed the demolition process by embracing shock therapy, an euphemism for massive cancellation of state procurement contracts, including weapons (Rosefielde, 2005a, b), coupled with exhortations for managers to be self-sufficient when firms had no alternative clients, no credit, no capacity to redesign products, and no marketing skills. The admonition was little more than a ploy to conceal Yeltsin's policy of social abandonment.

Q2

It is precisely in this sense that Gorbachev and Yeltsin are responsible for *catastroika*. Muscovite Command and Reform Communism could have chugged along *ad infinitum* producing weapons and things no one desired, had they stood fast against self-seeking prompted by the Soviet economy of shortage.<sup>4</sup>

<sup>4</sup> Vitaly Shlykov, former deputy chairman of Yeltsin's Russian Defense Council has recently clarified an important aspect of Birman's thesis. He contends that Soviet Command Communism was a shipwreck waiting to happen because of structural militarisation, and that Yegor Gaidar's shock therapy never stood a chance of success (Shlykov, 2005, 2006a, b). Shlykov suggests that Soviet cumulative disequilibrium was due not just to the failures of planning, and second economy diversion, but excessive natural resource reserves held by the VPK, together with war mobilisation entailments on civilian production capacities that kept a large amount of consumer goods production off line. The term structural militarisation coined by Shlykov, describes the institutionalisation of Russian war preparedness including the construction and maintenance of enormous weapons production capacities, and the material reserves needed for full throttle arms manufacture. Under Command and Reform Communism weapons were procured at a pace which implied that the Soviet Union was continually at the brink of war. The government and VPK planned for the worst, and then added more for safety sake, fully utilising capacities, except those dedicated to civilian war mobilisation reserves. According to Academician Yuri Yaremenko, Shlykov and some American DOD calculations military activities absorbed roughly 30% of Soviet GDP in the late 1980s (Rosefielde, 2005a, b). During the Yeltsin years arms production plummeted, but capacities including those for civilian wartime mobilisation were preserved intact, and are currently in the process of being brought back on line (Cooper, 2004). Shlykov in effect contends that Birman's economy of shortage was the consequence of structural militarisation, and therefore the ultimate source of its derailment, not only because the Soviet arsenal was excessive, but because it hoarded colossal natural resource, and raw material reserves that could have been allocated to better alternative use

Q10

Q11



## THE REIGN OF HEAVEN

China shares many of Muscovy's characteristics and propensities, with a few critical differences that may withstand the test of time. First and foremost both civilisations are imperial, ruled by omnipotent emperors (Communist Party first secretaries, presidents) with the power of unrestricted informal command (but not totalitarian nano-management) over their subjects. Both have laws and judiciaries, but not the politically tamper-proof rule of contract law required for well-functioning markets in the west. Both, at least since 1992 grant state enterprise managers extensive custodial rights,<sup>5</sup> and in many instances proprietary stakes as well. Most state companies are allowed to engage in for-profit consumer business and act entrepreneurially. Private

inside 'fortress Russia', including commercially viable innovation. It is possible to counterargue that there were no alternative superior uses under autarkic planned chaos without nullifying Shlykov's larger point. Even if there had been alternatives, they would have been disregarded in the Soviet authoritarian martial police state, putting the system squarely on a path to self-destruction with or without the shadow economy, an observation that may once again prove prophetic as Putin increasingly embraces the Soviet superpower mindset (Laskova, 2006). Shlykov conjectures that this vicious cycle could have been broken if Yeltsin had overridden Yegor Gaidar, using mobilisation of natural resource reserves to maintain full industrial employment and by rescinding reserve mobilisation capacity entailments to expand market-led civilian production. And he insists that Putin can still turbo-charge domestic consumer goods production by bringing reserve mobilisation capacities into operation for civilian purposes. But it is worth pondering whether Muscovy cleansed of autocracy, great power military, secret police and 'fortress Russian autarky' is an oxymoron. The Muscovite system may not be eternal, but displayed little inclination to cede the field to democratic free enterprise under the rule of contract law for more than half a millennium. Its fortunes may wax periodically during petro bubbles, and wane with the Dutch disease, or bubbles may burst (OECD, 2007), with little real prospect of ever being globally integrated or competitive.

<sup>5</sup> In the Chinese case see 'The Regulations on Transforming the Management Mechanism of State-Industrial Enterprises', July 1992. Other reform milestones include: 'open door' policy allowing foreign trade and investment to begin (1978), decision to turn collective farms over to household (1979), township and village enterprise (TVEs) given stronger encouragement (1979), special economic zones created (1980), self-proprietorships (getihu) encouraged, of less than eight persons (1984), provisional bankruptcy law passed for state-owned enterprises (1986), contract responsibility system introduced in state-owned enterprises (1987), 1988 beginning of retrenchment of TVEs (1988), stock exchange started in Shenzhen (1990), decision to establish a 'socialist market economic system' (1993), company law first introduced (1994), renminbi begins to be convertible on current account (1994), multiple exchange rates ended (1994), shift to contractual terms for state-owned enterprises begins (1997), constitutional amendment passed that explicitly recognises private ownership (1999), China accedes to the World Trade Organization (WTO) (2001), communist party endorses role of the private sector, inviting entrepreneurs to join (2002), decision to 'perfect' the socialist market economic system (2003), constitution amended to guarantee private property rights. (OECD, 2005, p. 29). Also, on 18 March 2007 a law passed by the National People's Congress (effective 1 October 2007) defines the scope of state, collective and private property and grants them equal protection. Also, land use rights on residential dwelling will be 'automatically' extended, and compensation provided in cases of expropriation (Li and Fung Research Center, 2007).

Q12



enterprise is permitted based on leases of varying duration,<sup>6</sup> and in Russia freehold ownership has become widespread. Russia and China both have managed foreign exchange rates and some state price-fixing, but for the most part prices are partially competitive in varying degrees. Both permit licensed transactors to participate in international trade and publically welcome foreign direct investment (FDI). Both are adept at pirating foreign technologies, illegally copying trade marked designs, and flouting intellectual property rights. Both have powerful regulatory economic bureaucracies,<sup>7</sup> employing conventional monetary, fiscal and administrative policies to manage aggregate effective demand. Both have social welfare safety nets and provide barebones social services.<sup>8</sup> And of course both are authoritarian with various kinds of subsidiary elective procedures, possess immense nuclearised military establishments, and use secret police to discipline and repress opposition to the system and supreme leader.

At this level of abstraction there appears to be little that can explain the immense disparity between Chinese and Russian economic performance during the last quarter century (Tables 1 and 2), nor China's superior recent performance (Table 3 and Table 4). The differences between their systems and programmes however are more illuminating. China in some important regards is closer to Langean market socialism (or Soviet NEP) because most of the means of production including real estate remain state owned, with assets leased to state managers and independent entrepreneurs (Lange, 1938). China has been much more cautious about permitting insiders to spontaneously privatise and otherwise enrich themselves from state assets, no doubt chastened by the chaos of the 'cultural revolution'.<sup>9</sup> Nor has it condoned private capital flight or tolerated behaviour subversive to the Party's development programme. Yeltsin had the power to emulate Deng's

Q3

<sup>6</sup> There is little freehold property in China. The state is the primary leasor, and consequently remains ultimate owner. This encumbers private proprietary rights, and justifies the claim that China operates today as a form of Langean market socialism. The OECD, among others, prefers to focus on claimants to residual income (profit) as the distinguishing characteristic of private property. The scope of the state sector on this score was only 40.8% of the economy in 2003. The OECD's analysis of Chinese economic performance conceals the leasing distinction, permitting it to convey the mis-impression that China's expanding private sector is rapidly driving systemic convergence toward full free enterprise where property rights are market determined, not imposed by the state (OECD, 2005, pp. 80-94).

<sup>7</sup> Russia's economic regulatory bureaucracy is relatively small. In 2004 it employed 3.2 federal administrators per 1,000 population, compared with 3.8 in America, and 5.1 in Canada. See OECD (2006, p. 119).

<sup>8</sup> (OECD (2007, Chapter 5, pp. 187-222).

<sup>9</sup> Kurtenbach (2006). These deals are null and void and perpetrators will be punished. For a discussion of traditional Chinese landownership, see Deng (2007).



**Table 4:** Recent Chinese economic trends and prospects per cent

	1983–1988	1998–2003	2003	2004	2005	2006
Real GDP growth	12.1	8.0	9.5	9.5	9.0	9.2
<i>Sources of growth</i>						
labor	1.5	0.3				
capital	5.0	4.9				
residual	5.6	2.8				
of which education	1.0	0.5				
Inflation			1.2	3.9	4.0	4.0

Source: Data are from national sources. OECD, *Economic Surveys, China*, Vol. 2005/13, September 2005, Paris, pp. 32, 60

protection of the people's wealth against insider asset seizing and the PRC's orderly liberalisation even after he destroyed communist power, but chose not to exercise it. Similarly, the Chinese leadership never abandoned Command Communist resource mobilisation. Some involuntary unemployment has been accepted as the price for curtailing unprofitable state enterprises, but monetary and fiscal policy, together with state civil construction is dedicated to fostering rapid development in sharp contrast to the Yeltsin administration which treated resource demobilisation as an unfortunate consequence of crony asset-grabbing. Even now Putin's National Projects campaign is mostly empty rhetoric (OECD, 2007). Also, with respect to governance, the Confucian foundations of China's administrative and regulatory bureaucracies with its stress on competitive qualifying examinations and ethical self-restraint for the community's benefit seems to provide some counterweight to the venality exhibited by Russian bureaucrats who treat government posts as rent-seeking ways of making a living from bribes (OECD, 2007), with little obligation to provide worthy service. Corruption in both economies is pandemic, but the paralysis in Russia is more severe.

Q4

China also benefits from a pro-competitive commercial culture willing to satisfy customers and aggressively price discount, whereas Russians treat service as an avoidable burden, and price gouge in the spirit of Gogol's *Dead Souls* (Gogol, 1966). Chinese merchants do not disdain over-charging the gullible, and the quality of domestic construction and manufactures is shoddy, but these problems are milder where buyers are savvy, like the wholesale export sector. Although Russian construction contractors ruthlessly exploit itinerant Central Asian workers,<sup>10</sup> there was little scope for using cheap labour as a platform for industrial exports and import substitutes under Yeltsin, and none now that the Putin administration has overvalued the

<sup>10</sup> Bigg (2005).



ruble.<sup>11</sup> Moreover, Russia's weak industrial and service competitiveness is compounded by its abundant natural resource riches, which allow the privileged to import whatever they choose without concern for de-industrialisation, and attendant involuntary underemployment.<sup>12</sup> As George Kleiner, Deputy Director of TsEMI puts it, Russia's economy is an archipelago with a few islands of natural resource financed prosperity, and a multitude of impoverished industrial and agrarian islets, some partially submerged, separated by a vast sea without bridges or other adequate connections.<sup>13</sup>

China's economy also suffers from geographical segmentation between the Eastern coastal islands of modernity and its backward hinterland, but rent-granting and rent-seeking in a relatively natural resource poor setting have not repressed industry, nor industrial growth in export and import substitution sectors (Zweig and Bi, 2005). China's authoritarian martial police state in a nutshell thrives by promoting value-added (especially in the FDI intensive export sector), while Russia is content to live as it can from extraction, spillovers, and cheap Chinese consumer goods.<sup>14</sup>

Q5

China's pursuit of pro-value-adding industry and commerce furthermore does not appear to be severely hampered by military prioritisation. Although its two million plus strong armed force is the world's largest, and its military industrial base is regionally strong, the scale of defense activities is substantially smaller than Russia's on a per capita basis (Office of the Secretary of Defense, 2005; Rosefielde, 2005a, b). The high opportunity costs of raw material mobilisation reserves mitigates against replicating Russia's Soviet era hoarding (Shlykov, 2005, 2006a, b), with attendant implications for the scope of war mobilisation entailments on civilian production capacities, which might otherwise constrain pro-value-adding industry.

The crowning element of China's authoritarian systemic success however is its aggressive pursuit of technology transfer, not through the industrial espionage Putin practiced as a KGB control in East Germany,<sup>15</sup> but *via* hands-on direct foreign investment in export industries. The Soviet Union had, and

<sup>11</sup> Russian leaders usually favour a 'strong' ruble providing the Kremlin with favourable terms of trade. A wide variety of restrictive policies are utilised to compel foreign purchasers to pay more for rubles than they would absent government intervention. This problem is obscured today by speculative factors associated with the 'petro-bubble', but the underlying reality is discernible. If Russia's inferior non-natural resource exportables had to be priced to clear the current account in an environment free of state manipulation, the ruble would depreciate drastically. It is in this sense that the ruble is overvalued.

<sup>12</sup> See Rosefielde and Hedlund (2008), chapter 11 for a detailed assessment.

<sup>13</sup> George Kleiner, personal interview, Moscow, 16 May 2006.

<sup>14</sup> Evgeny Gavrilin, Chief economist, Troika Dialog, personal interview, Moscow, 30 May 2006.

<sup>15</sup> Pacea (2004)



Russia today has no difficulty innovating commercially useless technologies.<sup>16</sup> Muscovy's problem is not science, mathematics and engineering. It is an ongoing inability to apply these intellectual resources profitably. Deng and his successors have partly overcome this impediment by opening enclaves to privately owned and joint state venture FDI, allowing its nationals to master superior transferred technologies, the products of which have assured markets in the west (Ma, 2005). And it has leveraged these gains by domestic imitation, tied to the global marketing expertise of the overseas Chinese. In doing so it has enticed direct foreign investors granting them access to cheap resources, especially labour, creating platforms for continuous rapid industrial modernisation, supplemented by domestic imitators and indigenous entrepreneurship (Hale and Hale, 2003).

The process can be interpreted in Alexander Gerschenkron's framework as a 'missing prerequisite'.<sup>17</sup> Deng Xiaoping discovered that barriers to growth concealed by Mao's misleading GDP growth statistics, associated with the low quality of China's domestic importables could be side-stepped first by enticing FDI, and second by harnessing transferred technologies to fuel high value-added export led development. Foreign investors were lured by abundant outsourcing opportunities and cheap labour that made coastal China a low cost export platform. The more exports soared, the more FDI was attracted (Table 5), and the greater the scope for internal transfers. This two-pronged strategy increased real income doubly by raising the value-added of exportables and domestic goods where conditions permitted. Its feasibility hinged on an undervalued foreign exchange rate, repressed wages, and high-quality manufacturing tailored to western taste. The leadership deliberately under priced exports (by undervaluing the RMB), and overtraded from a static perspective, because it felt that the sacrifice was justified by the dynamic benefits of technology transfer and diffusion, which were particularly large due to the inertia that otherwise would have prevailed in the domestic importables sector. The strategy has proven remarkably robust, and is allowing China to become the industrial workshop for the world, with ample labour reserves to continue expansion well into the future, while Russia is content to play its natural resource card.<sup>18</sup>

Beijing's stubborn defense of the undervalued RMB shows that FDI-driven, export-oriented industrial modernisation is indeed partly a policy

Q13

<sup>16</sup> OECD (2007), Chapter 3. Cf. Sachs and Woo (2000),

<sup>17</sup> On 'missing pre-requisites,' 'relative economic backwardness,' and 'catch-up,' see Gerschenkron (1961).

<sup>18</sup> Foreign direct investment is concentrated in the natural resource sector, rather than general manufacturing. See OECD (2007), chapter 3. China's excess dollar holdings are the necessary consequence of overtrading. It will vanish as the RMB appreciates.

**Table 5:** Foreign direct investment inflows to China U.S. dollars (billions)

	2000	2001	2002	2003
<i>Total</i>	40.7	46.9	52.7	53.5
<i>Origin</i>				
Hong Kong	15.5	16.7	17.9	17.7
Taipei	2.3	3.0	4.0	3.4
Singapore	2.2	2.1	2.3	2.1
Per cent of GDP	3.8	4.0	4.2	3.8

Source: ECIC database, KPMG (2004) and national governments. OECD, *Economic Surveys, China*, Vol. 13, September 2005, Paris, p. 36

ploy.<sup>19</sup> But, it is also essential to recognise that Deng's broader two-pronged strategy would not work effectively in 'fortress Russia', even if the Kremlin undervalued the ruble because anti-competitive rent-granting dominates market behaviour.<sup>20</sup> China's relative success is more than a matter of clever development strategy. It is an artefact of an historically embedded culture, tolerant of commercial and industrial entrepreneurship, stressing responsible Confucian administration, with a government willing to put social prosperity above rent-seekers' parochial interests. China accordingly is well placed to overtake, and perhaps overwhelm its not-so-good neighbour in the decades ahead, even as the advantages of relative economic backwardness wane (Calder, 2006).

Q6

Q7

It is also well positioned on narrower technical grounds. Its population is growing, new domestic industrial capital formation is brisk, science is improving, transferred know-how is enhancing the effectiveness of domestic R&D, and financial and marketing skills are blossoming. Conventional production function theory therefore points to continued rapid growth driven by labour, capital and technological progress (OECD, 2006; Bosworth and Collins, 2007; Bergson and Levine, 1983). Russia by contrast is likely to grow more slowly than the Soviet Union did during the Gorbachev years because its labour force is declining, immigrant labour is being discouraged,<sup>21</sup> new

<sup>19</sup>The real exchange rate is gradually appreciating. Also, it should be observed that if America jawbones Beijing into substantially appreciating its foreign exchange rate, Deng's two-pronged strategy could go haywire. Some counter-claim that the RMB is overvalued because rapid productivity gains are reducing real domestic unit cost. This assumes that productivity is rising as fast as official data indicate (De Jonquieres, 2007).

<sup>20</sup>For example, Putin has prohibited foreign direct investment in 'strategic' industries, which encompasses most large, potentially lucrative undertakings.

<sup>21</sup>Fleishman (2007), 'Population' (2007). The number of able-bodied people in Russia will decrease 2.5 million during the next three years.



fixed capital formation is increasing relatively slowly, Russia's scientific base has shrunk, and R&D expenditures have fallen drastically.<sup>22</sup> A strong preference for western brand names among 'new Russians', oligarchs and *siloviki* is a further depressant. This sluggish propensity should be partly mitigated by improved foreign technology access, lingering benefits of the petro-bubble, including a rising tide of FDI, some positive aspects of post-Soviet liberalisation, and modest advances in competitiveness. Given Russia's economic backwardness, the net result could be moderate GDP growth of a few per cent per annum on official measures, and less taking account of the 'hidden inflation' Khanin has shown still persists.<sup>23</sup> And, if the petro-bubble bursts, the Kremlin surely will experience hard times. The Muscovite authoritarian martial police state is inferior in most regards, and this predictably will be reflected in periodic *smuta*, and subpar long-term Russian economic growth.

China likewise suffers from 'hidden inflation', and may find the road ahead bumpier than official statistical trends suggest. Long-term Chinese leaseholds are gradually hardening into more durable private freehold property rights that could easily tempt Communist Party insiders, like Soviet managerial, ministerial, VPK, and KGB opportunists before them to indulge in an orgy of asset-grabbing, combined with an anti-competitive rent-granting order sheltering them from newcomers and foreigners alike. This 'Russian disease' (substituting asset-grabbing for value-adding as managers' primary objective) certainly is not what globalisers are anticipating, nor is it fully compatible with China's resource endowments, its competitive proclivities or Confucian ethics (Rosefield, 2002). But if greed leads to pandemonium, the comparative authoritarian merit of China's martial police state could quickly evaporate.<sup>24</sup>

<sup>22</sup> For sources of Russian GDP growth, comparable to those in Table 4 OECD, see (OECD, 2007), Table 1.4, pp. 27, 157.

<sup>23</sup> According to Girsh Itsykovich Khanin, Russia's GDP statistics continue to greatly exaggerate real growth as they did during the Soviet era. The 1998–2003 average ratio of reported to actual is 51% (6.5/4.3% per annum). See Khanin (2005).

<sup>24</sup> Rosefield and Mills (2007), Cambridge, Perkins (2007), Naughton (2007), Woo (2007). Woo broadly agrees with this assessment, formulating the threats of disorder, growth retardation and collapse in terms of flawed institutions, poverty, inequality, and environment. He also adds fiscal balance as a potential crisis trigger. But Woo is cautiously optimistic, calling attention to the possibility that the Chinese leadership has gotten the message, subordinating development to (1) a democratic society under the rule of law, (2) a society based on equality and justice, (3) an honest and caring society, (4) a stable, vigorous and orderly society, at the 6th Plenum of the 16th Central Committee of the Communist Party of China (CPC) concluded on 11 October 2006. He recognises that the CPC's declaratory commitment to establishing an harmonious society by 2020 may be fulsome, but he insists that the altered Party line should not be disregarded. 'Specifically, I believe that the policy change has come about because the younger and better educated CPC leadership led



## WISHFUL THINKING

Until 2004 western international policy institutions like the G-7, IMF, World Bank, and OECD were unperturbed by Russian and Chinese authoritarianism, claiming that both were in the process of full throttle transition to European style social democracy, or democratic free enterprise. Although carefully caveated, it was repeatedly predicted that liberalisation, westernisation and global integration would rapidly propel living standards to the global high frontier, and strengthen prospects for world concord. It served no purpose from this perspective to dwell on the seamier sides of their authoritarian martial police states, or ponder how failed westernisation might roil international security relations.

The growing power of Russia's president, FSB, VPK, *siloviki*, military modernisation, weakened electoral institutions, combined with internal repression and external belligerency drastically altered western perceptions, scotched loose transition talk, and raised the spectre of renewed cold war with Russia, without significantly altering the posture of international economic policy institutions (McConnell, 2007; Maples, 2007). For example, the OECD in its latest report on the Russian Federation barely mentions 'transition' or democracy, but reintroduces them through the backdoor under the rubric of 'framework' requirements (OECD, 2007). It contends that Federation leaders understand and are energetically striving to improve market efficiency and popularly responsive public programmes, while acknowledging past failures. Based on this hope, and anticipated further success in 'sterilising' petro windfalls, the OECD concludes that Russian GDP will continue growing in the future as it has during the recovery years of the Putin administration, without giving any weight to the effects of a shrinking labour force, de-industrialisation, rearmament (Rosefield, 2005a, b),<sup>25</sup> creeping re-nationalisation, and increasing authoritarian coerciveness.

Q8

by Hu Jintao and Wen Jiabao recognizes that : 1. material conditions and public expectations in China have changed., and 2. unless their new policies produce significant improvements in social harmony by 2020 social instability would reduce China's economic growth, hence making the leadership of CPC in China politics unsustainable' (p. 5). 'I do not think it is naive to see the Harmonious Society program as a serious attempt at fundamental reform of China's institutions, going well beyond the reform of economic institutions'(p. 4) (Keidel, 2005; Tanner, 2004, pp. 137-156; Pei, 2006; Chang, 2001; Diamond, 2005). For a contrary view, see Liang Jing, 'Can a hypocritically benevolent government go on for long?' *Xin shiji*, March 2007. He contends that the reality behind the 'Harmonious Society' rhetoric is the corruption-driven degradation of the healthcare and education systems. Also, Liang Jing (2007) asserts that Hu wants the state sector to continuously expand to preserve communist power.

<sup>25</sup> Defense spending as a share of GDP using a 1991 base of 100 has risen from a low of 23 in 1998 to 41 in 2006(budgetary data). The recovery in arms procurement has proceeded more



It understands that Russia's attainment of sustained rapid GDP growth will be an uphill battle. Like the CIA before it in Soviet times, a combination of wishful thinking, political sensibility, and bureaucratic hedging make its assessments inoffensive, and palatable, while providing plausible deniability. But it also gives policymakers an implausible perception of Russia's future because it fails to come to grips with Muscovy's primary characteristics, captured effectively in Harry Rowen and Charles Wolf, Jr. description of the Soviet Union as an 'impoverished superpower' (Rowen and Wolf, Jr., 1990). Putin's authoritarian martial police state cannot be Pareto efficient in factor supply, finance, technological development, choice, transfer and diffusion, production and distribution because of rent-granting, restricted market entry, state ownership, sheltered 'strategic enterprises,' mal-administration, and debilitating corruption. Its comparative advantages lie in natural resources, and armaments, and its economic prospects are tied to this last. This means that even if the Kremlin is able to harness markets more effectively, and modernise in other respects, Russia's living standards will remain inferior, with its military prowess strongly affected by resource prices and availabilities. Russia will not converge to the western per capita consumption norm, tempting the Kremlin to re-prioritise the military, play the superpower card, and withdraw to 'fortress Russia'. None of this is written in the stars. Putin can repudiate Muscovy. But until he, or his successors do so, international economic institutions do a disservice to the policymaking community by making it appear that authoritarianism isn't a bar to western efficiency, prosperity and social welfare.

The same judgment holds for China. Although policymakers have not yet turned bearish, despite periodic hand wringing over Taiwan, Tibet, arms modernisation, deteriorating Sino-Japanese relations, sooner or later they are apt to recognise that authoritarianism matters. Deng's two-prong catch-up strategy, China's leasing arrangements, movements toward freehold proprietorship, and limited rule of contract law do not make Beijing's authoritarian martial police state benign, or superior to democratic free enterprise. China's partially marketised economy, like Russia's still suffers from rent-granting, rent-seeking, insider restricted market entry, state ownership, mal-administration, bureaucratic corruption, and its own mild form of military over prioritisation. Although there is ample scope for FDI and technology transfer driven growth, the joy ride would not last forever, even if Beijing avoids the 'Russian disease', keeps the RMB undervalued, and deflects Indian

**Q14** dramatically at high double-digit rates. Weapons rose from 16.6 in 1998 to 42.6 in 2003 using the same 1991 base, and appears to be continuing apace (Cooper, 2004, 2006; Frolov, 2007; Rosefield, 2006a, b, pp. 42-45).



competition. Eventually, as Krugman rightly stresses, there is no Asian miracle, and policymakers must be alerted to this fact and its consequences (Krugman, 1994, 1998).

## CONCLUSION

There are a multitude of general and specific reasons why the world's two most prominent authoritarian martial police states, Russia and China have performed disparately during the past 25 years, but the persistent influence of antithetic economic cultures is fundamental: Russia's predicated on anti-competitive, socially compassionless rent-granting (the Muscovite proclivity), and China's on pro-competitiveness, and the Confucian ethos. Their comparative merit, both always inferior to democratic free enterprise and European social democracy, has waxed and waned across epochs and conjunctures, but in recent times, and for the foreseeable future, China's economic culture appears more conducive to facilitating sustained economic growth and military power.

The policy community, especially its economic branch has no difficulty with this forecast, but is more diffident about the fine print. It does not seriously entertain the prospect of another Russian *smuta*, slow growth, increased divergence from western living standards, and military reprioritisation, preferring to believe that improved 'framework conditions' will lead the Kremlin *via* the back door to democratic free enterprise, peace and prosperity. Likewise, it perceives no clouds in Beijing's sky. In both cases, wishful thinking of the sort that prevented most Sovietologists from seeing the handwriting on Gorbachev's wall prevents western economic policy institutions from getting Russia and China right.

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